Income Tax Exit Strategies for the Closely-Held Business Upon the Retirement of a Principal Owner

by

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I. Income tax deferral

The creative tax lawyer should always be thinking about opportunities to postpone the reporting of income from the year when a gain is financially realized to a tax year far in the future. The ability to defer the payment of income taxes for a substantial period of time, say for 20 years, is the practical equivalent of an 80% to 90% reduction in the effective rate of tax. And, this deferral can sometimes be obtained for certain kinds of ordinary income as well as capital gains.[1] Thus, the effective rate on a long-term capital gain can of around 30% (taking into account both Federal and state income taxes and the increase in the rate brackets for individuals scheduled to return in 2013) can be reduced to something like 6%. A variety of income tax deferral techniques are permitted in the Internal Revenue Code, but most of them have to be implemented several years in advance of an anticipated sale of an appreciated asset for cash to meet the requirements in the Internal Revenue Code. Thus, there is a need to communicate the availability of these income tax deferral techniques at an earlier stage in the planning process.

Many of the rules in the Internal Revenue Code are enacted to eliminate techniques viewed as abusive. These rules set forth various standards that, if not satisfied, will result in current income taxation. These rules should be looked upon favorably as they set forth the requirements that, if satisfied, permit the desired income tax saving. In other words, by setting forth what you cannot do, these rules also tell you what you can do and provide a roadmap on how to structure an income tax saving technique.

Non tax objectives When an individual transfers assets to family entities such as trusts for junior family members, family partnerships, family limited liability companies or family corporations for income tax saving and estate tax saving purposes, these tax saving vehicles can also achieve creditor protection for the assets in these family entitles. Implementing as asset protection technique where income tax and estate tax savings are the primary objectives further insulates these family vehicles from exposure to creditors.

Integrate income tax planning with estate planning. When one comes to their tax advisor for estate planning, the advisor often focuses on the estate planning and fails to consider the income tax saving and asset protection objectives. There still remain numerous opportunities for creative planning. All that needs to change is the focus.

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[1] With the scheduled 3.6% tax on investment income and a return to the Federal capital gains rate to 20%, the just the Federal rate will be 23.6%. And, in a state such as New York, add another 7.0%. Essentially, the capital gains rate can easily be 30%.

II. Setting the stage

The typical situation involves a closely-held business or private investment where the principal owner or owners either desire to pass on the valuable asset to junior family members or intend to cash out at some point in the future.[2]

If a principal owner desires to pass on the closely-held business to junior family members, the exit strategy typically focuses on how to do this with little or no gift and estate taxes. There is no need to worry about how to pay the income taxes on any gains realized from the sale of the closely-held business because no such sale for cash is anticipated. Instead, the exit strategy is part of a succession plan designed to pass on the family business to the next generation. Thus, traditional estate planning is designed to shelter the closely-held business from inclusion the gross estate. If there is no inclusion in the gross estate, there is no income tax-free, step-up in basis at death. The estate planning focus frequently results in the failure to also consider income tax planning.

For a closely-held business or investment asset where the exit strategy anticipates either a sale to an unrelated third-party for cash or a sale to the continuing owners upon the retirement of a principal owner who is required to sell their interest to the other principal owners pursuant to a buy-sell agreement, the exiting owner will receive cash and will realize a substantial capital gain.[3]

III. Using the typical buy-sell agreement.

Where a closely-held business is owned by individuals who are not members of the same family, there is typically a buyout agreement designed to allow the remaining owners to succeed to the interest of the owner who leaves the business by retirement or by an early and unexpected death. The typical buyout agreement accomplishes two important functions.

In any sale of a closely-held business, the seller typically feels that the value is far greater that the buyer's view. Therefore, the first function of a buyout agreement is to arrive at a valuation formula so that when a principal owner retires, or dies before retirement, there are no arguments as to value between the withdrawing owner and the continuing owners, especially if the withdrawing owner is the decedent's estate. Since we have a methodology arrived at by parties who are bargaining in their own self-interest, the typical buyout formula is designed to arrive at a value that does not take into account valuation discounts for lack or control or lack of marketability, valuation factors that generally arise for gift tax and estate tax valuations.

The second function addressed in a buyout agreement is how to fund the buyout of a withdrawing owner. Although life insurance plays a role, owners plan on withdrawing by retirement and not by dying early. Thus, the funds needed to purchase the retiring owner's share will have to come from other sources, and the business typically addresses how these funds will be obtained.

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[2] The expectation where one would anticipate that the closely-held business would eventually go public is far less realistic in today's environment.

[3] In a state like Florida where there are no state income taxes, paying a 15% capital gains tax is a relatively small surcharge and many clients are willing to pay it. If capital gains increase back to 20%, the seller's concerns may change. And, for states with an income tax, the extra taxes on the capital gain will further influence the client.

Unfortunately, the planning for a buyout of a withdrawing owner does not deal with the income taxes that the retiring owner will have to pay when the buyout payments are received. Thus, the parties are conceding that the retiring owner will have to pay the full capital gain tax upon receiving payments under the buyout agreement.

Can an owner who is under a buyout agreement and who anticipates retiring in a few years defer the reporting of the capital gain that would otherwise be reported upon the receipt of cash under the buyout? Consider the following situation.

> **Example**. Senior owns a 25% interest in an S corporation. The other 75% is owned by three individuals who have been in the business with Senior since it was started close to 30 years ago. As of today, the formula in their buyout agreement values Senior's 25% interest at $16,000,000. Senior is age 67 and anticipates retiring at age 71, some four years in the future. Senior expects that his 25% interest will continue to appreciate in value and would like to adopt an estate plan that is designed to shift all appreciation in his 25% interest to a trust for his descendants without any gift tax. Senior is married, and his spouse is age 65. Mr. and Mrs. Senior have two adult children and several grandchildren, none of whom has started college.
>
> Senior has been advised to sell his 25% interest to a non-grantor trust for the benefit of Senior's descendants, for an amount equal to the $16,000,000 value arrived at in the buyout agreement and taking back an interest-only, 20-year installment note for the entire purchase price.
>
> Senior asks why no discount is being proposed.

This proposal raises a number of income tax issues and transfer tax concerns. While addressing these issues, also consider that the closely-held business entity is characterized as a partnership for Federal income tax purposes.

1. Is an installment sale of Senior's 25% interest in the S corporation eligible for the installment method of accounting?

2. Is the installment sale to a related party eligible for the installment method if the S corporation owns depreciable property? What about a partnership?

3. Will Section 1239 characterize the entire gain as ordinary income because the S corporation owns depreciable property and the sale is to a related party? A partnership?

4. If this is an interest-only installment sale, what should be the maximum term of the promissory note?

5. What about the special interest charge for installment sales in excess of $5,000,000 under Section 453A?

6. What about the two-year resale prohibition under Section 453(e) which will require Senior to accelerate the gain previously deferred under the installment method if the related party purchaser resells the

asset within the next 24 months? In other words, why should this technique be implemented at least 24 months before Senior intends to retire?

7. Can Senior start the 3-year statute of limitations running on the valuation used and other concerns if no gift tax return is filed? Can the filing of an income tax return also start the running of the statute of limitations for the gift tax?

8. Does Senior need to pay an appraiser for a valuation report?

9. If the formula in the buyout agreement is used to determine the value for the intra-family installment sale, will the IRS challenge it under Section 2703(b), especially if the family trust subsequently has the 25% interest redeemed for an amount significantly in excess of the $16,000,000?

10. Why were no valuation discounts taken for lack of control and lack of marketability?

11. How can the S corporation make sure that the non-grantor family trust is an eligible S corporation shareholder?

12. How will the family trust fund the interest payments on the promissory note before its 25% interest is redeemed for cash?

13. Has the estate planning freeze objective been satisfied? Can the non-grantor trust be used to accomplish other estate planning objectives?

14. In the operation of the trust after the intra-family installment sale, how can the parties assure that it will be respected under "reality of sale" principles? Should the trust have its own funds or will 100% seller-provided financing and a bootstrap sale be respected? Can the trust beneficiaries guaranty the trust's obligations?

15. Why is it not a concern if Senior dies during the note term and the installment note is an asset included in Senior's gross estate? Since the gain was realized and recognized, but its reporting was deferred under the installment method of accounting, why is there is no income tax free step up in basis at death? Is the installment note is income in respect of a decedent?

If the IRS audits the intra-family installment sale, what are the risks that the IRS will challenge any of the above?

I. The Installment Method

Issue Presented: Can a buyout agreement be formulated so that Senior can defer the reporting of the entire amount of capital gain that would otherwise be required to be reported upon the sale of Senior's interest. Will the sale have the effect of freezing the value of the asset in Senior's estate? Which asset?

Answer: Taxpayer can defer the gain by reporting the entire amount of capital gain that would otherwise be reported in the year of sale pursuant to the installment sales rules. In addition, the installment sale will have the effect of freezing the value of the installment note received in Senior's estate.

Analysis and Application of the Installment Sales Rules:

A. Under § 1001(a), upon the sale of property, the seller is required to report all of the recognized gain or loss in the year of sale. Specifically, taxpayer's recognized gain equals the excess of the amount realized[1] on the sale over the adjusted basis of the property sold.[2] This requirement applies to both cash and accrual basis taxpayers. Consider the following two examples, one illustrating the sale of property by a cash basis[3] taxpayer and one illustrating the sale of property by an accrual basis[4] taxpayer.

1. **Cash Basis Taxpayer Sale Example**:

   John, a cash basis taxpayer, owns Diamondacre with a fair market value of $10,000 and a basis of $1,000. He sells Diamondacre to Sally for $2,000 in cash and Sally's note in the amount of $8,000. Assume the note has a fair market value of $8,000. Per the terms of the note, he is entitled to receive $2,000 per year for 4 years plus adequate interest. John's amount realized on the sale will be $10,000 ($2,000 cash plus $8,000 which is the fair market value of the note[5]). This will result in $9,000 of recognized gain due in the year of sale.

2. **Accrual Basis Taxpayer Sale Example**:

[1] The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. Treas. Reg. § 1.1001-1(a).
[2] § 1001(a).

[3] A cash basis taxpayer will recognize gain when it has been actually or constructively received. Treas. Reg. § 1.451-1(a).

[4] Under the accrual method of accounting, income is includible in gross income when all the events have occurred to fix the right to income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. § 1.451-1(a).

[5] Treas. Reg. § 15A.453-1(d)(2)(ii), a taxpayer using the cash receipts and disbursements method of accounting shall treat as an amount realized in the year of sale the fair market value of the obligation.

Assume the same facts, except that John is an accrual basis taxpayer. The accrual method of accounting would produce the same results.[6] John's amount realized on the sale will be $10,000 ($2,000 cash plus $8,000 which is the face amount of the note[7]). Per Section 1001(a), this will result in $9,000 of recognized gain due in the year of sale.

B. There is an exception to the rule that the taxpayer is required to recognize all of the realized gain in the year of sale. The exception is found in § 453, which provides for the installment method of accounting. The installment method is a method of accounting used to determine when a gain that has been *realized* and *recognized* on a sale is reported. The installment sales rules provide that the selling taxpayer is allowed to defer the taxation of the gain by only paying income tax as the payments of the sale price are received. The term installment sale refers to the disposition of property where at least one payment is to be received after the close of the tax year in which the sale occurred.[8] It is important to note that the installment sale method is only a timing mechanism for the reporting of the gain realized and recognized on the sale of property. The installment method does not have anything to do with determining the amount or character of the gain realized from the sale of an asset. The specific statutory language of § 453(b)(1) is as follows:

"*The term 'installment sale' means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs*."

Thus, a transaction can qualify as an installment sale even if there is only going to be one principal payment as long as that payment takes place in a year after the year of sale.

1. If the transaction qualifies for the installment method of reporting, the seller's recognition of gain is spread over the period during which the sales proceeds are received.[9] Simply stated, the installment sales rules permit the taxpayer to pay the tax as the cash attributable to the sale is received.

2. Each payment received by the taxpayer is bifurcated for federal income tax purposes. Specifically, each payment received by the seller consists of two components: one portion is a nontaxable return of capital (i.e. tax basis) while the remaining portion represents a taxable gain. The amount of gain is computed by multiplying the annual payment received by the transactions gross profit percentage. The gross profit percentage

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[6] An accrual method taxpayer recognizes income when the all the events have occurred which (1) establish the right to income and (2) the amount can be determined with reasonable accuracy. In this case, the contract establishes John's right to income and the amount can be determined with reasonable accuracy.

[7] Treas. Reg. § 15A.453-1(d)(2)(ii), a taxpayer using the accrual method of accounting shall treat as an amount realized in the year of sale the total amount payable under the installment obligation.

[8] Section 453(b)(1).

[9] Section 453(c).

represents the percentage of each dollar received that must be recognized as gain.[10]

3. Any interest income received on the deferred payment is recognized separately as ordinary income.[11]

C. Pursuant to IRC Section 453(c), taxpayer recognizes gain in a particular tax year in an amount equal to the product of the gross profit percentage times payment received. The gross profit percentage is a ratio determined by dividing the transaction's gross profit by the contract price.

1. Taxpayer's gross profit equals the excess of the selling price[12] less taxpayer's basis in the property sold.[13]

2. The contract price equals the total principal payments less the mortgage assumed or taken subject to by the buyer which does not exceed the seller's basis in the property sold.[14] The seller's basis is adjusted to include commissions and other selling expenses.[15]

3. **Installment Sale Example**:

John sells investment land to Betty for $280,000 payable as follows:

(i) $40,000 cash at closing, (ii) $80,000 mortgage assumed by Betty; (iii) $160,000 promissory note from Betty. Pursuant to the terms of the note Betty is to make annual principal payments in the amount of $40,000 plus pay adequate interest. John's adjusted basis of the property sold is $160,000.

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[10] *Ibid.*

[11] Section 1221.

[12] Selling price means the gross selling price without reduction for any mortgage or other encumbrance on the property, or for any selling expenses. Temp. Reg. § 15A.453-1(b)(2)(ii).

[13] Temp. Reg. § 15A.453-1(b)(2)(v).

[14] Temp. Reg. § 15A.453-1(b)(2)(iii).

[15] *Ibid*.

STEP ONE: DETERMINE THE GROSS PROFIT

SALES PRICE:	
Cash Down Payment	$ 40,000
Note Payable to Seller	160,000
Seller's Mortgage Assumed	80,000
AMOUNT REALIZED	$280,000
LESS SELLER'S BASIS	($160,000)
GROSS PROFIT	$120,000

STEP TWO: DETERMINE CONTRACT PRICE

CONTRACT PRICE = Total principal payments received less (i) mortgage assumed[16] and (ii) interest. Thus, the contract price equals $200,000 [$280,000 sales price less $80,000 mortgage assumed].

STEP THREE: DETERMINE GROSS PROFIT RATIO

The gross profit ratio is determined by dividing the gross profit by the contract price.

The gross profit ratio = $\frac{\$120{,}000}{\$200{,}000}$

STEP FOUR: DETERMINE INSTALLMENT GAIN

The taxpayer then applies this ratio to each installment payment when received to determine each installment gain. This is done by multiplying the amount of each payment by the gross profit ratio.

Thus, the formula to determine the gain reported for each payment is as follows:

$$\frac{\text{Gross Profit}}{\text{Contract Price}} \quad \text{X} \quad \text{Payments Received} = \text{Gain}$$

In this example, the determination of the amount of gain related to each payment is computed as follows:

$$\frac{\$120{,}000}{\$200{,}000} \quad \text{X} \quad \$40{,}000 = \$24{,}000$$

Gain recognized in the year of sale

In addition, $24,000 of gain is recognized in each subsequent year as each payment in the amount of $400,000 is received.

An additional benefit resulting from the delay in recognizing the income is illustrated as follows:

[16] That portion of the debt that does not exceed the basis of the property sold.

Assume seller is in the 35% marginal tax bracket with a 20 percent capital gain tax rate. Applying a discount rate of 5%, the present value of his tax savings from using the installment method is $2,000, computed as shown in the following chart.

Present Value Installment Sale Tax Calculation						
	Year of Sale	Year 1	Year 2	Year 3	Year 4	Total
Regular Sale						
Gain	$120,000					
Tax Rate	x 20%					
Tax	$ 24,000					$24,000
Installment Sale						
Gain	$ 24,000	$	$	$	$	
Tax Rate	x 20%	24,000	24,000	24,000	24,000	
Tax	$ 4,800	x	x	x	x	
Discount Factor	x 1.0000	20%	20%	20%	20%	
Discount Factor Cost	$ 4,800	$	$	$	$	$22,000
Present Value Tax Savings		4,800	4,800	4,800	4,800	$ 2,000
		x	x	x	x	
		.9524	.9070	.8638	.8227	
		$	$	$	$	
		4,751	4,354	4,146	3,949	

D. The term "payment" is significant for installment sales purposes. Taxpayer recognizes a gain only when a payment is received.[17] The receipt of purchaser's promissory note does not constitute payment whether or not the payment on the note is guaranteed by another person.[18] A third party guarantee of the installment note is not considered a payment on the installment obligation.[19] A standby letter of credit is treated as a third party guarantee and this is not considered a payment on the installment note.[20]

E. Generally, the amount deposited in an escrow account will also be treated as a payment which will trigger recognized gain if upon buyer's default, the seller can look to the escrowed account for payment on the promissory note.[21]

1. However, note the result in *Porterfield v. Commissioner,* 73 T.C. 91 (1979), a case in which the tax court held that the amounts placed in escrow were not considered payments since all payments due on the

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[17] § 453(c).

[18] § 453(f)(3).

[19] § 453(f)(3).

[20] Treas. Reg. § 15A.453-1(b)(3)(i).

[21] Treas. Reg. § 15A.453-1(b)(5), Ex. 8.

promissory note came directly from the buyer. The parties to the sale intended that the escrow account served as security for payment on the promissory note. In this case the buyer received all interest and principal payments from the fund and he personally paid all installments on the note. The seller intended to look at buyer as the primary debtor and considered the escrow merely as a security device. The escrowed funds would only be turned over to the seller if the purchaser defaulted. The escrow agreement was always operated in a manner consistent with this intention: the buyer received all interest and principal payments from the fund and he personally paid all installments on the note.

2. In *Revenue Ruling 77-294*, the service ruled that if the escrow agreement imposes a *substantial restriction* on the seller's right to receive the deposited funds, the deposited funds are not considered a payment.

a. For an escrow account to impose a *substantial restriction*, it must serve a bona fide business purpose of the buyer.[22] An example of a substantial restriction would be a provision providing that the escrow payments are contingent upon seller's compliance with a covenant not to compete.

b. Substantial Restriction Example:

Bob sells his business to Archie for a $400,000 installment note with principal payments to be received in equal installments over 10 years. Archie establishes an irrevocable escrow account from which payments will be made. Bob's receipt of payments from the escrow account is contingent on his refraining from entering into a competing business for a period of 10 years. Since the escrow agreement imposes a substantial restriction the funds deposited in the escrow account are not considered a payment. This result will follow even if Bob had the right to invest the escrowed funds and receive the interest from the investments.[23]

F. Reporting under the installment method is mandatory unless the taxpayer elects out of installment method treatment.[24]

1. The election must be made on a timely filed return for the taxable year of the sale.[25]

2. The seller is required to make a separate election for each sales transaction.

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[22] Rev. Rul. 79-91, 1979-1 CB 179.

[23] Murray, Rebecca, (1933) 28 B.T.A. 624.

[24] Section 453(d)(1).

[25] Section 453(d)(2).

3. A taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurred will be considered to have made an effective election.[26] The pertinent senate report provides that the taxpayer can make the election by reporting the entire installment gain from the sale on his return for the year of the sale.[27]

4. Electing out of the installment method requires the taxpayer to recognize the entire gain in the year of the sale regardless of whether the taxpayer receives sufficient cash to pay the tax or whether the seller is otherwise a cash-method taxpayer.[28]

II. Installment Sale of S Corporation Stock

Issue Presented: Is Senior's sale of his 25% interest in the s corporation eligible for the installment sale of accounting?

Answer: Senior's sale of S corporation stock is eligible for installment sale treatment. Generally, the statutory language of section 453(a) provides that the installment rules apply to all installment sales of property (unless the seller elects out). The statute does provide for certain sales that are ineligible for installment sales treatment.

A. The installment sale rules do not apply to the following transactions:

1. Loss sales;[29]

2. Sale of inventory[30] assets including dealer sales (with timeshare and farm property and residential lot exceptions);[31]

3. The deprecation recapture component of any gain;[32]

4. Sales of depreciable property between related parties;[33]

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[26] Temp. Regs. § 15A.453-1(d)(3)(i).

[27] S. Rep. No. 471, 96th Cong. Sess. 12.

[28] Section 453(d)(1).

[29] Section 453(a).

[30] For purposes of Section 453(b)(2)(B), the term inventory refers to property held by the taxpayer primarily for sale to customers in the ordinary course of business.

[31] Section 453(b)(2)(A), Section b(2)(B), Section 453(l).

[32] Section 453(i).

5. Marketable securities.[34]

III. Installment Sales of Depreciable Property

Issue Presented: Does the fact that the sale is of corporate stock owning depreciable property and is to a family trust result in the sale being ineligible for installment sale reporting?

Answer: Generally, the installment sale of depreciable property will be eligible for the installment method of accounting. However, certain rules limit the applicability of the installment sales rules to depreciable property. Included in these rules are sales to related parties of depreciable property. In this case, even though the S corporation owns depreciable property, Senior is selling the S corporation stock and not the underlying depreciable assets. Furthermore, Senior's family trust for the benefit of his descendants is not an ineligible purchaser for purposes of the installment sales rules. Thus, Senior will be entitled to use the installment method.

Analysis Relating to Depreciable Property:

A. Installment sales of depreciable property require special consideration by reason of some restrictive rules that come into play. One such rule provides that the installment sales of depreciable property will not receive the deferral benefit of the installment sales rules. Specifically, IRC Section 453(i) provides that any gain attributable to Section 1245 or Section 1250 recapture income is recognized in the year of sale.[35] That Code Section further provides that any gain in excess of the recapture income shall be taken into account under the installment method. Section 453(i) provides in pertinent part as follows:

"*…In the case of any installment sale of property …(A)…any recapture income shall be recognized in the year of disposition, and (B) any gain in excess of the recapture income shall be taken into account under the installment method.*"

1. Thus, per Section 453(i), the Section 1245 and Section 1250 recapture rules will override the installment sales rules and require immediate recognition of the recapture amount. In other words, depreciation recapture will be recognized in full in the year of sale, even if no principal payments are received in the year of sale.

2. Pursuant to Section 1245, that portion of the gain recognized on the disposition of Section 1245 property (i.e., generally, depreciable personal property) to the extent of prior depreciation is characterized as 1245 recaptured ordinary income. Pursuant to Section 1250, gain on the sale of improved real estate is recaptured as ordinary income to the extent excess depreciation exceeds straight-line depreciation. Note, however,

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[33] Section 453(e).

[34] Section 453(k)(2).

[35] Section 453(i).

that the Section 1245 recapture rules rather than Section 1250 recapture rules applied to non-residential real estate placed in service after 1980 and before 1987 if accelerated depreciation was used. The disposition of depreciable real estate placed in service after 1986 will not trigger section 1250 gain, since such property can generally only be depreciated using the straight-line method.

Depreciable property and real property used in business are not capital assets. *Section 1221(a)(2)*. However, pursuant to Section 1231, the gain on the disposition of such property can be treated as long-term capital gain if it satisfies the long term holding period requirement. This is referred to as Section 1231 gain. Section 1231 gain will consist of that portion of the gain that exceeds the amount of recapture income recognized on the assets sold.

3. **Depreciation Recapture/Section 1231 Example**:

John buys equipment (1245 property) for $10,000. He takes $4,000 of depreciation deductions on the property before he sells it several years later for $11,000. The depreciation deduction reduces his tax basis to $6,000. On the sale, he has $5,000 of income ($11,000 amount realized less $6,000 basis). The character of the gain consists of $4,000 of Section 1245 deprecation recapture ordinary income. The gain in excess of the $4,000 of recapture income is characterized as Section 1231 capital gain.

4. **Section 453(i) Example**:

John sells a piece of machinery in exchange for buyer's note in the amount of $125,000 due in two years. John did not receive any payments in the year of sale. Assume John's basis in the property sold was $25,000 and there was $40,000 of Section 1245 ordinary income depreciation recapture. Per Section 453(i), John will recognize $40,000 of Section 1245 ordinary income in the year of sale. This result occurs despite the fact that John did not receive any cash in the year of sale. The remaining $60,000 of gain will be reported under the installment sales rules. $60,000/$125 x $125,000 = $60,000 reported in two years.

B. In addition, several *related party* limitations apply with respect to the sale of depreciable property. One such provision is Section 453(g) which *accelerates* the deferred gain. The second provision is Section 1239 which affects the *character* of the income

C. **Section 453(g) Abuse Example**:

Taxpayer sells a depreciable asset to a related person such as a wholly owned S corporation and obtains a cost basis in order to again depreciate the property while being able to defer the gain, with the principal payment due in fifteen years. The S corporation would obtain a cost basis in order to obtain another run of depreciation deductions. In effect, the taxpayer would be able to depreciate the property twice without having to recognize gain for fifteen years.[36]

1. To prevent this abuse, under Section 453(g)(1), the installment sales rules do not apply to taxpayer gain on the sale of depreciable property to a related person.[37] The pertinent language of Section 453(g)(1) is as follows:

*(g) **Sale of depreciable property to controlled entity**.*

*(1) **In general**. In the case of an installment sale of depreciable property between related persons –*

(A) subsection (a) shall not apply,

(B) for purposes of this title –

(i) except as provided in clause (ii), all payments to be received shall be treated as received in the year of the disposition, and

(ii) in the case of any payments which are contingent as to the amount but with respect to which the fair market value may not be reasonably ascertained, the basis shall be recovered ratably, and

(C) the purchaser may not increase the basis of any property acquired in such sale by any amount before the time such amount is includible in the gross income of the seller.

In this case, all payments to be received shall be treated as received in the year of the sale. The term "related persons" is defined by Section 453(g) and includes:

a. A person and all entities, which are *controlled entities* with respect to such person. Generally, the term *controlled entities* refers to either a corporation in which the taxpayer owns directly or indirectly more than 50% of the value of the outstanding stock or a partnership in which such person owns directly or indirectly more than a 50% of the capital interests or profits;[38]

b. A taxpayer and any trust in which such taxpayer (or the taxpayer's spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest (within the

[36] See Stephen J. White and Steven C. Thompson, *Installment Reporting Offers Savings Through Tax* Deferral*, Taxation for Accountants*, Vol. 54, No.1, January 1995.

[37] Section 453(g)(1).

[38] Sections 1239(b)(1) and 1239(c)(1) (A) and (B).

meaning of Section 318(a)(3)(B)(i));[39]

c. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate;[40] and

d. Two (2) more partnerships in which the same person owns directly or indirectly more than 50% of either the capital or profit interests.

D. Abuse addressed by Section 1239:

The abuse addressed by Section 1239(a) is that a seller would obtain capital gain treatment and the related entity would get a step up in basis, which could be run down again with the depreciation deduction, which would reduce ordinary income.

To prevent this abuse, under Section 1239(a), in the case of a sale or exchange between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character, which is subject to the allowance for depreciation. Section 1239(a) provides in pertinent part as follows:

"*….In the case of a sale or exchange or property, directly or indirectly between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167*."

E. Generally, the effect of Section 453(g) and Section 1239(a) is that in the case of a sale of depreciable property between related persons, all of the income will be recognized in the year of sale and it will be characterized as ordinary income. Related parties under Section 1239 are the same as those listed in Paragraph IV.C at subparagraphs 1.a, b, and c.

1. Consider the following example which incorporates both Sections 453(g) and 1239:

John sells an office building with a fair market value of $250,000 and a basis of $160,000 to his wholly owned S corporation. He receives in exchange a promissory note in the amount of $250,000 from the S corporation. The terms of the promissory note require annual interest and the principal payment due in ten years. As a result of the related party rules, John will recognize the entire $90,000 of gain in the year of sale[41] and the character of the income will be ordinary in nature.[42]

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[39] 1239(b)(2).

[40] 1239(b)(3).

[41] 453(i).

IV. The Section 453(e) Related Party Rules in General

Issue Presented: Will Senior's deferred installment gain be accelerated if the family trust, a related party for purposes of Section 453(e), sells the purchased stock?

Answer: Pursuant to Section 453(e), the Senior's deferred gain will be accelerated if the family trust, which is a related party for purposes of Section 453(e), resells the stock within two years.

Analysis of Related Party Rules:

A. Abuse addressed by Section 453(e):

1. Prior to 1980, taxpayer could abuse the installment sales provisions by executing an installment sale with a related party thereby allowing the taxpayer to defer the gain (often for a very long time if the sale is, for example, a balloon payment), while the related party would obtain a cost basis in the property. A subsequent cash sale by the related party would trigger recognized gain only on the post-purchase appreciation. The result would be that the economic unit of seller and related purchaser would have realized the full cash proceeds of the sale, but deferred the tax.[43] This abuse was addressed in the Installment Sales Revision Act of 1980 with the passage of Section 453(e). The definition of a related party under Section 453(e) is the very broad one found in IRC Section 318(a) (without the option rule), with extensive attribution, and expanded to incorporate the partially overlapping definitions of Section 267(b).

2. Related Party Resale Abuse Example:

   John wants to sell Whiteacre with a fair market value of $1,000,000 and a tax basis of $100,000 to Bob and receive all of the cash at closing. However to avoid recognizing the entire gain in the year of sale, he first sells Whiteacre to his wholly owned C corporation for $1,000,000. In exchange, he receives the corporation's note in the amount of $1,000,000 with ten annual principal payments of $100,000 plus adequate interest. C corporation promptly sells the property to Bob for $1,000,000 in cash. If not for Section 453(e), the economic unit of John and his C corporation would have $1,000,000 in cash but would only be required to recognize $100,000 of gain income in the year of sale.

3. Related Party Resale Abuse Example With Income Tax Calculation:

   John owns Whiteacre with a fair market value in the amount of $400,000 and basis of $200,000. He initially plans on selling Whiteacre to Bob for $400,000. Instead he sells Whiteacre to his daughter, Betty, for $10,000

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[42] Section 1239.

[43] S. Rept. 96-1000, at 12-17(1980), 1980-2 C.B. 494, 500-502.

cash and Betty's $390,000 note due in five years. One month later, Betty subsequently sells Whiteacre to Bob for $400,000.

a. John's gross profit is $200,000 and his gross profit percentage equals 50%.

b. John's gain in the year of sale equals $5,000 (50% Gross Profit percentage x $10,000 payment in year of sale).

c. John would have a deferred gain of $195,000. ($200,000 gain reduced by reported gain of $5,000).

d. Betty would have a cost basis in Whiteacre. Thus, she would not recognize gain on the sale of the property to Bob.

e. Section 453(e) prevents this result.

B. The applicable Code provision, 453(e)(1), is as follows:

(1) ***In general.*** *If –*

(A) Any person disposes of property to a related person (hereinafter in this subsection referred to as the "first disposition"), and

(B) Before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the "second disposition"),

then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

C. Generally, Section 453(e)(1) will trigger immediate installment gain recognition when taxpayer sells property to a related person and such related person disposes of the property before the seller has received all payments due on the initial sale. It was Congressional intent to accelerate the recognition of the deferred gain when cash is received by the related person.[44] The term related person is defined in Section 453(f)(1).[45] The definition is much broader than that found in Section 453(g)(3).

1. Pursuant to Section 453(e)(1), the amount realized on the second disposition is treated as received by the person making the first disposition. The gain recognized to the taxpayer is based on his gross

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[44] S. Rept. 96-1000, at 12-17 (1980), 1980-2 C.B. 494, 500-502.

[45] Section 453(f)(1)(A) incorporates the IRC Section 318(a) (other than paragraph 4) attribution rules to the person first disposing of the property. Section 453(f)(1)(B) refers to a person who bears a relationship described in section 267(b) to the person first disposing of the property.

profit ratio and is recognized only to the extent the amount realized from the second disposition exceeds the actual payments under the installment sale. The amount realized from the second disposition won't be taken into account to the extent attributable to any improvements that had been made by the related installment purchaser.[46]

2. The amount realized on the second disposition is treated as received by the taxpayer at the time of the second disposition.[47]

3. **Section 453(e)(1) Example**:

   Bob sells Blackacre with a basis of $60,000 to his daughter, Betty, for its $100,000 fair market value. Bob receives a note from Betty in the amount of $100,000. The terms of the note provide for interest at an adequate rate and a balloon payment in the fourth year. Within two years, Betty sells Blackacre to John, an unrelated third party for $120,000 cash. Bob must treat the amount realized by Betty on the subsequent sale as a collection on the installment note. Therefore, Bob must recognize the entire unreported gain in the amount of $40,000. Bob will not have to report the receipt of the $100,000 balloon payment from Betty as income.

D. A major exception to this rule, except in the case of marketable securities, is that Section 453(e)(2) will only apply if the second disposition is not more than two (2) years after the date of the first disposition.[48] For purposes of the related party rules a "second disposition" means a disposition by the related party buyer including a sale, exchange, gift, or cancellation of the installment obligation.[48.1]

1. **Two Year Rule Example**:

   Bob sells investment property with a fair market value of $100,000 and basis of $10,000 to his son on June 1, 2009, in exchange for son's note in the amount of $100,000. The note requires the son to pay interest annually and calls for a balloon payment in 2016. On June 2, 2011, the son sells the property to Betty for $140,000. Since the resale did not occur within two years after the initial sale, Section 453(e) will not trigger Bob's deferred gain. The son reports $40,000 of gain in the year of the subsequent sale.

2. Section 453(e) does not define the term disposition. It would appear to apply to transactions in which the taxpayer receives consideration other

[46] S. Rept. No. 96-1000 (PL 96-471) p. 15.

[47] Section 453(e)(1).

[48] Section 453(e)(2)(A)

[48.1] See Installment Sales 565 BNA Portfolio, Lisa Marie Starczewski A-29 (1998).

than cash.[49] Thus, it would apply to non-taxable transactions in which the related party received consideration such as a Section 351 incorporation, a Section 721 transfer to a partnership and a Section 1031 like kind exchange. As already stated the term disposition would apply to a sale, exchange, gift, or cancellation of the installment obligation.[50]

3. The term disposition does not refer to: a (1) a sale or exchange of stock by the related party to the issuing corporation;[51] (2) a compulsory or involuntary conversion within the meaning of Section 1033 if the first disposition occurred before the threat or imminence of the conversion;[52] (3) a disposition after the earlier of the death of the taxpayer or related party;[53] or (4) a disposition which did not have as one of its principal purposes the avoidance of Federal income tax.[54]

4. During the two (2) year period, the purchaser must accept the risk of a substantial risk of ownership.[55] Thus, the two (2) year period is suspended for any period in which the related person's risk of loss with respect to the property is substantially diminished.[56] This would occur if the related buyer either holds a put option with respect to such property,[57] or makes a short sale or any other transaction,[58] or if another person holds a right to acquire the property.[59]

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[49] The Senate Report explains the provision as "an acceleration of recognition of the installment gain from the first sale to the extent additional cash and other property flows into the related group as a result of the second disposition." S. Report 96-1000 at 14.

[50] See Installment Sales 565 BNA Portfolio, Lisa Marie Starczewski A-29 (1998).

[51] Section 453(e)(6)(A).

[52] Section 453(e)(6)(B).

[53] Section 453(e)(6)(C).

[54] Section 453(e)(7).

[55] Section 453(e)(2)(B).

[56] Section 453(e)(2)(B).

[57] Section 453(e)(2)(B)(i). Note that the holding of an option is not considered to substantially diminish the risk of loss if the option price is to be determined by reference to the fair market value of the property at the time the option is exercised. See The 1980 Act Senate Report, p. 15.

[58] Section 453(e)(2)(B)(iii).

[59] Section 453(e)(2)(B)(ii).

V. Section 453(e)(1) Second Dispositions by Related Parties

Issue Presented: Can a corporate liquidation be a disposition for purposes of Section 453(e)?

Answer: In the *Shelton* case (105, TC 114), the Tax Court held that a corporate liquidation was a disposition for purposes of Section 453(e).

Analysis:

A. In *Shelton*, the Tax Court was presented with the following facts: On June 22, 1981, taxpayer's wholly owned corporation, JMS, sold the stock in a subsidiary corporation, EPSP (S), to Wallington Corporation (Wallington) a corporation owned by related parties, taxpayer's son and daughter and two trusts for his grandchildren. Pursuant to a Section 337, JMS liquidated and the note was distributed to taxpayer. On March 31, 1983, Wallington and its subsidiaries, including EPSP, adopted IRC Section 337 12 month plans of liquidation. On the same day, EPSP sold most of its assets, including all of its operating assets, to an unrelated party for $35,000,000 in cash and assumption of $4,000,000. On March 15, 1984, both Wallington and EPSP liquidated, and their assets were distributed to Wallington shareholders, who also assumed Wallington's liability on the installment note to the taxpayer.

B. The Service argued that the liquidation of EPSP was a Section 453(e) disposition which accelerated the deferred gain to taxpayer.

C. The Tax Court agreed with the service and concluded that the liquidation was a disposition. It noted that cash and other property flowed into a related group when the assets of EPSP were sold and the stock of EPSP was liquidated. The Tax Court reasoned that section 453(e) was designed to prevent the related group from cashing out the appreciation on the stock on a current basis while deferring the gain. According to the Tax Court, the liquidation had the effect of a second disposition within the meaning of section 453(e).

Issues Presented: Can a sale of corporate assets, subsequent to the installment sale of corporate stock, toll the two-year period? How broad is the term "any other transaction" which appears in Section 453(a)(2)(B)(iii)?

Answer: The tax court in *Shelton* held that the sale of the underlying corporate assets tolled the two-year period.

Analysis of tolling of the statute:

A. Section 453(e)(2) is as follows:

(2) 2 –year cutoff for property other than marketable securities.

(A) In General.—Except in the case of marketable securities, paragraph (1) shall apply only if the date of the second disposition is not more than 2 years after the date of the first disposition.

(B) – Substantial diminishing of risk of ownership.—The running of the 2 – year period set forth in subparagraph (A) shall be suspended with respect to any property for any period during which the related person's risk of loss with respect to the property is substantially diminished by-

(i) the holding of a put with respect to such property (or similar property)

(ii) the holding by another person of a right to acquire the property, or

*(iii) a short shale or any **other transaction**.* [Emphasis added].

B. A synopsis of arguments and court's conclusions is as follows:

1. Taxpayer argued that even if the liquidation was a disposition, it occurred on March 15, 1984, which was more than 2 years after the first disposition that occurred on June 22, 1981.

2. The Service countered by arguing that the sale of assets by ESPC (S) on March 31, 1983, caused the 2 year period to be suspended. The Service asserted that the sale qualifies and an "other transaction" which substantially diminished the risk of loss with respect to the EPSP (S) stock.

3. The Tax Court reasoned that the two-year period is tolled when the related purchaser's risk of loss with respect to the sold property was substantially diminished at any time during the two-year period. Section 453(e)(2)(B); S. Rept. 96-1000 at 15 (1980), 1980-2 C.B. 502.

4. According to the Tax Court, on the date the assets of EPSP(S) were sold, the purchaser's risk of loss was substantially diminished. On the date of the sale for $35 million in cash and the purchaser's assumption of liabilities, any appreciation or depreciation in those assets were realized at that time. On the same day, purchaser adopted a 12-month plan to liquidate the subsidiary. During the 12-month liquidation period subsidiary conducted no business and was in effect just a holding company or repository for the $35 million in cash. The court concluded that any risk of loss associated with Wallington's ownership of the stock of EPSP(S) during the period was essentially nil.

5. The court concluded that the sale of the operating assets of EPSP in combination with the adoption of the plan of liquidation comprised a transaction with the meaning of section 453(e)(2)(B), which substantially diminished Wallington's risk of loss with respect to the EPSP stock, which tolled the 2 year period on March 31, 1983.

6. Accordingly, the court held that the sale of the EPSP stock on March 15, 1984, constituted a second disposition; that the 2 year period had been

tolled beginning March 31, 1983, and that accordingly, the second disposition occurred before the expiration of the 2 year period.

Issues Presented: Taxpayer wants to sell stock of wholly owned business but defer capital gain. While attending a seminar, he is introduced to the "Deferred Sales Trust." According to this technique, the taxpayer would sell his business stock to an irrevocable trust for fair market value and take back an installment note. The irrevocable trust will then sell the stock to a third party (without realizing any gain) and hold the entire sales proceeds within the trust. Will the taxpayer be able to defer the gain? Is deferred installment gain assured if the trust satisfies the two-year period of Section 453(e)?

Answer: If the sale by the trust occurs within two years the gain will not be deferred. If the sale occurs outside of the two-year period, there is no guarantee that gain will be deferred. Depending on the facts, the step-transaction doctrine could apply.

Analysis of use of "Deferred Sale Trust" Technique:

A. Meeting the technical requirements of Section 453(e) does not guarantee that the gain will be deferred.

1. It is possible that an argument can be made that the step transaction doctrine could apply.

2. For example, assume the taxpayer sells the business stock to the irrevocable family trust on May 10, 2011, and the trustee executes a resale on May 11, 2013. It would appear that the two-year period of Section 453(e) is satisfied.

3. However, assume that the trustee negotiates the terms of sale on June 1, 2011. Even though the sale occurs outside of the two-year period, but the fact that the trustee delayed the sale until the two-year period expired could result in the service successfully arguing that the step transaction doctrine would apply.

4. It is well established that the courts will examine the objective realities of a multi-step transaction in applying the tax laws. *Court Holding Co.* 324 U.S. 331 (1938). The step transaction doctrine provides that the "…interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. Thus, by linking together all interdependent steps with legal or business significance, rather than taking them in isolation federal tax liability is applied on the basis of a realistic view of the entire transaction. *Clark, 489 U.S. 726 (1989).* Conversely, the substance of each of a series of steps will be recognized, and the step transaction will not apply, if each such step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not the mere avoidance of taxes. *Penrod, 88TC 1415 (1987).*

5. The multiple step transaction will be collapsed where it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. *King Enterprises, Inc., 418 F.2d 516 (1969)*.

6. The existence of a valid business purpose does not bar the application of the step transaction doctrine. *True, 190 F 3d 1165 (1999).*

VI. Certain Nondealer Dispositions

Issue Presented: Does the fact that the installment sale price is $16,000,000 pose any problems for Senior?

Answer: Generally, Section 453A imposes special interest charge with respect to installment sales in excess of $5,000,000. Senior faces the risk, absent pre-transaction planning, of incurring the special interest charge imposed by Section 453A.

Analysis of Section 453A:

A. The ability to defer gain on certain installment sales by nondealers is subject to an additional tax in the nature of an interest charge to be paid on the deferred tax liability.[60] Section 453A provides for the additional tax and reads in pertinent part as follows:

Sec. 453A. Special Rules for Nondealers.

(a) General rule.
In the case of an installment obligation to which this section applies –
(1) *interest shall be paid on the deferred tax liability with respect to such obligation in the manner provided under subsection (c), and*
(2) *the pledging rules under subsection (d) shall apply.*
(b) Installment obligations to which section applies.
(1) ***In general***. *This section shall apply to any obligation which arises from the disposition of any property under the installment method, but only if the sales price of such property exceeds $150,000.*
(2) ***Special rule for interest payments***. *For purposes of subsection (a)(1), this section shall apply to an obligation described in paragraph (1) arising during a taxable year only if –*
(A) such obligation is outstanding as of the close of such taxable year, and
(B) the face amount of all such obligations held by the taxpayer which arose during, and are outstanding as of the close of, such taxable year exceeds $5,000,000.

B. This interest charge applies to any nondealer installment obligation in excess of $150,000 which arose during the taxable year and which remains outstanding at

[60] Section 453A(a)(1).

the close of the taxable year if the face amount of all such obligations that arose from sales during the year and remaining outstanding as of the close of such taxable year exceeds $ 5 million.[61]

1. These rules only apply to nondealer installment obligations which arise from dispositions for more than $150,000 of property.[62]

2. For purposes of the $150,000 threshold, all sales that are part of the same transaction, or series of related transactions, are treated as a single sale.[63]

3. For purposes of these rules, all persons treated as a single employer under Section 52 are treated as one person, except as otherwise provided in Treasury Regulations.[64]

4. In *TAM 98-53-002* the service concluded that for purposes of the $5 million threshold, married taxpayers, each of whom separately owns shares in an S corporation, are treated as separate taxpayers. Congress did not provide for spousal attribution under Section 453A. Accordingly, in the case of married taxpayers, a separate $5 million threshold would apply to each when calculating the interest due. Thus, gifting between spouses can reduce or eliminate the interest charge.

5. Personal use property is exempt from the nondealer installment sales rules.[65] For purposes of these rules, "personal use property" means any property substantially all of the use by the taxpayer is not in connection with a trade or business of the taxpayer or an income producing activity.[66]

6. Notes received from the sale of any property used or produced in the trade or business of farming are excluded by these rules.[67]

C. Interest is charged on the tax deferred amount to the extent that the deferred payments from all such nondealer installment dispositions which arose during and are outstanding at the end of that year exceed $5 million.[68] In determining whether the $5 million threshold has been exceeded for any taxable year, the face

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[61] Section 453A(b)(2).

[62] Section 453A(b)(1).

[63] Section 453A(b)(5).

[64] Section 453A(b)(2).

[65] Section 453A(b)(3)(A).

[66] Section 1275(b)(3).

[67] Section 453A(b)(3)(B).

[68] Section 453A(b)(2).

amount of installment obligations arising during the year and outstanding as of the close of the current year is to be reduced by the amount treated as payment on such obligations for such taxable year.

D. It is noteworthy that for purposes of the $5 million threshold it is the aggregate amount of nondealer notes that are considered.[69] Consider the following example:

Sally, a nondealer in real estate, owns two parcels of investment property. Each property will be sold for $4,000,000 with a $1,000,000 down payment and $3,000,000 in installment obligations payable in future years. The two parcels of investment property will be sold to different buyers in December of the current tax year. Sally will have to pay interest on deferred taxes because each property is sold for over $150,000 and the $6,000,000 total face amount of installment obligations arising during and outstanding at the end of the year exceeds $5,000,000. Sally could avoid the interest charge by either (1) taking an additional $1,000,000 of down payment in the year of sale, or (2) selling one of the properties in January of the following year.

Planning Tip: John, a nondealer in real estate, sells Whiteacre for $12 million dollars and the sale takes place in one year. The nondealer interest rules will apply and taxpayer will incur an interest charge. Alternatively, if he has the sale take place over three years ($5 million in each of the first two years and $2 million in the third year) the sale will avoid the nondealer rules. However, each individual sale does not have to be three years apart. The sale could be done in a little over one year. Sale one could take place on December 31 of year 1; sale two could take place on January 1 of year 2; and, sale three could take place on January 1 of year 3, which means the sales are a little over 1 year apart.

Planning Tip 2: If in Example 2 the taxpayer is married, the transaction could take place over a period of a few days, because each spouse in the transaction could make an installment sale of $5 million per tax year. Thus, in our example each spouse could make an installment sale for $5 million totaling $10 million on December 31 of year 1 and another sale for $1 million totaling $2 million in early January of year 2. Thus, gift giving between spouses can eliminate the interest charge.

E. If interest is required to be paid on an installment arising in any tax year, it must also be paid for any subsequent tax year in which the obligation is outstanding at year end.[70]

F. The sale of an interest in a partnership or other pass-thru entity will be treated as a sale of the proportionate share of the assets of the partnership or pass-thru entity.[71] Thus, Section 453A(e) applies to partnerships and other pass through

[69] Section 453A(b)(2)(B).
[70] Section 453A(b)(2)(B).

[71] Section 453A(e)(2).

entities such as S corporations.

G. The amount of the interest charge is the applicable percentage of deferred tax liability arising from the nondealer obligation multiplied by the underpayment rate on tax deficiencies in effect under Section 6621(a)(2) for the month with, or within, which the tax year ends.[72]

1. The deferred tax liability equals the amount of unrecognized gain multiplied by the maximum income tax rate for that year.[73] The maximum rate on capital gains is used for any portion of the unrecognized gain that is long term capital gain.[74]

2. The applicable percentage with respect to nondealer installment obligations arising in a taxable year is the percentage determined by dividing (1) the portion of the aggregate face amount of such installment obligations outstanding as of the close of the taxable year in excess of $5 million, by (2) the aggregate face amount of all installment obligations outstanding as of the close of the taxable year.[75]

3. Section 453A Calculation of Interest Payable Example:

John sells Whiteacre for $12,000,000 and receives an installment obligation in the amount of $10,000,000 which remains outstanding at the close of the taxable year. The applicable percentage is 50% ($10,000,000 less $5,000,000/$10,000,000). Assume the deferred gain on the installment sale is $4,000,000, which is long term capital gain. Assume the applicable capital gain rate is 15% and the Section 6621(a)(2) interest rate is 7%, the interest on the deferred tax is computed as follows:

(1)	Deferred tax ($4,000,000 x 15%)	$600,000
(2)	Applicable percentage	x 50%
(3)	(1) x (2)	$300,000
(4)	Interest Rate	x 7%
(5)	Interest payable on deferred tax (3) x (4)	$ 21,000

H. When interest is required to be paid with respect to any obligation that arises during any year, interest must be paid for any subsequent taxable year if any portion of the obligation is still outstanding at the close of that later year.[76] The

[72] The Section 6621(a)(2) underpayment rate equals the IRC Section 1274(d) Federal Short Term Rate plus 3 percentage points.

[73] Section 453A(C)(3).

[74] Section 453A(c)(3).

[75] Section 453A(c)(4).
[76] H.R. Rep. No. 495, 100th Cong., 1st Sess. 930 (1987).

[77] *Ibid*.

applicable percentage rate will not change as payments are made in subsequent taxable years.[77]

I. If the seller is a pass-through entity, such as a partnership or S corporation, Notice 88-11, 1988-2 C.B. 397, provides that the $ 5,000,000 threshold is applied, and interest calculations are made, at the owner level.

Pass-through Entity Example:

Profit LLC, which has two members, owning 40% and 60% respectively, sells investment land for a $10,000,000 installment note. In this case, the installment sales are $6,000,000 and $4,000,000 for the shareholders. Thus, the 40% shareholder is not exposed to the special interest charge, and the 60% shareholder has to pay the special interest charge on the postponed gain inherent on only $1,000,000 of the installment note.

VII. Death of the Taxpayer and Installment Obligations

Issues Presented: What are the estate and income tax consequences upon the death of Senior as to any unpaid balances of the note? What are the income tax consequences if Senior gifts the note?

Answer: The death of the taxpayer will trigger both estate and income tax consequences. The note is an asset included in decedent's gross estate. The death of the taxpayer will trigger Income in Respect of a Decedent ("IRD") to the transferee of the note.

In the case of a lifetime gift, Senior will immediately recognize income in the amount of the deferred gain on the gift of the installment note.

Analysis of effect of death of seller on unpaid installment note balance:

A. Generally, Section 453 also addresses the income tax consequences resulting from the seller's disposition of an installment obligation. Per Section 453B(c), however, Section 691 addresses the income tax consequences if seller dies before collecting all payments under an installment sale contract. The specific issues to be addressed are the amount of the remaining installment payments which remain subject to tax, the timing of the income recognition, and which taxpayer is taxed on the amounts.

B. Death of the taxpayer who is receiving payments under an installment sale results in the installment obligation being treated as transferred by reason of the taxpayer's death to taxpayer's estate, heir, legatee or devisee, or any other person. This will result in a disposition of the installment obligation which will trigger gain or loss.[78] The amount of income equals the excess of the face amount of the obligation over its basis in the hands of the decedent.[79] As the face

[78] Section 691(a)(4).

[79] Section 691(a)(4)(A).

amount is collected, the decedent's executor, beneficiary, or other recipient includes in the recipient's gross income the same proportion of the payment as would be reportable as income by the decedent if the decedent had lived and received the payment.[79.1] The reportable income will be offset by a deduction under Section 691(c) for any estate tax attributable to inclusion of the note in decedent's gross estate.

C. **Disposition by Death Example**:

John sells Whiteacre with a basis of $100,000 for $200,000. In the year of sale, John receives $50,000 in cash and Bob's note for $150,000. One year later before Bob makes any further payments on the note, John dies. Income in the amount of $75,000 is reported as follows:

Face amount of obligation	$150,000
Less: Basis of obligation[80]	75,000
Taxable Income	$ 75,000

D. The deferred gain from decedent's installment obligation which was outstanding at death will be considered income in respect of a decedent.[81] Since the note is considered an item of IRD it will not receive a step up in basis per Section 1014(c). IRD will not be taxable to the decedent but instead will be taxed to the successor in interest.[82] The character of the amount includible as IRD is the same as it would have been in the hands of the decedent.[83]

E. Per the IRD rules, income taxation is shifted from the decedent's final income tax return to the person actually receiving the income, the successor in interest.[84] The term successor in interest includes:

1. The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;[85]

2. A designated beneficiary whose right to income arises by operation of law (i.e. a co-owner of property such as a co-owner of a joint bank

[79.1] Treas. Reg. § 1.691(a)-5(a).

[80] Per Section 453B(b), the basis of the obligation equals the face amount of the obligation ($150,000) less the income reportable if the notes were satisfied in full (50% GPP x $150,000 = $75,000). In this case it would be $75,000 ($150,000 less $75,000 = $75,000).

[81] Section 691(a)(4).

[82] Treas. Regs. § 1.691(a)-4(b), 1.691(a)-5.

[83] Section 691(a)(3).

[84] Section 691(a)(1).

[85] Section 691(a)(1)(A).

account);[86] and

3. A beneficiary who receives the IRD from the decedent's estate as a result of a provision in the decedent's will or from a provision in the decedent's testamentary trust that entitles the beneficiary to a specific IRD item.[87]

F. If the decedent bequeaths the installment obligation to the obligor, any deferred gain is taxed to the decedent's estate as IRD and such gain is reported on the first fiduciary income tax return filed by the estate.[88]

1. **Decedent Bequeaths the Installment Obligation to the Obligor Example**:

   In 2011, Betty sells property with a basis of $50,000 to her son, Bob, for $200,000. She receives Bob's promissory note in the amount of $200,000 with appropriate interest. She dies in 2012 and her will cancels any debt owed by Bob on the purchase price. The note's fair market value on the date of death is $200,000. The $200,000 note is included in Betty's gross estate.[89] The estate's first income tax return must report the entire $150,000 gain ($200,000 amount realized less $50,000 basis in the promissory note) as IRD.

G. The note is an asset included in the decedent's gross estate. The receipt of the note by Senior has the effect of freezing value since any post-sale appreciation is deflected transfer tax free to the purchasers of the property.

> **Estate Freeze Planning Tip**: In our Discussion Problem Senior sells $16,000,000 of stock pursuant to an installment sale with a balloon payment due in 20 years. Assume Senior dies in the 20th year prior to the receipt of the balloon payment. In this case the installment note with a fair market value of $16,000,000 will be included in his gross estate. If the sale had not taken place and assuming a 5% annual growth rate, Senior's value of the stock in 20 years would be $42,452,800. With the installment sale, Senior deflected transfer tax on growth totaling $26,452,800. Assuming a 45% estate tax rate in 20 years, the transfer tax savings equals $11,903,760.

H. If the taxpayer makes a lifetime gift of the installment note, the gift is considered to be a disposition which would trigger recognized gain equal to the fair market

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[86] Section 691(a)(1)(B).

[87] Section 691(a)(1)(C).

[88] Section 691(a)(5). See Zaritsky and Lane *Federal Income Taxation of Trusts and Estates,* Warren Gorham and Lamont, 3rd Edition, 2001, page 15-46 for an excellent discussion of this issue.

[89] Treas. Reg. § 20.2033-1(b) provides that notes, even though they are cancelled by the decedent's will, are includible in the gross estate.

value of the obligation at the time of the gift less the obligation's basis.[90]

VIII. Thin Capitalization, Bootstrap Sales and Funding

Issues Presented: What are the risks if the intra-family installment sale is not respected under "reality of sale" principles? How will the purchasing trust fund the interest payments on the promissory note before it is redeemed for cash? Should the trust have its own funds or will 100% seller – provided financing and a bootstrap sale be respected? In lieu of a "seed" money gift to the trust, can the trust beneficiaries guarantee the trust's obligations?

Answer: A thinly capitalized sale could trigger the special valuation rules of section 2702 and section 2036. It has been suggested that "old and cold" seed money equal at least 10% of the purchase price.

Analysis of Bootstrap Sale and Source of Note Payment:

A. The issue of thin capitalization arises when the purchaser does not have enough cash to make either the principal down payment or the remaining principal and/or interest payments on the installment note.

B. There are two risks with respect to a thinly capitalized bootstrap sale. The first is that the note would be regarded as a retained interest of the transferor with respect to the interest in the trust which would trigger the special valuation rules of Section 2702.[97]

1. If Section 2702 applied to a fact situation where the terms of the note provide for annual interest only payments over the term of the note with a balloon principal payment at maturity, the entire value of the property transferred to the trust would be a taxable gift.

2. This result would follow since the final payment would be more than 20% greater than the immediately preceding payment, thus, none of the

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[90] Section 453B(a)(2).

[97] See Milford B. Hatcher Jr. and Edward M. Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, Journal of Taxation, Vol. 92, No. 03, March 2000, for an excellent synopsis of the bootstrap sales issues which are incorporated herein.

[98] Treas. Reg. § 25.2702-3(b)(1)(i) and (ii).

[99] Section 2702(a)(2)(A).

[100] See: Milford B. Hatcher Jr. and Edward M. Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, Journal of Taxation, Vol. 92, No. 03, March 2000; Mulligan, "Sale to an Intentionally Defective Grantor Trust for a Balloon - An End Around Chapter 14, 32 U. Miami Philip E Heckerling Inst. on Est Plan., Chapter 15 par. 1505.2, par. 1507.1; Wallace, "Installment Sales to Irrevocable Grantor Trusts: Better than a GRAT?," 34 So. Fed. Tax Inst.-10 (1999); Abbin, "[S]He Loves Me, [S]He Loves Me Not - Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to be Applied in Selection From the Cafeteria of Techniques, "31 U. Miami Philip E. Heckerling Inst. on Est. Plan., par. 1300.1 (1997).

debt service would be a qualified interest[98] resulting in the entire note having a zero value under Section 2702.[99]

C. It has been suggested by several commentators, some citing discussions with the IRS, that an "old and cold" initial gift of "seed" money equal to at least 10% of the purchase price is required.[100] This analysis suggests that such a seed gift would result in an acceptable debt-equity ratio of 10:1.

1. One commentator[101] suggested that the 10% seed gift is analogous to the 10% minimum value rule of Section 2701(a)(4).[102] It is pointed out that if Section 2701(a)(4) is the basis for the 10% rule then the amount of the seed gift should actually constitute 11% of the note principal.[103] In other words, the seed gift should equal 10% of the total amount of trust assets including the seed gift itself. Thus, if the fair market value of the property transferred equals $100,000 and the seller receives a promissory note from the trust for $100,000 then the seed gift should be $11,000.[104]

2. A bona fide guarantee from a person who has the financial means to back it up should be able to satisfy the 10% test. The IRS has recognized that either a "seed gift" of 10% or a guarantee for 10% should be acceptable.[105]

3. It is noteworthy that the Service has accepted 100% seller financing based upon expected cash flow.[106]

4. The Service will accept sales arrangements for an asset that is acquired at its fair market value in an arm's length transaction, creating a bona fide purchase and a bona fide debt obligation. In order to satisfy this requirement, it is necessary that both the formula for the purchase price as well as the payment terms be negotiated in an arm's length transaction.[107]

D. The second risk with thin capitalization is that the death of the seller during the

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[101] See Milford B. Hatcher Jr. And Edward M. Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, Journal of Taxation, Vol. 92, No. 03, March 2000.

[102] Pursuant to Section 2701(a)(4) in order to avoid a taxable gift, the value of the nonpreferred junior equity interests must be at least 10% of the sum of the value of all equity interests plus the total indebtedness of the entity to the transferor and the other family members.

[103] *Ibid*.

[104] $100,000 value of assets sold plus $11,000 seed = $110,000 total assets in trust. Thus, $110,000 x 10% = $11,000 seed. Therefore, a seed gift of 11% of the total trust assets will result in a debt-equity ratio of 9:1.

[105] *PLR* 95-15-039.

[106] See *Commissioner v. Clay Brown,* 380 U.S. 563 (1965).

[107] Rev. Rul. 69-77, 1969-1 CB. 59, acquiescing to *Mayerson v. Commissioner*, 47 TC 340 (1966);

term of the note could trigger Section 2036[108] causing inclusion of the sold property in the estate of the seller under the premise that the seller could be considered as having a retained interest in the property sold.[109] Furthermore, the sold assets will be included in seller's gross estate at date of death fair market value.[110] Thus, any appreciation in the sold assets from the date of sale to the date of death will be included in the decedent's gross estate. Consider the following language of Section 2036(a)(1):

"The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death:

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

E. The following factors are helpful to avoid a determination that the capitalization was too thin thereby triggering 2036(a)(1):[111]

1. The size of the payments to the seller should not be based on the actual income of the assets sold to the trust;

2. The assets sold should not be the sole source of the debt repayment;

3. The liability incurred should be a personal obligation of the transferee/purchaser.

F. It is also imperative that the sales price represents the fair market value of the property transferred. If less than fair market value, the sale would trigger the first element of Section 2036(a) contained in the parenthetical since it would not be a bona fide sale for full and adequate consideration and would be considered a gift transfer.

G. Sufficient seed money and guarantees may solve the problems associated with Section 2702 and 2036 but an additional practical problem must also be resolved. That is, sufficient cash flow sources must exist to meet the installment note's payment provisions.

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[108] Section 2036(a)(1).

[109] *Estate of Mitchell v Comm'r* 43 TCM (CCH) 1034 (1982).

[110] See Henkel, *Estate Planning and Wealth Preservation*, Warren Gorham and Lamont, 2003, pages 30-31 and 23-15.

[111] *Fidelity-Philadelphia Trust Co. v. Smith,* 356 US 274 (1958); Rev Rul. 77-193.

1. It may be possible to back load the note with a delayed balloon payment of principal and/or interest to reduce the immediate cash need. But delay may be unattractive from the seller's perspective.

2. One possible source is the cash flow produced by the asset purchased through the note.

3. If the asset is a business interest perhaps the management fees are reduced by reason of the departure of the seller from the business. The reduction may result in increased cash flow availability from the asset.

4. In the right setting, the business might be able to set aside earnings in anticipation of a transfer and perhaps even invest the earnings in income producing assets to further increase liquidity.

5. In the framework of a C corporation, depreciated assets might be paid to the seller in lieu of cash and leased back from the seller.

6. Obtaining outside financing may be an option.

7. In the case of a purchase at the death of the owner of the asset, life insurance proceeds payable to a business entity, or to descendants of the seller, or to a trust for the seller's descendants may be another source of cash flow.

IX. Installment Sale of Partnership Interests

Issue Presented: What is the effect if instead of S corporation stock, Senior owns a 25% membership interest in an LLC that elects to be taxed as a partnership for Federal income tax purposes?

Answer: The sale of an LLC interest taxed as a partnership is treated differently from a sale of corporate stock. Pursuant to the entity theory of partnership taxation, a portion of the sale will be treated as a sale of an equity interest with the character of the income generally considered capital gain. Pursuant to the aggregate theory of partnership taxation, a portion of the sale will be treated as a sale of partnership assets with the character of the income determined based on the character of the asset sold.

A. Section 741 provides that the sale of a partnership interest is considered a sale of a capital asset, except as provided in Section 751. Section 751 treats the selling partner as a sole proprietor in determining the character of gain attributable to certain partnership assets. Tax professionals recognize this dichotomy of classification as the struggle within Subchapter K between the "entity theory" and the "aggregate theory" of taxation.[112] The entity theory treats the partnership interest as equivalent to corporate stock, while the aggregate theory treats the individual partners as a group of sole proprietors, each with an undivided interest

[112] See James A. Fellows and Michael A. Yuhas, *Determining the Tax Consequences of an Installment Sale of a Partnership Interest*, Journal of Partnership Taxation, Vol. 12, No.4, Winter 1996.

in the partnership's underlying assets.

B. Consequently, the application of the installment sale rules becomes more complex if the item sold is a partnership interest. Under the entity theory, the sale of a partnership interest would be considered the sale of an equity interest. Thus, the sale of the partnership interest would be similar to the sale of stock and the installment method would apply to the entire sales price and generally would result in recognition of capital gain. Under the aggregate theory, the selling partner is treated as having sold an interest in each item of partnership property with the character of the income earned dependent upon the asset sold. Under this approach, eligibility to use the installment method is determined on an asset-by-asset basis. For example, any imputed sale of partnership inventory would not qualify for the installment method. The issue is whether the entity or aggregate theory applies to the sale of the partnership interest.

C. This dichotomy is reflected in the fact that two different partnership code provisions, Section 741 and Section 751, apply to the sale of a partnership interest. Pursuant to Section 741, the sale of a partnership interest is considered a sale of a capital asset. However, in an attempt to thwart the opportunity to convert ordinary income into capital gain, Congress passed Section 751 which adopted a modified aggregate approach for determining the gain on the sale of a partnership interest. Specifically, Section 751 overrides the capital nature of the disposition to the extent that the selling partner's amount realized is attributable to certain ordinary income assets. These ordinary income assets are referred to as "Section 751 assets" (often called "hot assets"), which are defined as "unrealized receivables" and "inventory items." Thus, Section 751 severs the following income items from the partnership interest.[113]

1. Section 751 defines "unrealized receivables" broadly to include not only the partnership's rights to payment for services rendered or goods sold, but also items of recapture income (e.g. potential depreciation recapture under Sections 1245 and 1250).[114]

2. The term inventory is broadly defined for purposes of Section 751. It includes, of course, property held primarily for sale to customers in the ordinary course of business[115] but also includes any other property that would not be a capital asset in the hands of the partnership.[116] The term inventory also includes other property pursuant to Sections 751(d)(1) and (d)(2). Section 751(d)(3), inventory includes any other property held by the partnership, which, if held by the seller or distributee partner, would be considered property of the type described in Section 751(d)(1) or (d)(2).

[113] H. Rep. No 1337 at 71, and S. Rep. No. 1622, 83rd Cong., 2d Sess. 99 (1954).

[114] Section 751(c).

[115] Section 751(d)(1).

[116] Section 751(d)(2).

D. Pursuant to Section 751, a selling partner is required to allocate a portion of both the amount realized[117] and his basis in the partnership interest (outside basis) to a Section 751 asset. The portion of the amount realized allocated to the Section 751 asset equals such asset's fair market value. Generally, the portion of the outside basis assigned to a 751 asset is the selling partner's proportionate share of such asset to the partnership ("inside basis").

1. The selling partner realizes ordinary income equal to the gain on the Section 751 asset. The difference between the remaining sales price and remaining outside basis is capital gain or loss.

Example: John, a 20 percent general partner in the Profit Partnership, sells his partnership interest for $24,000. His basis in the partnership interest was $10,000. The partnership has the following assets:

	Basis	*Value*
Cash	10,000	10,000
Inventory	25,000	80,000
Capital Asset	20,000	30,000
Total	55,000	120,000

John's share is as follows:

	Basis	*Value*
Cash	2,000	2,000
Inventory	5,000	16,000
Capital Asset	4,000	6,000
Total	11,000	24,000

Result: John's amount realized is $24,000 and his recognized gain is $14,000 ($24,000 amount realized less his $10,000 outside basis).

The inventory is a Section 751 asset. John must allocate to the inventory $16,000 of the amount realized. This amount equals his 20 percent of the total $ 80,000 fair market value of the partnership inventory.

He then subtracts $5,000 of his outside basis (his 20 percent pro rata share of the partnership's inside tax basis in the inventory) from this $16,000, resulting in ordinary income in the amount of $11,000.

[117] Pursuant to Section 752(d), partnership liabilities shall be included in the selling partner's amount realized upon the sale of the partnership interest.

His remaining unallocated amount realized and outside basis are $8,000[118] and $5,000,[119] respectively. The difference between these two amounts generates a capital gain in the amount of $3,000.

E. Of note, the partnership rules are silent as to whether the entity, aggregate, or modified aggregate approach applies in determining the applicability of Section 453 to the sale of partnership interests.

F. Section 453 provides some guidance to the installment sale of partnership interests. One such rule is found in Section 453(i), which indicates that any gain attributable to Section 1245 or Section 1250 recapture is not entitled to deferral and must be recognized in the year of sale.

G. The Service attempted to provide some clarity regarding this issue in Revenue Ruling 89-108, 1989-2 C.B. 100. There, a partner sold his partnership interest in exchange for an installment note. The partnership had substantially appreciated inventory. [120] The issue was whether the selling partner was entitled to recognize gain attributable to the inventory on the installment method, or whether that gain had to be recognized in the year of sale. The service ruled that the partner could not use the installment method for reporting gain attributable to the substantially appreciated inventory.[121]

1. The service noted that Section 453(b)(2)(B) precludes the installment reporting for gains realized from the sale of inventory.

2. The service concluded that Section 751 overrides Section 741 when a partner sells an interest in a partnership that holds substantially appreciated inventory.

3. Thus, John must recognize ordinary income on the sale of the interest, to the extent the gain is attributable to substantially appreciated inventory.

H. The Service's approach of modified aggregation illustrated in Revenue Ruling 89-108, effectively denies the application of Section 453 to the selling partner's gain to the extent certain underlying partnership assets would not qualify for

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[118] $24,000 amount realized less $16,000 of the amount realized allocated to inventory.

[119] $10,000 outside basis less $5,000 or outside basis assigned to inventory equal to John's proportionate share of the inventory's basis to the partnership.

[120] Prior to the Taxpayer Relief Act of 1997, inventory would only be 751 property if it was substantially appreciated. The term "substantially appreciated inventory" referred to inventory the fair market value of which exceeded 120% of adjusted basis and its fair market value exceeded 10% of the fair market value of all other partnership assets.

[121] Mckee, Nelson and Whitmire, Federal Taxation, Partners and Partnerships, Warren Gorham and Lamont 4th Edition, 2007, page 17-42, fn 160 ".. the elimination of the 'substantial appreciation' test from section 751(a) by the Taxpayer Relief Act of 1997, should have no effect on this ruling."

installment sale reporting if sold directly.[122]

I. The holding of Revenue Ruling 89-80 ignores the issue of the tax result if the partnership inventory was not substantially appreciated. Some commentators have suggested that the seller would be entitled to use the installment method of accounting if the partnership held inventory is not substantially appreciated.[123]

J. A collateral issue is whether the parties can agree to a specific allocation of payments to assets qualifying and not qualifying for installment sale treatment. The general rule is, absent an agreement, each installment payment received for the partnership interest is allocated among the partnership assets in proportion to their fair market values.[124]

1. However, some courts have been willing to respect agreed-upon allocations. Thus, it appears possible to allocate a disproportionately large amount of year-of-sale payments to nonqualifying assets thus maximizing seller's tax deferral opportunities.[125]

K. Sections 741 and 751 are unique to sales of partnership interests. The subchapter S rules do not contain provisions of this nature. Thus, the entire gain recognized on the sale of S corporate stock should be capital in nature regardless of the nature of the S corporation's assets.[126]

X. Section 2703 and Buy-Sell Agreements

Issues Presented: If the formula in the buy-sell agreement is used to determine the value for the intra-family installment sale, does the IRS have a basis to challenge it under section 2703(b)? Might the answer be different if the purchasing trust subsequently has the 25% interest redeemed for an amount significantly in excess of $16,000,000? Does Senior need to pay an appraiser for a valuation report with respect to the sale to the trust?

Answer: The buy-sell agreement will freeze the value of the portion of the business sold on the date the installment sales agreement is executed if the buy-sell agreement is in compliance with section 2703.

Analysis of Application of Special Valuation Rules of Section 2703:

[122] Mckee, Nelson and Whitmire, Federal *Taxation, Partners and Partnerships,* Warren Gorham and Lamont 4th Edition, 2007, pp. 16-50.

[123] Lind, Schwarz, Lathrope and Rosenberg, *Fundamentals of Partnership Taxation*, Foundation Press 4th Edition, 1994, p. 267.

[124] See Mckee, Nelson and Whitmire, *Federal Taxation, Partners and Partnerships,* Warren Gorham and Lamont 4th Edition, 2007, pp. 17-43. The authors incorporate this discussion herein.

[125] See Charles A. Collins, 48 TC 45 (1967)(acq.). See Mckee, Nelson and Whitmire, *Federal Taxation, Partners and Partnerships,* Warren Gorham and Lamont 4th Edition, 2007, pp. 17-43.

[126] See Alan Gunn, Partnership Income Taxation, Foundation Press, 3rd Edition 1999, for a discussion of this issue, p.131.

A. Buy-sell agreements have been used by closely held business owners to serve a variety of personal needs. Such agreements control the transfer of ownership, prevent the transfer of the business to unrelated parties, provide a market for the business interest, and provide a plan for future liquidity needs either during life or at death. Such agreements, if in compliance with the provisions of Section 2703, may be able to freeze the value of the business interest at a level which is equal to the value of the business on the date the agreement is executed which may be below the fair market value of the transferred interest at the time of death.[127]

B. Buy-sell agreements sometimes are used to arrive at a valuation formula or a set price to provide certainty for the seller of a sales price. While valuation discounts are factors that arise for estate and gift tax issues, they generally are not a factor in buy-sell agreements between unrelated parties since the parties are bargaining to preserve their own self-interests.

C. In intra-family sales the buy-sell agreement historically was a device used to fix values for transfer tax purposes. During the 1970's and 1980's, a valuation freeze was a commonly used device. The service considered valuation freeze buy-sell agreements as a device to avoid estate taxes and litigated the issue. In response, Congress passed the anti-freeze provisions, including Section 2703 which dealt with buy-sell agreements in the family context.

D. Section 2703 provides that the value of property for transfer tax purposes is determined without regard to any "right or restriction" relating to the property. The term right or restriction means (1) any option, agreement, or other right to acquire or use the property at a price less than fair market value (determined without regard to the option, agreement, or right); or (2) any restriction on the right to sell or use the property.[128] A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement, or may be implicit in the capital structure of an entity.[129]

E. Section 2703 does not apply to any option, agreement, right, or restriction which meets each of the following requirements:

1. The agreement is a bona fide business arrangement;[130]

2. The agreement is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money

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[127] For a good discussion of buy-sell agreements and section 2703 see C. Wells Hall III, *Valuation of Stock Under Buy-Sell Agreements After Chapter 14 - General Business Practice or Business as Usual?,* Journal of S Corporation Taxation vol. 7 No. 3, Winter 1996.

[128] Section 2703(a).

[129] See Henkel, *Estate Planning and Wealth Preservation*, Warren Gorham and Lamont, 2003, p. 27-8.

[130] Section 2703(b)(1).

or money's worth;[131] and

3. At the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.[132]

   a. It was not Congressional intent that Section 2703 would disregard a buy-sell agreement merely because its terms differ from those by another similarly situated entity.[133]

   b. The conference report recognized that more than one valuation methodology may be considered valid, even within the same industry, and that one of several generally accepted methodologies may satisfy the comparability standard.[134]

F. Each of the three requirements must be independently satisfied for a right or restriction to meet this exception. Thus, the mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish that the right or restriction is not a device to transfer property for less than full and adequate consideration.[135] The Regulations adopt the reasoning of *St. Louis County Bank v. United States.*[136]

G. The requirements for a valid buy-sell agreement are governed by Section 2703. In analyzing the validity of the buy-sell agreement it is also necessary to refer to the requirements which existed prior to the passage of Section 2703.[137]

This point is mentioned in the senate report as follows:

"*The bill does not otherwise alter the requirements for giving weight to a buy-sell agreement. For example, it leaves intact present law rules requiring that an agreement have lifetime restrictions in order to be binding on death.*"[138]

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[131] Section 2703(b)(2).
[132] Section 2703(b)(3).

[133] H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1137(1990).

[134] Letter from Senator Lloyd Bensten, Chairman, Senate Committee on Finance to Senator Jim Sasser, Senate Committee on the Budget (Oct. 15, 1990), reprinted in 136 Cong. Rec. S. 15631, S. 15683 (daily ed. Oct. 18, 1990). See C. Wells Hall III, *Valuation of Stock Under Buy-Sell Agreements After Chapter 14 - General Business Practice or Business As Usual?*, Journal of S Corporation Taxation, Volume 7, Number 3, Winter 1996.

[135] Treas. Reg. § 25-2703-1(b)(2).

[136] *St. Louis County Bank v. United States,* 674 F2d. 1207 (8th Cir. 1982).

[137] See Kathryn G. Henkel, *Estate Planning and Wealth Preservation*, Warren Gorham and Lamont page 27-2 for an excellent discussion of this issue.

[138] 136 Cong. Rec. S 15862(10/18/90).

H. The requirements that existed prior to the passage of Section 2703 which remain as part of the law are:[139]

1. Seller must be obligated to sell the interest if buyer wants to buy.[140]

   a. A right of first refusal will not satisfy this requirement.[141]

   b. If the decedent is entitled to dispose of the interest at any price he chooses during his lifetime, the agreement will not be considered effective.[142]

2. The agreement must contain a method for determining the price, which must be fixed or determinable pursuant to a formula.[143] This requirement is met if the established price reflects full and adequate consideration and reflects fair market value at the time the agreement is executed. The courts have upheld buy-sell agreements where the price was reasonable at the time the agreement was executed, despite the fact that the interest value at the time of death was higher.

   a. In *Estate of Hall v. Comm'r.*,[144] the Tax Court held that the agreement was effective with respect to the value of stock as long as it reflected fair market value at the time the agreement was entered into even if the price is significantly less than the value at the decedent's death.

   b. Generally, a periodic reevaluation of the buy-sell agreement pre-determined price is required.

3. The fixed pre-determined price must be binding upon the seller during the his lifetime as well as upon his estate after death.[145] If the buy-sell agreement is not binding on lifetime transfers then the buy-sell agreement is not determinative of the value of the interest at death.[146] In

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[139] See Budget Comm., 101st Cong., 2d Sess., Informal Report on S. 3209, 136 Cong. Rec. S15,629, S15, 683 (Oct 18, 1990). See Kathryn G. Henkel *Estate Planning and Wealth Preservation,* par. 27.03[4][(b), Warren Gorham and Lamont p. 27-10.

[140] *St. Louis County Bank v. United States*, 674 F2d. 1207 (8th Cir. 1982).

[141] *Est. of Fry v. Comm'r.*, 9 TC 503 (1947) acq.

[142] Treas. Reg. § 20.2031-2(h).

[143] *Estate of Bischoff v. Comm'r*. 69 TC 32 (1977).

[144] *Estate of Hall* 92 TC 312, (1989).

[145] Treas. Reg. § 20.2031-2(h).

[146] *Estate of Caplan v. Comm'r*. TC Memo 1974-39. See also C. Wells Hall III, *Valuation of Stock Under Buy-Sell* Agreements *After Chapter 14- General Business Practice or Business As Usual?*, Journal of S Corporation Taxation, Volume 7, Number 3, Winter 1996.

Gannon Estate v. Comm'r.,[147] the National Office advised that the agreement price did not determine the value of the interest for estate tax purposes since that price was only effective as to the interest owned at death and not for lifetime transfers. It stated that under Treas. Reg. § 20.2031-2(h) and Revenue Ruling 59-60, an agreement price for an interest is given little weight if the decedent is free to dispose of the interest at any price during his lifetime.[148]

I. The statutory requirements imposed by IRC Section 2703 in order to have a valid buy-sell agreement are as follows:

1. It must be a bona fide business agreement.[149]

   a. The agreement must have a bona fide business purpose.

   b. Generally, a buy-sell agreement employed to keep the business in the family will satisfy this requirement. In *Estate of Bischoff* v. *Comm'r*.,[150] the tax court held that a goal to maintain control within the ownership group and assure continuity of management is a valid business reason.[151]

   c. However, where a restriction on an interest was not binding on all the interest holders or applicable to all outstanding interests and was imposed by a testamentary instrument after the interest was issued, the restriction did not represent a bona fide business arrangement.[152]

2. It must not be a testamentary device. Specifically, the buy-sell agreement must not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.[153]

   a. The IRS has privately ruled that where a right of first refusal does not specify a purchase price or provide guidelines for determining a purchase price, the right may not satisfy the "no

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[147] *Gannon Estate v. Comm'r*., 21 TC 1073 (1954).

[148] See C. Wells Hall III, *Valuation of Stock Under Buy-Sell Agreements After Chapter 14-General Business Practice or Business as Usual?*, Journal of S Corporation Taxation vol. 7 No. 3, Winter 1996.

[149] Section 2703(b)(1).

[150] In *Estate of Bischoff* v. *Comm'r*. 69 TC 32 (1977).

[151] *Ibid*.

[152] Tech. Adv. Mem. 95-50-002 (August 31, 1995).

[153] Section 2703(b)(2).

device" requirement if the terms of the purchase price may be more favorable than those which the potential purchaser could otherwise obtain.[154]

b. The following items are considered in determining whether the agreement was a testamentary device:

i. Health or age of the decedent when entering into the buy-sell agreement;[155]

ii. The time interval between the date the agreement was executed and the date of decedent's death;

iii. Whether the parties adhered to the terms of the agreement prior to the death of the decedent;[156]

iv. The likelihood that the decedent could have survived the other interest holders;

v. Whether the interest price was arrived at through interest holder negotiation;[157]

vi. Whether the formula reflected the fair market value at the time the agreement was executed;[158]

vii. Whether all the parties to the agreement were equally bound by its terms;[159]

viii. Whether the buy-sell value was based upon an appraisal;[160] and

ix. Whether the terms of the price were arrived at without professional guidance.[161]

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[154] TAM 95-50-002 (August 31, 1995). See Henkel, *Estate Planning and Wealth Preservation*, Warren Gorham and Lamont, 2003, p. 27-11.

[155] *Slocum v United States*, 256 F. Supp. 753 (1966), *Estate of Gloeckner*, 152 F. 3d 208 (2nd Cir. 1998).

[156] *St. Louis County Bank*, 674 F.2d 1207 (8th Cir. 1982).

[157] *Estate of Lauder v. Comm'r*. TCM (CCH) 1992-736.

[158] *Estate of Carpenter* TCM (CCH) 1992-653.

[159] *Brodrick v. Gore* 224 F.2d 892, (10th Cir. 1955).

[160] Cameron W. Bomner Revocable Trust TCM 1997-380.

[161] *Ibid*.

3. Its terms must be comparable to similar arrangements entered into by persons in an arms' length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length.[162] A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business.[163] The determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the agreement, and the adequacy of any consideration given in exchange for the rights granted.[164]

   a. This test applies at the time the right or restriction is created.

   b. Generally, the purchase price set in the buy-sell agreement must represent the interest's fair market value at the time the agreement is entered into.[165] There should be a formula for periodically adjusting the price to represent any value increases.

   c. Reliance upon experts will be important in determining the comparability of allegedly similar arrangements.[166]

   d. The taxpayer bears the burden of showing that an agreement is of the type that could have been in arm's length transactions.[167]

   e. Evidence of general business practice is not met by showing isolated comparables.[168] If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only

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[162] Section 2703(b)(3); Treas. Reg. § 25.2703-1(b)(4), See Henkel, *Estate Planning and Wealth Preservation*, Warren Gorham and Lamont, 2003, p. 27-5 for the following interesting commentary. *"..Controversy has dogged this requirement, since many practitioners deem it too hard to meet as a purely practical matter. In particular, evidence of comparable arrangements maybe difficult to obtain. The IRS has indicated that it will not necessarily require evidence of comparable agreements in all cases. PLR 9350016 (Sept. 16, 1993). Moreover, the IRS National Office has informally indicated that it does not intend to use this evidentiary requirement as a back-door means to eliminate the recognition of values pursuant to buy-sell agreements as establishing value for transfer tax purposes. However, some IRS offices are requiring evidence of similar agreements on audits."*

[163] *Ibid*.

[164] *Ibid*.

[165] Treas. Reg. § 25.2703-1(b)(4)(i).

[166] 136 Cong. Rec. S 15862 (10/18/90).

[167] *Ibid.*

[168] Treas. Reg. § 25.2703-1(b)(4)(ii).

one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.[169]

f. Note that book value is not fair market value.

4. It is noteworthy that the regulations provide that each of the above three tests must be independently satisfied for a right or restriction to meet this exception.[170]

5. The regulations provide that a right or restriction is considered to meet each of the three requirements if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family.[171]

a. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor.[172]

XI. Preserving S corporate Status in an Installment Sale

Issue Presented: How can Senior ensure that the non-grantor purchasing trust qualifies as an eligible S corporation shareholder?

Answer: It is important that the trust qualifies as an S shareholder or the S election will be lost. Two trusts which qualify are Qualified S Shareholder Trusts (QSST) and Electing Small Business Trusts (ESBT).

Analysis of Trusts Qualifying as S Corporation Shareholders:

A. It is important that the S election be preserved after a taxpayer's sale of stock to a non-grantor trust. One of the requirements of an S corporation is that each shareholder must be an individual, or decedent's estate, or certain trusts, or a tax exempt Section 501(c)(3) charitable organization or another S corporation. [174] Furthermore, no shareholder of an S corporation may be a non-resident alien per Section 1361(b)(1)(C). A bankruptcy estate of an individual may be an S

[169] Treas. Reg. § 25.2703-1(b)(4)(ii).

[170] Treas. Reg. § 25.2703-1(b)(2).

[171] Treas. Reg. § 25.2703-1(b)(3).

[172] Treas. Reg. 25.2703-1(b)(3).

[174] Section 1361(b)(1)(B) and 1361(b)(3).

corporation shareholder.[175]

1. Stock transferred to a custodian for a minor under the Uniform Gifts to Minors Act or Uniform Transfer to Minors Act is not held in trust and does not disqualify the S election. The minor, and not the custodian, is treated as the shareholder.[176]

2. An individual under a disability, such as an infant or incompetent, is an eligible S shareholder. The S stock is considered owned by him, not by an estate.[177]

B. The following trusts can be shareholders:

1. A trust that is a grantor trust under IRC Sections 671-677 or 678;[178]

2. A trust that was a grantor trust and that continues as a trust that is not qualified to be an S corporation shareholder after the deemed owner's death, but only for two years;[179]

3. A trust which receives stock under a will during the two-year period beginning on the day the S corporation stock is transferred to it;[180]

4. A voting trust created primarily to exercise the voting power of stock transferred to it;[181]

5. An electing small business trust;[182] and

6. A Qualified Subchapter S Trust.[183]

XII. Qualified Subchapter S Trust

A. A Qualified Subchapter S Trust (hereinafter "QSST") qualifies as an eligible S shareholder. A QSST is a trust that:

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[175] Treas. Reg. § 1.1361-1(b)(2).

[176] Treas. Reg. § 1.1361-1(e)(1).

[177] Rev. Rul. 66-266, 1966-2 CB 356.

[178] Section 1361(c)(2)(A)(i).

[179] Section 1361(c)(2)(A)(ii).

[180] Section 1361(c)(2)(A)(iii).

[181] Section 1361(c)(2)(A)(iv).

[182] Section 1361(c)(2)(A)(v).

[183] Section 1361(d).

1. Distributes (or is required to distribute) all of its income currently to one individual who is a U.S. citizen or resident;[184] and

2. Requires that:

   a. during the life of the current income beneficiary there will be only one income beneficiary of the trust;[185]

   b. any corpus distributed during the term of the trust must be distributed to the current income beneficiary;[186]

   c. The current income beneficiary's income interest terminates on the earlier of the termination of the trust or the death of that income beneficiary;[187]

   d. Upon trust termination or the death of the current income beneficiary all corpus and income must be distributed to that beneficiary.[188]

B. All of the trust document requirements must apply from the date of the QSST election throughout the term of the trust.[189] Thus, the trust instrument cannot provide that the QSST required provisions apply only during the period that the trust holds S stock.[190]

C. The trust must distribute (or be required to distribute) all of its income currently to one individual who is a U.S. citizen or resident.[191] For QSST purposes, the term "income" refers to fiduciary accounting income.[191.1] Items of income that constitute principal will be taxed to the QSST.[191.2] The trust may make a Section 663(b) election to consider distributions made within the first 65 days of the year following the year in which the trust earned the income distributed as made on

[184] Section 1361(d)(3)(b).

[185] Section 1361(d)(3)(A)(i).

[186] Section 1361(d)(3)(A)(ii).

[187] Section 1361(d)(3)(A)(ii).

[188] Section 1361(d)(3)(A)(iv).

[189] Treas. Reg. § 1.1361-1(j)(5).

[190] See Henkel, *Estate Planning and Wealth Preservation*, Warren Gorham and Lamont, 2003, pp. 18-21. Her materials provide an excellent synopsis of the QSST rules which are incorporated herein.

[191] Section 1361(d)(3)(B).

[191.1] Treas. Reg. 1.1361-1(j)(1)(i).

[191.2] Treas. Reg. 1.1361-1(j)(8).

[191.3] Treas. Reg. 1.1361-1(j)(1)(i).

the last day of that taxable year.[191.3] The trust will not qualify if the income beneficiary is a nonresident alien.[192] If a U.S. income beneficiary's shareholder's spouse is a nonresident alien who has a community property interest in the stock held in trust by reason of a state's community property law or a foreign country's law, the trust will not qualify.[193]

D. The trust terms must provide that during the life of the current income beneficiary there will be only one income beneficiary of the trust.[194]

1. A husband and wife who file joint returns and are U.S. citizens or residents are treated as a single beneficiary as long as they fulfill these conditions and both join in the QSST election and any other action required of the income beneficiary.[195] For example, Husband and Wife must continue to file joint returns for the entire period that the QSST election is in effect.[195.1]

2. A trust will be a QSST even though it distributes the income to the parents of the beneficiary as the custodians of the beneficiary.[196]

3. A trust distribution which satisfies the grantor's legal obligation to support the income beneficiary ceases to be a QSST as of the date of the distribution. In this case the grantor would then be treated either as the owner of the ordinary income part of the trust under the grantor trust rules, or as a trust beneficiary if corpus is distributed.[197]

4. If state law permits a third person, such as a creditor, to obtain access to the income beneficiary's trust interest by a court order, the trust will qualify as a QSST until such a person actually obtains such access.[198]

5. The income beneficiary can assign his interest. In such instance the assignee will be treated as the new income beneficiary and the trust is

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[192] *Ibid*.

[193] Treas. Reg. 1.1361-1(g).

[194] IRC Section § 1361(d)(3)(A)(i).

[195] Treas. Reg. § 1.1361-1(j) 2(i).

[195.1] *Ibid.*

[196] PLR 88-31-020.

[197] Treas. Reg. § 1.1361-1(j)(2)(ii)(B).

[198] Treas. Reg. § 1.1361-1(j)(2)(v).

[199] Treas. Reg. § 1.1361-1(j)(2)(iv), 1.1361-1(k)(1), example 5.

[200] Treas. Reg. § 1.1361-1(j)(8).

required to satisfy the QSST requirement after the assignment to retain its QSST status.[199]

6. The income beneficiary is treated as the owner, for purposes of 678(a), of that portion of the trust that consists of stock in the S corporation for which the QSST election was made.[200]

E. Any corpus distributed during the life of the current income beneficiary must be distributed to the current income beneficiary per Section 1361(d)(3)(A)(ii).

1. A trust that may terminate during the life of the current income beneficiary and distribute corpus to persons other than the current income beneficiary does not qualify as a QSST. This result follows even if the termination and distribution are allowed only if the trust holds no shares in the S corporation at that time.[201]

2. The trust will not qualify as a QSST if the income beneficiary has a limited power of appointment over a QSST during his lifetime.[202] However, if the power of appointment results in the Grantor being taxed as the owner of the entire trust, the trust may be a permitted shareholder under Section 1361(c)(2)(A)(i).[203]

3. A trust that provides for termination on the sole income beneficiary's death or 21st birthday if earlier, with the corpus to revert on termination to the grantor, did not qualify as a QSST. However the trust did qualify as a permitted S corporation shareholder by reason of its being a grantor trust.[204]

F. The trust instrument must provide that if the trust terminates during the income beneficiary's life, the trust must distribute all of its assets to the income beneficiary.[205]

G. A trust will immediately be an ineligible S corporation shareholder on the date it no longer meets any of the QSST requirements other than the income distribution requirements.[206]

H. If the income distribution requirement is not met, but the other QSST requirements continue to be met, the trust ceases to be eligible as of the first day of the tax year beginning after the tax year that the income requirement is not

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[201] Rev. Rul. 89-55, 1989-1 CB 268.

[202] Treas. Reg. 1.1361-1(j)(2)(iii).

[203] *Ibid*.

[204] Treas. Reg. § 1.1361-1(k)(1), Ex. 7.

[205] Section 1361(d)(3)(A)(iv).

[206] Section 1361(d)(4)(A).

met.[207]

I. A trust that ceases to meet the eligibility requirements of a QSST at the income beneficiary's death may continue to hold stock of the S corporation for a two-year period beginning on the day of the income beneficiary's death.[208]

1. During that period, the income beneficiary's estate, not the trust, is treated as the shareholder for S corporation eligibility requirements.[209]

2. However, during this two-year period the trust is taxed as the S corporation shareholder on the S corporation income passed through to the trust, and is treated as the S corporation shareholder for the tax treatment of S corporation distributions, and for adjustments to stock basis.[210]

3. The trust may also continue to be an eligible S corporation shareholder after the income beneficiary's death if it is a grantor trust or if it continues to meet the QSST eligibility requirements with a successor income beneficiary.

J. The QSST's income beneficiary is treated as the S shareholder for income tax purposes.[211] Thus, since the S corporation is a pass-through entity, the trust's share of the S corporation's income will be reported by the income beneficiary, regardless of whether the current income beneficiary gets any distributions or not. Thus, the current income beneficiary is taxed on the trust's share of trust income, and is treated as the S corporation's shareholder for the tax treatment of S corporation distributions and for adjustments to stock basis.[212]

K. An election must be made in order for a QSST to be an eligible S corporation shareholder. The election is made by the current income beneficiary or his legal representative per Section 1361(d)(2)(A). If there is no legal representative the election may be made by that person's natural or adoptive parent.[213]

1. The election must be made separately with respect to each corporation that has stock held by the trust.[214]

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[207] Section 1361(d)(4)(B).

[208] Treas. Reg. § 1.1361-1(j)(7)(ii).

[209] *Ibid.*

[210] Treas. Reg. § 1.1361-1(j)(7)(ii).

[211] Section 1361(d)(1)(B).

[212] Treas. Reg, § 1.1361-1(j)(7)(i).

[213] Treas. Reg. § 1.1361-1(j)(6).

[214] Treas. Reg, § 1.1361-1(j)(6).

2. This election does not constitute an election for the corporation to be taxed as an S corporation. The corporation is still required to make the election provided by Section 1362(a) to be taxed as an S corporation.

3. The election, once made, is irrevocable.[215]

4. The election requirements are set forth in Treas. Reg. § 1.1361-1(j)(6).

L. Once the QSST election is made, it will be treated as made by each succeeding income beneficiary unless the succeeding income beneficiary affirmatively refuses to consent to the election.[216]

M. A successor beneficiary makes the affirmative refusal to consent to the QSST election by filing a statement with the IRS service center with which the S corporation files its income tax return.[217] The statement must be filed within 15 days and two months after the date on which the successive income beneficiary became the income beneficiary.[218]

N. A QTIP trust created at the death of one spouse for the surviving spouse should always qualify as a QSST if the election is made, unless the surviving spouse is a non-resident alien.

1. However an inter vivos QTIP will not qualify as long as the spouses are married to each other because the trust will be a grantor trust.

2. However, the trust will still qualify as an eligible S shareholder as long as the grantor is considered the owner of the entire trust.

XIII. Electing Small Business Trust

A. An Electing Small Business Trust ("ESBT") is an Eligible S shareholder.[219]

B. An ESBT is defined in Section 1361(e) as a trust that meets the following requirements:

1. The trust does not have any beneficiaries other than individuals, estates or certain charitable organizations.[220]

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215 Section 1361(d)(2)(c).

216 Section 1361(d)(2)(B)(ii).

217 Treas. Reg. § 1.1361-1(j)(10)(i).

218 Treas. Reg. § 1.1361-1(j)(10)(ii)(A).

219 Section 1361(c)(2)(A)(v).
220 Section 1361(e)(1)(A)(i).

2. No interest in the trust was acquired by purchase.[221]

   a. An interest is acquired by purchase if the person becomes a beneficiary of the trust and the basis of the interest is at cost basis as determined by 1012.[222]

   b. However, the trust itself can acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.[223]

3. The trust makes an election to be taxed as an ESBT.[224]

4. The trust has not made an election to be taxed as a QSST and is not a tax-exempt trust nor a charitable remainder annuity trust or a unitrust.[225]

C. A beneficiary of an ESBT who, at any time during the period, is entitled to (or at the discretion of any person may) receive a distribution from principal or income of the ESBT is defined as a "potential current beneficiary."[226] The term "potential current beneficiary" does not include a beneficiary who only possesses a future interest in the trust.[226.1]

1. Each "potential current beneficiary" of an ESBT is treated as a shareholder for purposes of qualifying the corporation as an S corporation,[227] and for purposes of the 100 shareholder limit.[228] The trust shall be treated as the shareholder during any period in which there is no potential current beneficiary of the trust.[229]

2. It is noteworthy that when a potential current beneficiary owns stock directly or through more than one trust, the potential current beneficiary is not counted twice for purposes of the 100-shareholder limit.[230]

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[221] Section 1361(e)(1)(A)(ii).

[222] Treas. Reg. § 1.1361-1(m)(1)(iii).

[223] Treas. Reg. § 1.1361-1(m)(1)(iii); Joint Comm. Staff, Gen. Expl. of 104 Cong. Tax Legis., 12/18/96, p. 113.

[224] Section 1361(e)(1)(A)(iii).

[225] Section 1361(e)(1)(B).

[226] Section 1361(e)(2).

[226.] Section 1361(e)(2); Treas. Reg. § 1.1361-1(m)(4)(i).

[227] Treas. Reg. § 1.1361-1(e)(1).

[228] Treas. Reg. § 1.1361-1(m)(4)(vii); H Rept No. 104-586 (PL 104-188) p. 83.

[229] Treas. Reg. § 1.1361-1(e)(1).

[230] Treas. Reg. § 1.1361-1(m)(4)(vii); Joint Comm. Staff, Gen. Expln. of 104 Cong. Tax Legis., 12/18/96, p. 113.

D. The trustee makes the ESBT election which applies for the tax year in which it is made and for later years, unless it is revoked with IRS consent.[231]

1. The trustee must make the ESBT election by signing and filing the election statement, with the service center where the S corporation files its income tax return.[232]

2. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement. If one of several trustees can legally bind the trust, one trustee may effectively make the election by signing the election statement.[233]

3. Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT. However, if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service centers where the corporations file their income tax returns.[234]

E. The portion of the ESBT that consists of stock in an S corporation is treated as a separate trust for income tax purposes.[235]

1. The deemed separate trust is taxed on its taxable income at the highest individual rate applicable to income of trusts.

2. The income from the S portion of the ESBT is taxed to the trust, therefore it is not included in the trust's distributable net income.[236]

3. Thus, no deduction is available for distributions to beneficiaries. Furthermore, none of the ESBT separate trust income is included in the income of the beneficiaries.[237]

F. A trust may convert from an ESBT to a QSST[238] or a QSST may convert to an ESBT.[239]

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[231] Section 1361(e)(3).

[232] Treas. Reg. § 1.1361-1(m)(2)(i).

[233] Treas. Reg. § 1.1361-1(m)(2)(i).

[234] Treas. Reg. § 1.1361-1(m)(2)(i).

[235] Section 641(c)(1).

[236] Section 641(c)(3)(B).

[237] Section 641(c)(2)(C).

[238] Treas. Reg. § 1.1361-1(m)(7).

[239] Treas. Reg. § 1.1361-1(j)(12).

G. An ESBT election terminates when any of the following events occurs:

1. The trust fails to meet the ESBT requirements. In this case the last day the trust will be taxed as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.[240]

2. The trust disposes all of its S corporation stock. The trust ceases to be an ESBT on the first day following the day of disposition. If the trust disposes of the stock in an installment sale the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.[241]

3. The trust has a potential current beneficiary that is ineligible to be an S corporation shareholder. ESBT status terminates on the day such an ineligible potential current beneficiary becomes a current beneficiary.[242]

H. An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the IRS in the form of a letter ruling request.[243]

XIV. Statute of Limitations

Issues Presented: Can the filing of an income tax return start the running of the statute of limitations for the gift tax? Can Senior start the 3–year statute of limitations on the valuation used and other concerns if no gift tax return is filed?

Answer: The filing of an income tax return reporting the installment sale will start the running of the statute of limitations for gift tax purposes if the transaction is one in the ordinary course of business, otherwise a gift tax return must be filed to start the running of the statute.

Analysis of Statute of Limitations:

A. It is generally in the selling taxpayer's interest to start the statute of limitations running on the gift tax valuation as well as other issues.

B. Completed transfers to members of the transferor's family as defined by Section 2032A(e)(2)[244] that are made in the ordinary course of operating a business are deemed to be adequately disclosed for gift tax purposes, even if the transfer is not reported on a gift tax return, provided the transfer is reported by all parties for

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[240] Treas. Reg. § 1.1361-1(m)(5)(i).

[241] Treas. Reg. § 1.1361-1(m)(5)(ii).

[242] Treas. Reg. § 1.1361-1(m)(5)(iii).

[243] Treas. Reg. § 1.1361-1(m)(6).

income tax purposes.[244.1] Sale of property (including a business) by a parent to a child is not considered a transfer in the ordinary course of operating a business.[245] Any other completed transfer that is reported, in its entirety, as not constituting a transfer by gift will be considered adequately disclosed only if a statement explaining why the transfer is not a gift has been made part of the return along with the information required for adequate disclosure of a transfer by gift as listed at subparagraphs XIV. E.1, 2, 3, and 4 below.[246]

C. Whether or not the transfer is reported on a gift tax return, the installment sale must be reported on the selling shareholder's and the trust's income tax returns to start the running of the statute of limitations. The statute will commence to run at the time the income tax return is filed. Absent fraud or a greater than 25% understatement, the assessment period generally expires three years after the income tax return is filed.

D. Assuming the sale of an asset was not intended to be a gift, or part sale and part gift, to a family member or to a trust for the seller's family and was made for full and adequate consideration, to obtain gift tax value certainty, it will be important to cause the commencement of the running of statute of limitations with respect to an IRS challenge of the valuation of the transferred property.

1. Per Section 6501, the assessment period generally expires three years after the transfer has been reported on a federal gift tax return. If the transfer is not reported on a federal gift tax return, the assessment period remains open. In effect, the IRS could then challenge the valuation of the transferred property at any time through the running of the statutory limitations period with respect to the transferor's estate; three (3) years after filing the transferor's federal estate tax return or six (6) years if the twenty-five percent (25%) in excess of the gross estate rule is violated.

E. For gifts made beginning in 1997, to have a transfer be treated as being reported on a gift tax return, Section 6501(c)(9) requires that the transfer be "disclosed in such return, or a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item." Under Treas. Reg. § 301.6501(c)-1, the adequate disclosure requirement is met only if the return provides a complete and accurate description of the transaction, including:

1. a description of the transferred property;

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[244] Section 2032A(e)(2) The term "member of the family " means with respect to any individual only:
(A) An ancestor of such individual;
(B) The spouse of such individual;
(C) A lineal descendant of such individual, of such individual's spouse. or a parent of such individual (a legally adopted child of such individual shall be treated as a child of such individual by blood); or
(D) The spouse of any lineal descendant described in subparagraph (C).

[244.1] Treas. Reg. § 301.6501(c)-1(f)(4).

[245] Preamble to TD 8845, 12/2/1999.

[246] Treas. Reg. § 301.6501(c)-1(f)(4).

2. the consideration, if any, received by the transferor;

3. the identity of, and relationship between, the transferor and each transferee;

4. a statement describing any position taken that is contrary to any proposed, temporary or Final Treasury regulations or revenue rulings published at the time of the transfer;

5. if the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

6. a detailed description of the method used to determine the fair market value of property transferred;

7. any restrictions on the transferred property that were considered in determining the fair market value of the property;

8. a description of any discounts or adjustments applied in valuing the property;

9. any financial data, such as balance sheets, utilized in the valuation process;

10. as an alternative to some of the foregoing requirements, appraisals utilized in the valuation process and a statement of the appraiser's qualifications.