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STARTING OFF ON THE RIGHT FOOT WHILE AVOIDING FOOT FAULTS-ISSUES AT THE FORMATION OF THE CLOSELY-HELD BUSINESS

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I. INTRODUCTION

A. SCOPE OF MATERIALS

These materials are intended as a primer on basic business tax issues most relevant at the formation of the closely-held enterprise. There are many other excellent, comprehensive resources to assist planners at the inception of the business. See, e.g., Dwight Drake, BUSINESS PLANNING: CLOSELY HELD ENTERPRISES (4th ed. 2013); Richard A. Shaw and Thomas J. Nichols, *Choice of Entity in Light of Recent and Proposed Tax Changes*, 68 NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION, Ch. 13 (2010); Richard A. Mann, Michael O'Sullivan, Larry Robbins, and Barry S. Roberts, *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773 (2004). Unlike these other sources, these materials focus on the federal income tax opportunities and traps applicable to each of the major business entity forms.

These materials do not address strategies applicable to all closely-held business interests. The installment payment of federal estate tax attributable to closely-held business interests under IRC §6166, for example, is not covered in these materials because this benefit applies to C corporations, S corporations, and entities taxed as partnerships. Instead, these materials focus on techniques that are unique to certain of the entity forms.

B. THE MENU OF CHOICES

Stated simply, a new business venture will take one of seven forms: (1) a sole proprietorship; (2) a general partnership; (3) a limited partnership; (4) a limited liability partnership; (5) a limited liability company; (6) an S corporation; and (7) a C corporation. The first form described above (sole proprietorship) is simply disregarded for federal tax purposes, so all items of income and deduction attributable to the business are added to the owner's other items of income and deduction on his or her (or their) Form 1040.

The next three forms (general partnership, limited partnership, limited liability partnership) are treated as partnerships for federal tax purposes, meaning they will subject to the marvelous complexities of Subchapter K. Any of these three forms is welcome to elect corporation status, but such elections for domestic entities are rare.

The fifth form, the limited liability company, will be treated as a sole proprietorship for federal tax purposes if it has only one owner; if it has multiple owners it will be treated as a partnership unless the owners elect to have the entity taxed as a corporation.

The last two forms, the corporations, have no choice. From a federal tax perspective, they are corporations and nothing else. Of course, an S corporation is a "pass-through" entity, meaning that the entity will generally not be liable for payment of federal income tax. The SA corporation's items of income, gain, loss, deduction, and credit pass to its shareholders in proportion to their ownership interests as if they derived such items themselves (though the character of any given item is determined at the entity level). Subsequent distributions of after-tax earnings from the S corporation are not again subject to tax as dividends. This is the major distinction between S corporations and C corporations. C corporations are

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separate taxable entities. Their taxable incomes are subject to a different progressive rate table, and distributions of after-tax earnings and profits are gross income to the recipient shareholders. Current law mitigates this "double tax" to some extent because dividends received from domestic corporations and certain foreign corporations are taxed at the same rate as net capital gains (*i.e.*, at zero percent, 15 percent, or 20 percent, though the latter two rates will be 3.8 percent higher where the IRC §1411 surcharge on net investment income applies). This preferential rate for "qualified dividend income" applies to dividends on common and preferred shares from both closely-held and publicly-traded corporations.

II. C CORPORATIONS

A. THE BASIC MECHANICS

1. Formation

From a tax perspective, forming a corporation is one of life's easier tasks. Generally, a taxpayer will not have to recognize gain on the transfer of property to a corporation solely in exchange for shares of the corporation's stock. IRC §351(a). Taxpayers will have to recognize any realized gain, however, if: (1) they receive property from the corporation in addition to the corporation's stock, IRC §351(b); (2) they do not own at least 80 percent of the corporation's stock, IRC §351(a); (3) they contribute services (rather than property) to the corporation, IRC §351(d); or (4) the amount of any indebtedness secured by the contributed property exceeds the taxpayer's adjusted basis in such property at the time of contribution, IRC §357(c).

EXAMPLE: Abbott and Costello each contribute a capital asset to a newly-formed corporation in exchange for 50 percent of the corporation's stock. Although neither of them owns 80 percent of the stock individually, all contemporaneous capital contributions are aggregated. Thus, neither will recognize the realized gain from the transaction because their transfers will be aggregated.

EXAMPLE: Suppose in the above example that Abbott transfers property worth $100,000 to the corporation in exchange for stock worth $80,000 and cash in the amount of $20,000. Abbott's basis in the contributed property was $70,000. Abbott must recognize $20,000 of his $30,000 realized gain from the exchange because in addition to receiving stock Abbott also received money. Under IRC §351(b) he must recognize his gain to the extent of the sum of any money and other property received.

If Abbott received $60,000 worth of stock and $40,000 of cash, however, Abbott's recognized gain from the exchange would be $30,000, the extent to which the total value of consideration received by Abbott ($100,000) exceeds the basis in the property exchanged ($70,000).

If a taxpayer enjoys non-recognition upon contribution, the basis of the shares received from the corporation is equal to the aggregate adjusted bases of the property transferred. IRC §358. Likewise, the corporation's basis in the contributed property is the same basis the contributing shareholder had in the property. IRC §362(a). If a taxpayer recognizes gain from the capital contribution, the taxpayer's basis in the acquired stock (and the corporation's basis in the contributed property) is generally its fair market value.

2. Operation

The C corporation is a separate taxable entity. It completes a Form 1120 to report its taxable income and pays tax at graduated rates ranging from 15 – 35 percent. IRC §11. The Unified Framework for Fixing Our Broken Tax Code, issued in September, 2017, proposed reducing the maximum tax rate on C corporation taxable income to 20 percent. C corporations are also subject to the alternative minimum tax (AMT), and may even be subject to additional "penalty taxes" where the corporate form is abused. These penalty taxes are discussed later in these materials.

3. Distributions

The signature feature of subchapter C is the double tax on corporate earnings. A corporate distribution will be included in the shareholder's gross income (currently subject to a maximum tax rate of 23.8 percent) to the extent the distribution represents the "earnings and profits" of the corporation. IRC §§301(c)(1); 316(a); 1(h)(11); 1411. Additional amounts in excess of the corporation's earnings and profits are presumed to be a return of the shareholder's contributed capital. IRC §301(c)(2). Consequently, the additional amounts received are tax-free to the extent of the shareholder's stock basis. If the shareholder's stock basis is used up and additional amounts still remain, the excess will be taxed as capital gain.

IRC §301(c)(3). If the corporation distributes property, the shareholder takes a fair market value basis in the property. IRC §301(d).

EXAMPLE: At a time when its earnings and profits totaled $70,000, a C corporation distributes $100,000 to one of its shareholders, Sharon. Sharon's stock basis at the time of distribution is $20,000. The first $70,000 of the distribution will be treated as a dividend, includible in Sharon's gross income but taxed at a preferential rate. The next $20,000 of the distribution will be treated as a return of capital to Sharon, meaning that portion will not be included in Sharon's gross income though it will serve to reduce her stock basis to zero. The final $10,000 of the distribution will be treated as capital gain to Sharon, includible in her gross income but taxed at a preferential rate.

If distributions of cash or property trigger the double tax, should distributions of the corporation's own stock also be taxable to the shareholder? In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Supreme Court held that pro rata stock distributions were not taxable to the shareholders. Taxpayers then pushed the envelope: they created elaborate classes of stock that could be converted into cash or property or the corporation's common stock at the demand of a shareholder. The Service objected to these elaborate classes of stock as disguised dividend distributions, and some courts agreed. Congress since cleared the air through a general rule proclaiming that stock distributions are tax-free. IRC §305(a). That general rule is subject to a number of exceptions, see IRC §305(b), but most proportionate stock distributions remain tax-free. If a shareholder receives stock tax-free, the shareholder must allocate his or her basis in the old shares among the old and new shares. IRC §307(a).

4. Liquidation

"Liquidation" refers to the dissolution or termination of the business entity. Under most state statutes, the assets of the entity are sold and the proceeds are used to pay off the entity's creditors. Any remaining proceeds are distributed proportionately to the owners. Instead of selling assets, liquidating entities may distribute assets to creditors and owners.

Unlike formation, corporate liquidation is rarely painless from a tax perspective. Since a double tax has not been imposed on such assets (or, in the case of a sale, the proceeds), liquidating distributions to shareholders are taxable. IRC §331. Similarly, the corporation recognizes gain and loss upon a liquidating distribution. IRC §336. If a subsidiary corporation liquidates, there is a potential for a triple tax: once to the liquidating subsidiary, again to the parent corporation upon its liquidation, and finally to the shareholders of the parent corporation. To mitigate the adverse consequences attendant with these general rules, most subsidiary corporations may liquidate on a tax-free basis. IRC §332.

B. PLANNING OPPORTUNITIES WITH C CORPORATIONS

1. Reduced Rate on Gain from Sale of Qualified Small Business Stock

In its original form, IRC §1202(a)(1) generally excluded half of the gain from the sale or exchange of qualified small business stock held for more than five years. The other half of such gain was subject to a preferential tax rate of 28 percent. IRC §§1(h)(1)(E); 1(h)(4); 1(h)(7). In effect, then, the entirety of such gain was taxed at a rate of 14 percent (half of the gain was taxed at 28 percent, half of the gain was not taxed at all).

COMMENT: Under IRC §57(a)(7), however, seven percent of the excluded IRC §1202 gain is an item of tax preference for purposes of the alternative minimum tax.

Under the American Recovery and Reinvestment Act of 2009, the exclusion increased to 75 percent of the gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before January 1, 2011. IRC §1202(a)(3). Where the special 75 percent exclusion applies, then, the effective rate of tax on the entire gain is only seven percent. The Creating Small Business Jobs Act of 2010, however, went one step further, increasing the exclusion to 100 percent for stock acquired on or after September 28, 2010. While introduced as a temporary measure, the 100-percent exclusion eventually became permanent.

EXAMPLE: Taylor realized $100,000 of gain from the sale of qualified small business stock. Taylor held the stock for more than five years. The amount Taylor may exclude from gross income depends on when Taylor *acquired* the stock, not the date of the sale. Specifically:

If the stock was acquired…	The portion of the $100,000 gain excluded is…

On or before Feb. 17, 2009	$50,000
After Feb. 17, 2009 but before Sep. 28, 2010	$75,000
On or after Sep. 27, 2010	$100,000

Only C corporation stock can claim this benefit. Specifically, "qualified small business stock" is any stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is a qualified small business. IRC §1202(c)(1). A "qualified small business" is one with aggregate gross assets of $50 million or less at all times after August 10, 1993, and before the time immediately after the stock's date of issuance. IRC §1202(d)(1). "Aggregate gross assets" is measured as the sum of cash plus the adjusted bases of all corporate assets (assuming that the basis of all contributed property is equal to its fair market value as of the date of contribution). IRC §1202(d)(2).

In addition to these requirements, the corporation must meet an "active business requirement" during substantially all of the shareholder's holding period in order for IRC §1202 to apply. IRC §1202(c)(2)(A). This requires that at least 80 percent of the value of the corporation's assets be used in the active conduct of a trade or business engaged in any activity *other than*: (1) professional services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or other business in which the principal asset is the reputation or skill of one or more of its employees; (2) banking, insurance, financing, leasing, investing, or similar business; (3) farming; (4) extraction or production of natural resources eligible for percentage depletion; or (5) operation of hotels, motels, restaurants, or similar businesses. IRC §1202(e).

Depending on the applicable percentage exclusion (based on when the stock was acquired), the benefit of IRC §1202 exclusion may be significant. If IRC §1202 does not apply but the client holds the stock for more than one year, the gain will be long-term capital gain subject to a preferential tax rate currently ranging from zero to 23.8 percent. In case of IRC §1202 stock acquired before February 17, 2009, the cost of losing the 14 percent rate applicable to IRC §1202 stock may not be very significant. To the extent a client can save much more than this additional tax amount by making a subchapter S election or otherwise operating the business in a more profitable or tax-savvy manner that sacrifices the IRC §1202 exclusion, a planner should not be afraid to recommend such action. Of course, where the seven percent (or zero percent) preferential tax rate applies, the comparative benefit of IRC §1202 is stronger; depending on the amount of gain at issue, foregoing pass-through taxation or similar strategies at formation might be desirable.

2. Like-Kind Exchange of Qualified Small Business Stock

One less heralded benefit of owning IRC §1202 stock is the ability to engage in a tax-deferred like-kind exchange under IRC §1045(a). As long as the selling shareholder purchases stock in another qualified small business within 60 days of the sale, he or she can elect to defer all non-recapture gain from the sale (provided the new stock costs at least as much as the amount realized from the sale of the old stock). The shareholder's basis in the new small business stock is reduced by the amount of gain deferred by the election. IRC §1045(b)(3).

EXAMPLE: Troy sells qualified small business stock in X Corporation with a basis of $13,000 to an unrelated buyer for $20,000. Within 60 days of this sale, Troy purchases qualified small business stock in Y Corporation from an unrelated seller for $20,000. Troy does not recognize any gain from the sale of the X Corporation shares but Troy's basis in the Y Corporation shares is $13,000 ($20,000 cost less $7,000 gain deferred from the sale of X Corporation stock). If Troy spends only $5,000 for the Y Corporation shares, Troy must recognize the $7,000 gain from the sale of X Corporation stock. Troy's basis in the Y Corporation shares would be $5,000.

3. Future S Election

If the C corporation qualifies as a small business corporation under IRC §1361(b), its shareholders may elect S corporation status to ameliorate the impact of the double tax on C corporation earnings. IRC §1362(a). The S election usually causes no immediate tax consequences to the corporation or the shareholders (but see IRC §1363(d) and discussion *infra*), although built-in gains on assets held by the C corporation at the time of its conversion to an S corporation may have to be recognized by the S corporation. IRC §1374. This is better than a conversion from C corporation to partnership because that requires a deemed liquidation of the corporation, a taxable event to the corporation and the shareholders. IRC §§ 331(a); 336(a).

The S election may have other benefits beyond avoiding the double tax. If the C corporation is unable to use the cash method of accounting (under IRC §448(b), a C corporation generally cannot use the cash method unless: (1) it is engaged in farming; (2) substantially all of its activities consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (3) its average annual gross receipts for the three prior taxable years does not exceed $5 million), conversion to S corporation status will permit the entity to use the cash method unless the S corporation is a "tax shelter." IRC §448(a). A tax shelter is any "syndicate" within the meaning of IRC §1256(e)(3)(B) or a "tax shelter" as defined in IRC §6662(d)(2)(C)(iii) (yes, a "tax shelter" means "a syndicate or a tax shelter"). IRC §§448(d)(3); 461(i)(3).

If the C corporation currently pays or may soon face liability for the personal holding company penalty tax in IRC §541, conversion to S corporation status will eliminate the penalty tax. IRC §1363(a).

COMMENT: A C corporation is a personal holding company if: (1) at least 60 percent of its "adjusted ordinary gross income" for the taxable year is "personal holding company income," and (2) at any time during the last half of the taxable year not more than five individuals own (directly or indirectly) more than 50 percent in value of the corporation's stock. IRC §542(a). Personal holding company income includes dividends, interest, royalties, annuities, rents, compensation for the use of corporate property by shareholders, and income from estates and trusts. IRC §543(a).

4. Other Chances to Minimize Double Taxation

Most C corporations can lessen the impact of the double tax by transferring earnings and profits into deductible payments of compensation, rent, or interest. While this is helpful to the corporation, it is worse for the shareholders, for these disguised distributions are ordinary income potentially subject to tax at rates far in excess of the preferential rate applicable to qualified dividend income. IRC §1(h)(11). One might expect that the competing interests of corporations and their shareholders might offset each other to the point that the Service might not care whether payments from corporations to shareholders are characterized as nondeductible (but tax-preferred) dividends or deductible (but fully taxable) forms of ordinary income. But these strategies are still effective in reducing the total tax bite to corporation and shareholder.

EXAMPLE: Adam owns all of the stock in *Corp*, a C corporation. *Corp* has taxable income in Year One of $100. Assuming *Corp* is taxed at the highest rate applicable to C corporations (35 percent), *Corp* will pay $35 in tax on this income, leaving $65 of after-tax earnings. If *Corp* distributes the $65 as a dividend to Adam in Year Two, *Corp* gets no deduction, but Adam will pay tax of only $13 on the dividend (20 percent), leaving *A* with $52 after tax. (For simplicity, this example uses a 20 percent rate for the qualified dividend income even though the applicable rate under current law is either 18.8 percent or 23.8 percent.)

If *Corp* makes no distribution but pays Adam a $65 salary in Year Two, *Corp* would get a $65 deduction for Year Two (saving *Corp* taxes of $22.75) but Adam would have to pay tax of $22.75 on the compensation (assuming Adam is in the 35 percent bracket), leaving Adam with $42.25 after tax. This is a worse result for Adam than the dividend distribution (treating the amount received from *Corp* as compensation reduces the after-tax amount by nearly $10) but a much better result for *Corp* (the compensation deduction saves $22.75 in tax). If Adam and *Corp* act in concert, they should collectively prefer the result of the salary payment instead of the dividend distribution because the benefit of the deduction to *Corp* exceeds the burden to Adam.

It should be noted that compensation paid to Adam will be subject to employment taxes, which increases the total tax burden to both Adam and *Corp*. Even if employment taxes are figured in, however, there may well be a preference for paying the after-tax earnings as compensation because of the deduction to the corporation.

5. Redemptions to Pay "Death Taxes"

If the estate tax value of the decedent's stock in a corporation (C or S) comprises more than 35 percent of what we might call the decedent's "adjusted gross estate," IRC §303(a) treats the redemption of an estate's interest in a closely-held corporation as a sale of the stock (even if the transaction would otherwise be treated as a distribution with respect to the stock under IRC §302) to the extent the redemption proceeds do not exceed the sum of all estate, inheritance, legacy, and succession taxes imposed by reason of death plus funeral and administrative expenses deductible under IRC §2053. The redemption must occur within the estate tax return's assessment period to qualify for this benefit. IRC §303(b)(1).

The statute does not use the term “adjusted gross estate.” It’s just shorthand for the base used by IRC §303(b)(2), namely the value of the gross estate less the amounts deductible under IRC §§2053 (administrative expenses) and 2054 (casualty losses during administration).

C. PLANNING CHALLENGES WITH C CORPORATIONS

1. Penalties on Excessive Retained Earnings

Congress worries that the shareholders of a closely-held corporation prefer for the corporation to accumulate and retain its net earnings instead of paying dividends. Distributions of after-tax earnings are taxable to the shareholders. But if the corporation retains its after-tax earnings, the value of the corporation’s stock increases without current taxation to the shareholders. The shareholders can thus defer the double tax on their shares of after-tax earnings until they either sell the stock (at an inflated price because of the retained surplus) or liquidate the corporation (at which point the retained earnings would finally be distributed). To thwart this deferral strategy, IRC §§531-537 impose an “accumulated earnings tax,” a surtax levied on retained earnings in excess of the reasonable needs of the business where such retention has the purpose of avoiding income tax to the shareholders.

Prior to 2003, dividends were taxed at a higher rate than net capital gain. In those days, shareholders had even more incentive to keep after-tax earnings inside the corporation and then sell the stock at an inflated price because of the retained earnings. Absent the accumulated earnings tax, the shareholders could achieve tax alchemy by converting ordinary income into net capital gain. Now that most dividend distributions are taxed at the same rate as net capital gains, part of the incentive to avoid dividend distributions is lost. But the accumulated earnings tax remains. Sure, shareholders would still benefit from deferral of the double tax if the accumulated earnings tax did not exist, but deferral alone is hardly a grave sin.

A corporation’s accumulated earnings tax is equal to 15 percent of its “accumulated taxable income.” IRC §531. The accumulated taxable income figure roughly represents the corporation’s undistributed taxable income (computed with some adjustments) in excess of amounts retained for the reasonable needs of the business. IRC §535(a). Note that the tax is imposed only with respect to the corporation’s earnings in a single taxable year. Those earnings are not again subject to tax in later years as they continue to be retained.

Accumulations of $250,000 or less are deemed to be retained for the reasonable needs of the business (in the case of a personal service corporation, i.e., one engaged in any of the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, where the owners provide the services, the threshold is reduced to $150,000). IRC §535(c)(2). So if a corporation’s retained earnings are within this threshold, there is no accumulated earnings tax exposure.

The tax is not self-assessed; rather it is a penalty imposed by the Internal Revenue Service. The Service initiates the issue by sending a notice to the corporation that all or part of a proposed notice of deficiency includes the accumulated earnings tax. At that point, the burden of proof shifts to the corporation to prove it is not liable for the tax. IRC §534.

In reviewing the financial statements for a client’s corporation, the planner should consider whether the corporation is vulnerable to the accumulated earnings tax. Annual retained earnings in excess of the applicable threshold described above should be a red flag. If there is exposure, the planner should consider any of a number of possible solutions, including: (1) paying higher salaries to the owners in order to reduce retained earnings in a deductible way; (2) documenting the corporation’s long-term capital-intensive plans that require accumulation of after-tax earnings; and (3) making a subchapter S election, if possible.

2. The Corporate Alternative Minimum Tax

Like individuals, C corporations are subject to the alternative minimum tax (AMT). The key to calculating a corporation's AMT liability is to determine its “alternative minimum taxable income” (AMTI). The starting point, no surprise, is the corporation’s regular taxable income. Certain adjustments to that figure are made under IRC §§56 and 58. For example, a corporation must recompute certain depreciation deductions by using the straight-line method of IRC §168(g)(2) rather than the usual accelerated cost recovery system allowed for regular tax purposes. IRC §56(a)(1)(A)(i). The taxable income figure is then further adjusted by the so-called "preference items" in IRC §57. For example, a corporation must increase taxable income by the amount of tax-exempt interest received on private activity bonds. IRC §57(a)(5)(A). For regular tax purposes, such interest is excluded from gross income under IRC §103.

The final major adjustment to taxable income is the "adjusted current earnings" (ACE) adjustment provided in IRC §§56(c)(1) and (g). The purpose of this adjustment is to reflect the corporation's true earnings for the taxable year. Once all adjustments have been made, a "tentative minimum tax" is computed by computing 20 percent of the corporation's AMTI as exceeds the exemption amount ($40,000). IRC §55(d)(2). The $40,000 exemption amount is reduced by 25 percent of the amount by which AMTI exceeds $150,000. IRC §55(d)(3). AMT liability arises to the extent tentative minimum tax liability exceeds the corporation's regular tax liability.

The corporate AMT is only a concern of very large corporations. Certain "small" C corporations are wholly exempt from the AMT. A C corporation with average annual gross receipts of $7.5 million or less for all three-year periods beginning after 1993 and ending before the current year is considered a "small" corporation and, as such, is deemed to have a tentative minimum tax liability of zero. IRC §55(e). For the corporation's first three-year period (or portion of a period), the limit is $5 million instead of $7.5 million.

Logically, most corporations subject to the AMT try to avoid it whenever possible. After all, the tax significantly increases the corporation's compliance and recordkeeping burdens, what with different depreciation schedules, different foreign tax credit carryovers, different net operating loss carryovers, and the like. But while AMT liability in any given taxable year means extra tax liability for the corporation, the corporation can reduce its *total* tax liability by *incurring* or increasing an AMT liability for the year.

EXAMPLE: X Corporation anticipates having a taxable income of $20 million and an AMTI of $40 million. X Corporation's regular tax liability for the year would be $7 million. Its tentative minimum tax for the year would be $8 million (20 percent of AMTI). Concerned that it would have to pay an AMT of $1 million (the excess of tentative minimum tax over regular tax liability), X Corporation decides to accelerate some income into the current year. Thus X Corporation quickly enters into a contract and ships goods to a customer at the end of the taxable year. The customer agreed to pay $5 million to the corporation for the goods.

Under the accrual method of accounting, X Corporation would recognize the income in the current taxable year. As a result of the last-minute income item, X Corporation's taxable income increases to $25 million (assuming it incurs no deductible expenses as a result of the sale). Its regular tax liability under IRC §11(b) therefore increases to $8.75 million. X Corporation's AMTI would also increase, reaching a total of $45 million. X Corporation's tentative minimum tax would therefore be $9 million. The sale has therefore decreased X Corporation's AMT liability to $250,000 (the excess of the new tentative minimum tax over the new regular tax liability figure).

But X Corporation is *worse* off than before. Without the sale, X Corporation's total tax burden is $8 million ($7 million of regular tax and $1 million of AMT). But with the sale, X Corporation pays total tax of $9 million ($8.75 million of regular tax plus $250,000 of AMT). X Corporation is better off having a higher AMT.

This example shows that a corporation facing AMT liability should not try to accelerate income or defer deductions solely with a focus of reducing AMT exposure.

3. Funding the Buy-Sell Agreement

Among other things, a buy-sell agreement provides for the purchase of a deceased shareholder's shares. Shareholders of a closely-held C corporation may prefer that the corporation redeem the shares of a retiring or deceased shareholder (a "redemption agreement"), as opposed to having the surviving shareholders to purchase the shares directly (a "cross-purchase agreement"). Using entity funds to purchase the stock offers centralized funding (together with increased certainty of funding, for it is easier to monitor the reserves of the corporation than to continually police the saving habits of the other shareholders). In addition, where insurance will be used to fund the purchase, the C corporation needs fewer pre-tax dollars to fund premium payments to the extent the corporation is in a lower tax bracket than the shareholders.

But a redemption agreement carries some risks when the business operates as a C corporation. *First*, payments to the retiring shareholder may be treated as dividends, and while the preferential tax rate applicable to qualified dividend income helps it does not substitute for the lack of stock basis that could be used to reduce the tax bite. *Second*, to the extent there is net buildup in the value of life insurance contracts funding the C corporation's payment obligation, there is increased risk of alternative minimum tax. IRC §56(g)(4)(B)(ii). *Third*, if the C corporation uses a sinking fund or similar reserve to save up for a future redemption, there is additional risk that the Service will assert liability for accumulated earnings tax. While the corporation should be successful in proving that an accumulation of earnings to fund a redemption agreement is a reasonable business need, the corporation still faces the hassle of having to make this showing. *Finally*, corporate-owned life insurance is an asset of the corporation that, in turn, drives up the estate tax value of the corporation's stock when a shareholder dies. See Treas. Reg. §§20.2031-2(f); 20.2042-1(c)(6). Together these risks may not outweigh the benefits of centralized funding, but they should be factored in to the decision of whether to use a redemption agreement.

III. S CORPORATIONS

A. THE BASIC MECHANICS

1. Formation

Unless a specific provision in subchapter S applies, the rules applicable to C corporations also apply to S corporations. IRC §1371. Because subchapter S is silent as to incorporation issues, the rules previously described for C corporations apply to S corporations. The only wrinkles upon formation of an S corporation pertain to the *eligibility* requirements to be an S corporation and the *timing* rules applicable to the subchapter S election.

a. Eligibility Rules

Not every corporation can elect to be treated as an S corporation. There are limits as to the number and types of shareholders that a corporation may have, although these limits are easily circumvented in most cases. There is also a limit as to the corporation's capital structure, a limit intended to ensure that the pass-thru of tax items remains relatively easy to administer.

As a threshold matter, **only domestic corporations** can elect to be treated as S corporations. IRC §1361(b)(1). A domestic corporation is any corporation organized in the United States or under the law of the United States or any particular state. IRC §7701(a)(4). A corporation organized in both the United States and a foreign country qualifies as a domestic corporation. Treas. Reg. §301.7701-5(a). See also PLR 9512001 (corporation organized in United States and in foreign country is eligible to make S election and will not be treated as having two classes of stock).

An S corporation can have **no more than 100 shareholders**. (From 1997 through 2004, there was a 75-shareholder limit.) With some exceptions, every person holding stock in an S corporation counts toward the 100-shareholder limitation. Rev. Rul. 59-187, 1959-1 C.B. 224. Spouses and their estates are treated as one shareholder for purposes of applying the limitation, IRC §1361(c)(1), regardless whether the spouses own shares jointly or separately or as community property. Furthermore, all "members of a family" are treated as one shareholder for purposes of the 100-shareholder limitation. IRC §1361(c)(1)(A)(ii). Members of a family are the common ancestor, the lineal descendants of the common ancestor (up to a maximum of six (!) generations), and the current *and former* spouses of the lineal descendants or the common ancestor. IRC §1361(c)(1)(B). This effectively eviscerates the 100-shareholder limitation. (The determination of whether there is more than six generations separating the common ancestor from the youngest generation of shareholders is made on the latest of: (1) the date the S election is made; (2) the first date on which the common ancestor or a lineal descendant (or spouse) owns stock in the S corporation; and (3) October 22, 2004 (the date of enactment for the American Jobs Creation Act of 2004).)

Very generally, subchapter S welcomes most individual shareholders (and their estates, see IRC §1361(b)(1)(B)) but exhibits hostility toward entity shareholders. A discussion of **trusts as shareholders** of S corporation stock appears later in these materials.

COMMENT: There is no limitation as to how long an estate may hold S corporation stock. This is not the case for testamentary trusts, which, as discussed *infra*, must distribute S corporation stock or otherwise qualify as a permissible S corporation shareholder within two years.

Most individuals are eligible S corporation shareholders. In Revenue Ruling 2004-50, 2004-1 C.B. 977, the Service ruled that a federally recognized Indian tribal government is not an eligible S corporation shareholder, meaning that the corporation in which the tribe owns shares cannot make a subchapter S election. The Service noted that only individuals and certain estates and trusts can hold S corporation shares under IRC §1361(b)(1). Since the Indian tribe is exempt from taxation under established authorities, and because the tribe is not subject to federal income tax as an individual under IRC §1, the Service determined that the tribe was not an "individual" for purposes of qualifying the corporation for election to subchapter S status.

A corporation cannot make an S election if it has a **nonresident alien** shareholder, IRC §1361(b)(1)(C), and if a nonresident alien individual becomes a shareholder in an S corporation, the corporation will lose its S election, IRC

§1362(d)(2)(A), and will generally be precluded from re-electing S status for five years. IRC §1362(g). A nonresident alien individual is an individual that is neither a citizen of the United States nor a resident of the United States. IRC §7701(b)(1)(B).

An individual is a resident of the United States if he or she meets either the "green card test" or the "substantial presence test." Both of these tests are objective; the intent of the individual and other such subjective measures (like domicile) are irrelevant. An individual meets the green card test if he or she is a lawful permanent resident of the United States at any time during the calendar year. IRC §7701(b)(1)(A)(i). An individual meets the substantial presence test if he or she is present in the United States on at least 31 days of the current year and at least 183 total days of the current and two preceding calendar years. IRC §§7701(b)(1)(A)(ii); 7701(b)(3)(A). Presence, for these purposes, is determined using a composite, weighted measure of the days of physical presence over a three-year period. All days in the current calendar year are added to one-third of the days in the first preceding calendar year and to one-sixth of the days in the second preceding calendar year.

EXAMPLE: Hamilton, neither a United States citizen nor one lawfully admitted for permanent residence in the United States, is present in the United States for 120 days in the current year. He was present in the United States for 120 days in each of the prior two years. Although that totals 360 days of presence over the three-year period, Hamilton does not meet the substantial presence test because under the weighted average approach there is only 180 days of presence:

Year	Days of Presence	Multiplier	Weighted Days
Current	120	1	120
Last Year	120	1/3	40
Year Before	120	1/6	20
		Weighted Average →	180 days

Hamilton is thus not an eligible S corporation shareholder.

If a current S corporation (or a C corporation or a partnership whose owners wish to make an S election) wants to invite a nonresident alien individual as an owner, the S corporation and the nonresident alien should form a partnership or other pass-thru entity for federal income tax purposes. This preserves the S election while permitting the nonresident to participate in the profits and losses of the enterprise. See Michael Schlesinger, S CORPORATIONS: TAX PLANNING AND ANALYSIS 12 (CCH 2000). Schlesinger notes that this structure would survive scrutiny under the partnership anti-abuse rules in Regulation §1.701-2 because the S corporation's shareholders are taxed on their shares of the S corporation's income while the nonresident alien is taxed on his or her share of the partnership's profits.

EXAMPLE: Adam and Beth each own 10 shares in an S Corporation. Evita, a nonresident alien individual, wants to join Adam and Beth as an equal stakeholder, and both of the existing owners want Evita involved in the business. To protect the corporation's S election, the corporation and Evita form a limited liability company to be taxed as a partnership for United States income tax purposes. The corporation contributes all of its business assets to the LLC in exchange for two-thirds of the membership interests in the LLC, while Evita makes proportionate contributions of cash and/or property in exchange for a one-third interest in the LLC. The LLC's operating agreement provides that all tax items shall be allocated according to the membership interests, meaning the S corporation is taxed on two-thirds of the LLC's taxable income and that Evita is taxed on one-third of the LLC's taxable income. The share allocable to the S corporation passes through in equal shares to Adam and Beth. This structure should accomplish the objectives of Adam, Beth, and Evita without sacrificing the S election.

COMMENT: In the above example, if the LLC distributes some of the assets contributed by Evita to the S corporation (or if the LLC distributes some of the assets contributed by the S corporation to Evita) within seven years of their transfer to the LLC, the parties may have to recognize gain under the disguised sale rules in subchapter K. See IRC §§ 704(c)(1)(B); 707; 737.

Planners in community property states need to pay special attention to the nonresident alien prohibition. For example, the non-employee spouse of a shareholder-employee may have a community property interest in any shares acquired by the employee as compensation. This would terminate the S election. Even if the shareholder-employee holds the S corporation shares as separate property, it may be possible for the non-employee spouse to acquire a community property interest in the shares to the extent the employee-shareholder otherwise receives inadequate compensation for the services he or she performs on behalf of the corporation. See William C. Staley, *S Corporations and Estate Planning*, at 6 (Glendale Estate Planning Council, Nov. 15, 2005).

Corporations, partnerships, limited liability companies, and other **business entities are not eligible shareholders** of S corporation stock. IRC §1361(b)(1)(B). Disregarded entities (such as single-member limited liability companies) are permissible shareholders if their owners are eligible S corporation shareholders. The Service will often ignore transitory ownership of S corporation stock by a partnership in the process of converting to an S corporation, even though there is no Code or regulation authority to forgive momentary ownership by an ineligible entity. See, e.g., PLRs 200237014, 200237011, 9010042, and 8934020.

Since 1998, organizations described in IRC §401(a) or IRC §501(c)(3) that are exempt from tax under IRC §501(a) can be S corporation shareholders. IRC §1361(c)(6). Translation? Employee stock ownership plans (ESOPs) and certain charitable organizations can hold S corporation stock. For eligible exempt organizations other than ESOPs, tax items from the S corporation pass through as unrelated business taxable income (UBTI). IRC §512(e).

An S corporation can only have **one class of stock**. IRC §1361(b)(1)(D). For this purpose, differences in voting rights among shares of common stock are disregarded. IRC §1361(c)(4). Estate planners like to see S corporations with voting and nonvoting shares, because nonvoting shares in a closely-held business make ideal assets for gifts and other wealth transfers from a discount planning perspective. An S corporation has a single class of stock if all shares have equal rights to distributions and liquidation proceeds. Treas. Reg. §1.1361-1(l)(1). Whether all shares have equal economic rights is determined with reference to what the regulations call the corporation's "governing provisions." Treas. Reg. §1.1361-1(l)(2)(i). These include the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements related to distributions and liquidation.

b. Election

All shareholders must consent to make a subchapter S election. IRC §1362(a). An election is effective for the taxable year following the year of election, except that an election made in the first two and a half months of a taxable year is effective as of the first day of the taxable year. IRC §1362(b). The Service will consider requests for relief from the effects of a late election. Unless a special situation applies, however, the corporation usually must request relief through a private letter ruling that will require payment of a user fee. See Rev. Proc. 2014-1, 2014-1 I.R.B. 1. The Service has identified a number of special situations:

• *A partnership, LLC, or other noncorporate eligible entity failed to timely file the Form 2553 and has not elected to be treated as a corporation.* If the entity can show reasonable cause for its failure to timely file the S corporation election (and the entity classification election on Form 8832), then requests for relief made within six months after the due date for the tax return for the first year the entity intended to be an S corporation will be honored and the entity will be given additional time to make the required elections. Rev. Proc. 2004-48, 2004-1 C.B. 172.

• *A corporation failed to timely file the Form 2553 but has reasonable cause for its failure to do so*. Requests for relief made within two years of the original due date for the S election will be considered by the Service provided either: (1) the corporation has not yet filed a return for the first year in which the election was intended and the request for relief comes within six months of the due date for that return; or (2) the corporation did file a return for the first year in which the election was intended and all of the shareholders have reported consistently with an S election on all of their affected returns for the year(s) in which the election was intended. Rev. Proc. 2003-43, 2003-1 C.B. 998.

• *The corporation filed a Form 1120S and, within six months, the Service did not notify the corporation or any shareholder of any problem with S corporation status*. If the shareholders reported their income consistent with S corporation status for the year(s) in which the S election was intended, then the corporation qualifies for automatic relief. Rev. Proc. 97-48, 1997-2 C.B. 521. To claim the relief, a completed Form 2553 must be filed with the words "FILED PURSUANT TO REV. PROC. 97-48" printed at the top of the Form.

2. Operation

In general, an S corporation will not pay income tax, since items of income, gain, loss, deduction, and credit pass through to the shareholders on a "per share" or "pro rata" basis. IRC §1366. Thus, if an S corporation has two equal shareholders, each must include one-half of the corporation's tax items on his or her own individual income tax return. The ultimate treatment of a tax item (as capital gain or ordinary income, for example) will depend upon the particular shareholder; consequently, some items pass through separately, while others are "netted" at the corporate level before passing through to the shareholders.

At the close of each taxable year, an S corporation shareholder's stock basis is adjusted to reflect both the shareholder's pro rata share of the S corporation's pass-through items and any distributions made during the year. IRC §1367(a). The adjustments to basis occur in this order (Treas. Reg. §1.1367-1(f)): (1) increase stock basis by the shareholder's share of income items; then (2) decrease stock basis by the amount of nontaxable distributions; then (3) decrease stock basis by the shareholder's share of noncapitalized, nondeductible expenses; then finally (4) decrease stock basis by the shareholder's share of loss and deduction items.

COMMENT: Examples of noncapital, nondeductible expenses include illegal bribes, fines, penalties, expenses related to tax-exempt income, disallowed losses under IRC §267, and the disallowed portion of meal and entertainment expenses under IRC §274.

The order is important since a shareholder may only deduct pass-through losses and deductions to the extent of the shareholder's basis in stock (and debt furnished by the corporation, if applicable). Losses and deductions in excess of a shareholder's basis carry over to the next taxable year. IRC §1366(d).

3. Distributions

The tax treatment of distributions from S corporations depends upon whether the S corporation has accumulated earnings and profits. Only C corporations can have "earnings and profits." IRC §312. Corporations that have always been S corporations do not have accumulated earnings and profits.

Distributions from "pure" S corporations (those that have never been C corporations) are tax-free to the extent of the shareholder's stock basis. IRC §1368(b)(1). Any distributions in excess of a shareholder's basis is treated as gain from the sale or exchange of property (i.e., as long-term capital gain if the stock has been held for more than one year, or short-term capital gain if the stock has been held for one year or less). IRC §1368(b)(2). Whether a shareholder has sufficient stock basis to absorb a distribution is tested at the end of the year, after all items of income and other increases to basis occur, but before any reductions to stock basis due to losses, deductions, and nondeductible expenses. Treas. Reg. §1.1367-1(f). This ordering rule maximizes the chances that any particular distribution will be tax-free. If an S corporation distributes appreciated property instead of cash, the distribution triggers gain to the corporation. IRC §§1371(a); 311(b). Like any gain, it passes through pro rata to the shareholders, with resulting increases to stock basis.

EXAMPLE: Cheryl, an S corporation shareholder, has a $30,000 basis in her stock. The corporation distributes $35,000 to her in the middle of the year. Cheryl's share of the corporation's gross income for the year is $10,000, and her share of the corporation's deductions is $50,000. Cheryl can exclude the entire distribution from gross income but will only be able to deduct $5,000 of the $50,000 share of corporation deductions. The excess $45,000 will carry over as deductions to the next taxable year. Cheryl may claim those deductions in that year if she has sufficient stock basis and/or debt basis.

Starting Basis	$30,000
+ Share of Income	$10,000
Basis for Distribution	$40,000
-- Distribution	(35,000)
Basis for Deductions	$5,000
-- Deductions	(50,000)
Ending Basis	0, plus $45,000 in suspended deductions

If an S corporation has accumulated earnings and profits, the distribution rules are slightly more complicated. A three-tier regime applies to such distributions. *First*, that portion of the distribution not in excess of the corporation's "accumulated adjustments account" ("AAA") is taxed under the rules applicable to distributions from S corporations without earnings and profits (i.e., tax-free to the extent of stock basis, with any excess treated as capital gain). IRC §1368(c)(1). If an S corporation makes more than one distribution during the taxable year, and if the total amount of such distributions exceeds the positive balance in the corporation's AAA, the AAA is allocated proportionately to all of the distributions. Treas. Reg. §1.1368-2(b).

Second, the remainder of the distribution is treated as a dividend to the extent of the corporation's accumulated earnings and profits. IRC §1368(c)(2).

Third, if the distribution exceeds accumulated earnings and profits, the balance is treated under the rules applicable to distributions from S corporations without earnings and profits. IRC §1368(c)(3).

The AAA is an entity-level account that begins at zero when the corporation's S election takes effect. Treas. Reg. §1.1368-2(a)(1). It is then adjusted upward and downward, generally by the same items that adjust a shareholder's basis under IRC §1367. IRC §1368(e)(1)(A); Treas. Reg. §§1.1368-2(a)(2), -2(a)(3). There are some differences, however, between the adjustments to the AAA and the adjustments to stock basis. For one thing, the AAA can go below zero. IRC §1368(e)(1)(A). And, importantly, no adjustment is made to the AAA for tax-exempt income or for expenses related to tax-exempt income. Thus, for example, death benefits received by an S corporation generally do not affect AAA even though the corporation has an increase in cash because the death benefits are excluded from gross income under IRC §101(a). Likewise, premium payments on life insurance policies should not affect AAA if the corporation will receive the death benefits on a tax-free basis.

Also, taxes paid by the corporation for years attributable to the corporation's period as a C corporation can adjust stock basis but such amounts do not affect the AAA. As these exceptions suggest, AAA is generally a reflection of the S corporation's items of income and deduction of tax consequence that have been passed through to the shareholders (in other words, perhaps, the corporation's previously taxed income).

Redemptions carry out a ratable share of the corporation's AAA if the redemption is treated as a sale or exchange under either IRC §302(a) or IRC §303(a). Treas. Reg. §1.1368-2(d)(1)(i). If the corporation makes both regular distributions and redemption distributions in the same taxable year, the AAA is adjusted first for ordinary distributions and then for any redemption distributions. Treas. Reg. §1.1368-2(d)(1)(ii).

Shareholders seeking to avoid the complexity of IRC §1368(c) may consider distributing the entire amount of the corporation's accumulated earnings and profits. This "purging" distribution permits future distributions to be tested under the simpler regime of IRC §1368(b). There are two ways to make a purging distribution. First, the corporation can elect to treat any distributions as coming first from accumulated earnings and profits and then from the AAA. Treas. Reg. §§1.1368-1(f)(1)(i); 1.1368-1(f)(2)(i). In effect, this election swaps the first two tiers of the three-tier regime. The practical effect of this election is that distributions are includible as dividends to the extent of earning and profits and *then* tax-free to the extent of stock basis. If one expects the preferential rates for qualified dividend income to expire in the near future, the election might be beneficial to the distributee-shareholders in the long term. At the same time, the election can be beneficial to the other shareholders.

The second way to make a purging distribution is for the corporation to elect a deemed dividend distribution. Under this approach, the corporation makes no actual distribution but the shareholders are taxed as though the corporation made a pro rata distribution of its accumulated earnings and profits at a time when its AAA is zero, followed by the shareholders' contribution of those same dollars back to the corporation, all on the last day of the taxable year. Treas. Reg. §§1.1368-1(f)(1)(ii); 1.1368-1(f)(3). This alternative keeps capital within the corporation's hands but may leave the shareholders without the dollars required to pay the tax associated with the deemed dividend.

4. Liquidation

The rules applicable to C corporation liquidations apply to S corporation liquidations. Thus, the corporation realizes gain and loss upon the distribution of assets to shareholders, and such gains and losses pass through to the shareholders like other income and deduction items. These gains and losses affect a shareholder's stock basis like other pass-through items.

B. PLANNING OPPORTUNITIES WITH S CORPORATIONS

1. Leverage the Purchase of Additional Shares

Normally, interest paid on debt incurred to purchase investment property ("investment interest") is deductible by the borrower only to the extent of his or her "net investment income." IRC §163(d)(1). This limitation does not apply to interest paid on debt incurred to purchase stock in an S corporation or a partnership. Instead, such interest is deemed to be paid on debt incurred to purchase the pass-through entity's inside assets. Reg. §1.163-8T. Accordingly, if all of the entity's assets are used in the conduct of a trade or business, the interest paid on debt incurred to buy stock in the S corporation or partnership will be considered business interest. That's good news because business interest is not subject to the same limitation applicable to investment interest (in other words, business interest is deductible without regard to the currently taxable income generated by the entity's business). IRC §§163(a); 163(h)(2)(A). So if the client is thinking about purchasing additional shares (or if the client wants to help another to purchase the client's shares in the S corporation), this benefit is worth keeping in mind when running the numbers.

2. The Employment Tax Loophole for Sole-Shareholder S Corporations

While all of the operating profits of a disregarded single-member LLC or sole proprietorship are subject to employment taxes, only the salary paid to the sole shareholder of an S corporation is considered "wages" subject to employment taxes. Rev. Rul. 73-361, 1971-2 C.B. 331. Operating income of an S corporation not distributed in the form of salary is not self-employment income. Rev. Rul. 59-221, 1959-1 C.B. 225. See also IRS Publication 533. As a result, sole shareholders of S corporations have an incentive to receive no salary from their S corporations and take all of their incomes in the form of distributions.

Of course, if an S corporation pays no salary to its sole shareholder-employee, the Service may recharacterize some portion of the corporation's distributions as wages for employment tax purposes. Rev. Rul. 74-44, 1974-1 C.B. 287. There are many cases in which the Service has been successful in converting a portion of S corporation distributions into wages for purposes of employment taxes. See, e.g., *Mike J. Graham Trucking, Inc. v. Commissioner,* T.C. Memo 2003-49, affd in unpublished opinion (3d Cir. 2004); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), affd in unpublished opinion (3d Cir. 2004). The taxpayers in both *Graham Trucking* and *VSC* argued that distributions from S corporations could not be treated as compensation because §530 of the Revenue Act of 1978 states that employment taxes do not apply if the S corporation has never treated the shareholder-employee as an employee for any period and if all filed returns are consistent with this assumption. The taxpayers conveniently forgot the language in §530 that says that employment tax relief does not apply if the corporation "had no reasonable basis for not treating such individual as an employee." The courts in both cases held that there was no precedent for treating the shareholder-employees as contractors or non-employees within their respective industries, and there were no audits of the corporations that upheld such treatment by the corporations. Accordingly, there was no basis for the corporations not to treat the taxpayers as employees, so some portion of the corporations' distributions must be treated as wages. See James A. Fellows and John F. Jewell, *S Corporations and Salary Payments to Shareholders: A Major Issue for the IRS,* 2006 THE CPA J. 46 (May 2006).

Still, it appears the Service is not exercising its recharacterization power as much as it could: over a decade ago, a report of the Treasury Inspector General for Tax Administration claimed that some 36,000 sole shareholder-employees received no salaries from their S corporations. Statement of J. Russell George, Inspector General, Treasury Inspector General for Tax Administration before the Senate Finance Committee (May 25, 2005), available at http://www.treas.gov/tigta/congress/congress_05252005. htm. See also Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (2005) at 426 (estimating that treating all net income from partnerships and S corporations as self-employment income could increase revenues by $57.4 billion over the nine-year period from 2006 to 2014); Tony Nitti, *S Corporation Shareholder Compensation: How Much is Enough?,* AICPA THE TAX ADVISER (August 1, 2011). The same report indicated that the percentage of S corporation profits paid to their sole shareholder-employees dropped from 47.1 percent in 1994 to 41.5 percent in 2001. To the extent sole proprietors and owners of disregarded entities have 100 percent of the business profits subject to employment taxes, there remains an advantage to keeping salaries modest and maximizing distributions from an S corporation.

The question becomes how much salary to pay to the sole shareholder-employee of an S corporation. The only defensible approach is for the S corporation to pay its shareholder-employee the same salary that he or she would require if the shareholder-employee were only an employee of the entity. See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41ST ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-3 (2006). Some clients may prefer the lemming approach: keep salaries to about 41 – 47 percent of the S corporation's net profits so as to be consistent with other S corporations, even if a non-shareholder-employee would insist upon a higher salary from the corporation. A planner should advise a shareholder of the risks of doing what others do as a defense to allegations of undercompensation.

3. Shift Built-in Gains to Your Low-Bracket (or Idiot) Co-Owners

When a shareholder contributes property with a value in excess of its adjusted basis to an S corporation, the corporation generally takes the contributing shareholder's basis in the property. IRC §362(a). When the S corporation subsequently sells the appreciated property, the gain from the sale, like any gain, is apportioned proportionately among the shareholders. The built-in gain is not allocated automatically to the contributing shareholder, which is not the case for a partnership. IRC §704(c)(1)(A). See discussion *infra* on partnerships. This provides contributing partners with an opportunity to shift gain to other, lower-bracket taxpayers without having to worry about the assignment of income doctrine.

EXAMPLE: *A* and *B* form an S corporation when *A* contributes inventory worth $100,000 (in which *A*'s basis is $10,000) and *B* contributes $100,000 cash. *A* and *B* are given equal shares in the corporation's single class of stock. If the corporation sells the inventory for $100,000 to an unrelated party, the corporation's $90,000 gain (ordinary income if the property is inventory in the hands of the corporation) will be allocated equally among *A* and *B*. Notice that $45,000 of the gain attributable to the period during which *A* held Blackacre is effectively shifted to *B*. If *B* is related to *A* and is in a lower tax bracket than *A*, this could be a beneficial result. Of course, *B* may not see it that way, so an "opportunity" for *A* is a "challenge" for *B*.

4. Manufacturing Basis to Claim Net Losses

An S corporation shareholder may deduct his or her proportionate share of the corporation's losses to the extent of the shareholder's stock basis and any basis in debt owed by the corporation to the shareholder. IRC §1366(d)(1). Losses in excess of these basis limitations are carried forward to subsequent taxable years, IRC §1366(d)(2), but time value of money considerations suggest we should do what we can to give the shareholder enough basis in the year the loss passes through to the shareholder.

If a client's share of an S corporation loss exceeds the client's stock basis and debt basis, the planner should explore techniques to give the client sufficient basis to claim the loss currently. A simple solution is for the client to make a loan or capital contribution to the S corporation, but the client may not have the dollars immediately available or may want to get basis now but pay later. It is not enough for the client to contribute a promise to pay to the corporation; there is no basis credit for the client's own note until actual payments are made on the note. But if the corporation has another shareholder, the client could consider giving a note to the other shareholder in exchange for some or all of the other shareholder's stock. Paying for stock with a note gives the client immediate stock basis that can be used to claim the loss flowing from the S corporation, while deferring the actual out-of-pocket cost to the client. See Jeanne E. Sullivan, *Structure and Techniques for S Corporations for 2007 and Beyond*, 31ST ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 11 (2007) at 61.

C. PLANNING CHALLENGES WITH S CORPORATIONS

1. Beware the Interests Given to Employees

If an employee of an S corporation owns more than two percent of the corporation's outstanding stock (or more than two percent of the total combined voting power of the corporation's stock) on any day of the taxable year, the employee is no longer eligible to receive "employee fringe benefits" on a tax-free basis. IRC §1372(a); Reg. §1.707-1(c). If the majority shareholder seeks to reward key employees with stock, it might have the unintended consequence of forfeiting some of these important benefits.

To be more precise, IRC §1372(a) states that so-called "2-percent shareholders" of an S corporation are to be treated as partners in a partnership for purposes of applying Code provisions related to employee fringe benefits. Regulation §1.707-1(c) treats fringe benefits paid to employee-partners as "guaranteed payments" because they are paid without regard to the partnership's income for services rendered. The same regulation states that a partner who receives guaranteed payments is not, by virtue of the payments, regarded as an employee of the partnership. Accordingly, the value of a fringe benefit "is not excludible from the partner's gross income under the general fringe benefit rules (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners) because the benefit is treated as a distributive share of partnership income … for purposes of all Code sections other than sections 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income." Rev. Rul. 91-26, 1991-1 C.B. 184. See also Albert B. Ellentuck, *S Corporation's Treatment of Employee-Shareholder Fringe Benefits*, THE TAX ADVISER (May 2003).

Examples of benefits not excludable by so-called "2-percent shareholders" are: (1) the cost of accident and health insurance plans under IRC §§105 and 106; (2) meals and lodging furnished on the business premises for the convenience of the employer under IRC §119; (3) the cost of group-term life insurance coverage under IRC § 79; and (4) cafeteria plans under IRC §125. When a 2-percent shareholder receives one of these taxable fringe benefits, it is to be treated as additional compensation subject to Federal withholding and employment taxes. Rev. Rul. 91-26, 1991-1 C.B. 184. That means the S corporation likely gets a deduction for the extra compensation, and this deduction will pass through to the shareholders *pro rata* like any other deduction item.

Not all fringe benefits excluded from the gross incomes of employees are lost; benefits that remain excludable include: (1) dependent care assistance under IRC §129 (IRC §129(e)(3) provides that the exclusion is available to self-employed individuals as well as employees; because partners in a partnership and 2-percent shareholders in an S corporation are deemed to be self-employed, as discussed *supra*, the exclusion is available to partners and 2-percent shareholders in an S corporation); (2) educational assistance programs under IRC §127, IRC §127(c)(2); and (3) several of the fringe benefits listed in IRC §132, including no-additional-cost services, qualified employee discounts, de minimis fringes, working condition fringes, and on-premises athletic facilities. Reg. §§1.132-1(b)(1); 1.132-1(b)(2)(ii); 1.132-1(b)(3); 1.132-1(b)(4).

2. Getting Basis Credit for Entity Debt

As mentioned above, S corporation shareholders need basis (either stock basis or debt basis) in order to claim their shares of the corporation's net losses. While partners in a partnership are entitled to basis credit for their shares of the partnership's debts, the same is not true for shareholders of an S corporation. It is not sufficient for a shareholder to guarantee the S corporation's debt in order to give the shareholder basis credit for the debt. (If the shareholder makes an actual payment on the guarantee, he or she gets basis credit for the amount paid.)

The preferred approach is for the lender to make the loan to the shareholder who then loans those proceeds to the S corporation. By structuring the loan arrangement in this fashion, the shareholder makes a loan to the corporation, which expressly entitles the shareholder to basis credit. In fact, as long as proper formalities are observed and the shareholder in fact assumes liability for servicing the debt, the refinancing of an entity debt into a shareholder debt can give the shareholder debt basis. See *Miller v. Commissioner*, T.C. Memo. 2006-125 (restructuring of corporation's line of credit under which shareholder assumed the debt gave shareholder basis credit to the extent of the shareholder's liability). As the *Miller* court observed, "The same result as a 'back to back' loan is reached where a shareholder substitutes his own note for the note of his S corporation on which he was a guarantor, thereby becoming the sole obligor on the new indebtedness. In such 'note substitution' scenarios, so long as the S corporation's indebtedness to the third-party lender is extinguished, so that the shareholder becomes the sole obligor to the lender, the shareholder's assumption of what was formerly the S corporation's legal burden serves as a constructive furnishing of funds to the S corporation for which the S corporation becomes indebted to repay to the shareholder."

It is worth noting that to the extent the shareholder incurs personal liability in order to have the loan structured in such a way as to give the shareholder basis credit for the debt, the shareholder bears a genuine risk that a direct loan to the corporation would not present. But since many loan arrangements with closely-held S corporations require personal guarantees from the shareholders already, structuring the loan to pass through the shareholder may not affect the shareholder's liability for repayment.

3. Debt as a Second Class of Stock

Speaking of debt, planners have to tread carefully here. Shareholder loans to an S corporation may be recharacterized as equity, which would give the S corporation an impermissible second class of stock. A loan to an S corporation will be treated as stock if the transaction constitutes equity under general principles of federal tax law or if the principal purpose of the transaction is to circumvent the single-class-of-stock or eligible-shareholder rules. Treas. Reg. §1.1361-1(l)(4)(ii)(A). To be safe, all loan arrangements from shareholders to S corporations should come within one of the three safe harbors outlined in the regulations: (1) short-term unwritten advances that never exceed $10,000 in the aggregate (Treas. Reg. §1.1361-1(l)(4)(ii)(B)(1)); (2) debts owed solely to the shareholders and in proportion to their stock holdings (Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2)); and (3) "straight debt." Straight debt is a written, unconditional obligation to pay a sum certain (on demand or on a specified due date) held by a United States citizen or resident, an estate, or an eligible trust shareholder and which does not provide for contingent interest (that is, interest computed or payable that is contingent on corporate profits, the borrower's discretion, the payment of dividends, or similar factors) and is not convertible to into stock. Treas. Reg. §1.1361-1(l)(5)(i).

The debt-as-second-class-of-stock problem can arise in situations planners may not expect. For example, if an S corporation redeems a portion of the shares of a retiring or deceased shareholder, the applicable buy-sell agreement usually permits the S corporation to pay the purchase price in installments. If the buy-sell agreement requires the S corporation to pay interest on the deferred payments, the obligation may create a second class of stock unless it qualifies under straight debt safe harbor. Planners should review the provisions of a buy-sell agreement involving S corporation stock to make sure this situation does not arise by accident.

4. The Perils of Former C Corporations

If an S corporation used to be a C corporation, the planner must proceed carefully. Three separate Code provisions come into play for former C corporations, although the last two are more significant because they continue to haunt the former C corporation for quite a while following the subchapter S election.

The first provision is IRC §1363(d), which forces a corporation using the LIFO method of inventory valuation to recapture as gross income the excess of the FIFO value of its inventory over the LIFO value of its inventory at the close of the corporation's last taxable year as a C corporation. The recapture amount is treated as gross income in such last taxable year, but the increase in tax caused by this recapture is payable in four equal annual installments without interest. Unless the planner is helping the business to elect S corporation status, the planner will likely not have to address this issue.

The second provision is IRC §1374, proof that the S election does not provide a perfect conduit for former C corporations. This provision imposes a tax on the disposition of "built-in gains." It is the S corporation that is liable for payment of this tax. The basic theme behind the IRC §1374 tax on built-in gains is that gains and losses attributable to taxable years prior to the S election should be taxed as though subchapter C still applied to the corporation.

EXAMPLE: *X* Corporation purchased raw land for $100 three years ago. Today, the land is worth $500, and *X* wants to sell the land to an unrelated purchaser. If *X* sells the land, *X* will be taxed on the $400 gain. If *X* then distributes the after-tax proceeds of the sale to its shareholders (as a dividend), the after-tax profit will be taxed again. The shareholders of *X* thus have an incentive to make the S election prior to the sale. If *X* makes an S election prior to the sale, the $400 gain will pass to the shareholders under IRC §1366, and subsequent distribution of the proceeds will be tax-free under IRC §1368. In effect, the election allows *X* to convert two levels of tax into one level of tax.

Congress reacted to this situation by enacting IRC §1374. Now, when the gain occurs during years in which the corporation was subject to two layers of tax, it is appropriate to tax that gain twice even though the entity is currently a valid S corporation.

The IRC §1374 tax applies to any "net recognized built-in gains" during each of the first several years following the former C corporation's subchapter S election (known as the "recognition period"). Until 2009, the recognition period was ten years. Legislation in 2009 shortened the recognition period to seven years for 2009 and 2010 only. IRC §1374(d)(7)(B). Under the Creating Small Business Jobs Act of 2010, the recognition period for taxable years beginning in 2011 was shortened to five years, and subsequent legislation later made this five-year period permanent.

The tax is computed by applying the highest rate under IRC §11 (now 35 percent) to the net recognized built-in gain for the taxable year or, if less, the corporation's taxable income for the taxable year. IRC §§1374(b)(1); 1374(d)(2)(A). The cumulative amount of net recognized built-in gains during the recognition period cannot exceed the corporation's "net unrealized built-in gain" as of the date of the S election. IRC §1374(c)(2). Note that the tax applies to any disposition that results in a recognized built-in gain, whether in the form of a sale or a distribution to the shareholders. IRC §§311(b); 1374(d)(3).

The tax imposed under IRC §1374 passes through to the S corporation's shareholders as a loss with the same character as the corresponding gain giving rise to the tax. IRC §1366(f)(2). This lessens the impact of the double tax to some extent.

There are several ways to avoid or lessen the burden of the IRC §1374 tax. Perhaps the most common solution is to wait out the recognition period: the tax does not apply to dispositions of built-in gain property that occur after the recognition period expires. The tax can be deferred if the corporation effects a like-kind exchange of the built-in gain property under IRC §1031, although the IRC §1374 taint is preserved in the asset(s) received in the like-kind exchange. IRC §1374(d)(6). Regulations provide that if an S corporation acquires some asset before or during the recognition period with a principal purpose of reducing or eliminating the IRC §1374 tax (because the asset will generate a loss, deduction, or credit that can be used to reduce the corporation's taxable income below the amount of net recognized built-in gain), such loss, deduction or credit shall be ignored for purposes of computing the IRC §1374 tax. Treas. Reg. §1.1374-9. Finally, one could consider a charitable contribution of the built-in gain property. The S corporation does not recognize gain upon making the gift to charity (so the IRC §1374 tax cannot apply), and the deduction flows through to the shareholders. The shareholders reduce their stock bases by their shares of the corporation's adjusted basis in the contributed property, which insures that the lurking gain is not later taxed upon sale of the shares or liquidation of the corporation. IRC §1367(a).

The third provision is IRC §1375, which imposes a penalty tax at the entity level when two conditions exist: (1) an S corporation has "accumulated earnings and profits" (which by definition only applies if the S corporation was formerly a C corporation), and (2) the S corporation's "passive investment income" exceeds 25 percent of its total gross receipts. If the IRC §1375 tax is imposed for three consecutive years, the corporation will face the "death penalty": its S election is terminated and the corporation will revert to C corporation status. IRC §1362(d)(3).

Why the concern with the amount of passive income generated by a corporation? One treatise explains the policy of these rules as follows:

> These statutory measures restrict attempts to use S corporations as incorporated pocketbooks for their shareholders by investing the corporations' retained earnings in marketable securities and other passive investments of a type that the shareholders would have purchased had the earnings been paid out as dividends. This ploy is particularly likely to happen when the C corporation has liquidated its business assets. The passive-investment-income limitation can also be viewed as a rough-and-ready offset to the fact that a C corporation can be converted to S status without subjecting its accumulated earnings to tax at the shareholder level as if the earnings were distributed in a quasi-liquidation.

Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (7th student ed. 2000) at 6-19. Basically, Congress wants to limit the benefits of subchapter S to corporations engaged in active businesses.

The mechanics of the IRC §1375 tax are relatively simple. The corporation's "excess net passive income" is multiplied by the highest rate of tax under IRC §11 (currently 35 percent). IRC §1375(a). Excess net passive income is computed under the formula below.

$$\frac{\textbf{(PII)} - \textbf{(25\% of GR)}}{\textbf{(PII)}} \times \textbf{(NPI)} = \textbf{Excess Net Passive Income}$$

PII = **passive investment income** (royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of securities). See IRC §§1362(d)(3)(C)(i); 1375(b)(3).
GR = **gross receipts** (the total amount received or accrued under the corporation's accounting method). See Treas. Reg. §1.1362-2(c)(4)(i).
NPI = **net passive income** (passive investment income less those deduction directly connected with the production of passive investment income other than net operating loss carryovers and dividends-received deductions). See IRC §1375(b)(2).

The corporate-level taxes are coordinated because built-in gains and losses are taken out of the definition of passive investment income. IRC §1375(b)(4). Instead of passing through as a loss, the amount of IRC §1375 tax serves to reduce the amount of each item of passive investment income passing through to the shareholders. IRC §1366(f)(3).

There are some planning suggestions for minimizing exposure to the IRC §1375 tax. If the corporation had relatively little earnings and profits at the time of the S election, it may be advisable to distribute the subchapter C earnings and profits to the shareholders, especially since those earnings will be taxed at preferential tax rates to the shareholders in the hopes of avoiding a 35 percent tax imposed on the corporation. IRC §1368(e)(3) permits the shareholders to declare that distributions come first from subchapter C earnings and profits and then from subchapter S earnings (the accumulated adjustments account), although the default distribution rules apply the opposite assumption. Once the subchapter C earnings and profits are gone, the IRC §1375 tax (and the risk of the death penalty under IRC §1362(d)(3)) cannot apply. Alternatively, the shareholders can try their very best to manage gross receipts so that the amount of passive income does not cross the 25 percent threshold.

5. Beware Trusts Holding S Corporation Stock

Only certain domestic trusts qualify as S corporation shareholders. If S corporation falls into the hands of an "ineligible" shareholder, the S election is lost and the corporation becomes a C corporation unable to elect S corporation status for five years unless it successfully obtains discretionary relief from an inadvertent termination of the S election. Although many trusts qualify as eligible shareholders of S corporation stock, some common trust arrangements do not qualify. For instance, a charitable remainder trust is not an eligible shareholder of S corporation stock. Planners should therefore not advise clients to fund charitable remainder trusts with S corporation stock because doing so would sacrifice the S election.

Generally there are five kinds of trusts that qualify as S corporation shareholders.

The first is the **qualified subchapter S trust**, or QSST. IRC §1361(d). Among other things, a QSST must be a domestic trust. See IRC §§7701(a)(30)(E); 7701(a)(31)(B). Under these rules, a trust is a domestic trust only if: (a) a court within the United States has primary supervision over the administration of the trust, and (b) one or more United States fiduciaries control all substantial decisions of the trust. The regulations give some examples of the "substantial decisions" related to a trust that a fiduciary may have. Treas. Reg. §301.7701-7(d)(1)(ii). These include, among others: (1) whether and when to make distributions of income and principal; (2) the amount of distributions; (3) whether a receipt is allocated to income or principal; (4) the selection of a beneficiary; and (5) whether to appoint a successor trustee to succeed another trustee that is unable or willing to serve or continue to serve.

Further, the QSST may have only one income beneficiary during that beneficiary's life (unless each beneficiary has a separate share of the trust, see IRC §663(c)) who is a United States citizen or resident. Spouses are treated as one current income beneficiary if they file jointly and each is a United States citizen or resident. The trust instrument must require that all income be distributed currently (or such income must in fact be paid at least annually to the current income beneficiary). A QSST may permit distributions of principal only to the current income beneficiary during his or her life. No one else may be entitled to distributions of income or principal during the trust term, and no payments can be made from the trust that discharge someone else's obligation to support the current income beneficiary. The trust instrument must provide that the current income beneficiary's income interest terminates at his or her death or, if earlier, upon expiration of a fixed term. If a QSST terminates during the current income beneficiary's life, all assets must be distributed to him or her.

To become a QSST, the current income beneficiary must make a QSST election. If the corporation loses its S election solely because the current income beneficiary of an otherwise valid QSST fails to make a QSST election, the S election may be preserved if a QSST election is filed within two years of its original due date. See Rev. Proc. 2003-43, 2003-1 C.B. 998.

In the case of a trust owning shares in a C corporation that becomes an S corporation, the QSST election is made on Part III of the Form 2553, Election by a Small Business Corporation. If the corporation's S election is already in effect when the trust receives the shares, the QSST election is made by signing and filing a statement with the service center where the corporation files its income tax return. Treas. Reg. §1.1361-1(j)(6)(ii). The statement must: contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation; identify the election as one made under IRC §1361(d)(2); specify the date on which the election is to become effective (cannot be more than 2 months and 15 days before the date the election is filed); specify the date(s) on which stock was transferred to the trust; and provide all information required to prove that the trust meets the requirements of a QSST.

The current income beneficiary reports all S corporation items attributable to the stock held by the QSST on his or her personal tax return. If the trust sells the S corporation stock, gain or loss is recognized by the trust (although the sale is considered to have been made by the current income beneficiary for purposes of the at-risk rules in IRC §465 and the passive loss rules in IRC §469). See IRC §1361(d)(1)(C).

For purposes of the 100-shareholder limitation, the current income beneficiary is treated as the shareholder of the stock. IRC §1361(c)(2)(B)(i).

The second is the **electing small business trust**, or ESBT. See IRC §1361(e). A trust can qualify as an ESBT if it has only individuals, estates, and/or qualified exempt organizations (any organization described in IRC §170(c)(2) – (5) is a qualified exempt organization, as is any IRC §170(c)(1) organization that holds a contingent interest and is not a potential current beneficiary) as present, remainder, or reversionary beneficiaries. A person who may take under the exercise of a power of appointment is not considered a beneficiary of the trust for this purpose unless such power is actually exercised in that person's favor.

A trust cannot qualify as an ESBT if any person has acquired an interest in the trust by purchase. A purchase includes any transaction in which the basis of the acquired property is its cost. IRC §1361(e)(1)(C). In addition, each "potential current beneficiary" of the trust must be an eligible shareholder of S corporation stock if the trust is to qualify as an ESBT. A potential current beneficiary is one entitled to (or who may currently) receive distributions of income or principal from the trust. IRC §1361(e)(2). The trust cannot be a charitable remainder trust or otherwise exempt from federal income tax.

An eligible trust becomes an ESBT when the trustee(s) with authority to legally bind the trust sign and file an election statement with the service center where the corporation files its income tax return. Treas. Reg. §1.1361-1(m)(2)(i). The statement must include: the name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the corporation; a statement that an ESBT election pursuant to IRC §1361(e)(3) is being made; the date when the trust first owned stock in the corporation; the date the election is to take effect (cannot be more than 2 months and 15 days before the date the election is filed); and representations that the trust meets all of the requirements of an ESBT and that all potential current beneficiaries are eligible shareholders of S corporation stock.

While the requirements for an ESBT are easier to meet than the requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself must pay a flat tax equal to the highest rate applicable to trusts and estates under IRC §1(e) (currently 39.6 percent) on the trust's taxable income attributable to the S corporation items, the exemption amount for alternative minimum tax purposes is reduced to zero, and no capital loss carryovers are permitted. IRC §641(c). The trust continues to pay tax at the slightly progressive rates of IRC §1(e) on income attributable to other assets.

For purposes of the 100-shareholder limitation, each potential current beneficiary is counted as a shareholder. IRC §1361(c)(2)(B)(v). During any period that there is no potential current beneficiary of an ESBT, the trust itself is treated as the shareholder for purposes of applying the 100-shareholder limitation.

In computing an ESBT's income attributable to the S corporation, the only items taken into account are: (1) the trust's shares of the S corporation's item of income, gain, loss, deduction, and credit; (2) gain or loss from the trust's sale of the S corporation stock; (3) state or local income taxes and administrative expenses allocable to the S corporation stock; and (4) interest paid or accrued on debt used to acquire stock in the S corporation. IRC §641(c)(2)(C).

The third kind of trust eligible to be an S corporation shareholder is a good, old-fashioned **grantor trust**. IRC §1361(c)(2)(A)(i). A grantor trust is any trust that is deemed to be owned by the grantor or another person under any of IRC §§671-678. For more on the use of grantor trusts in estate planning, see (ahem) Samuel A. Donaldson, *Understanding Grantor Trusts*, *in* 40 HECKERLING INSTITUTE ON ESTATE PLANNING 2-1 (Tina Portuando ed., 2006).

A grantor trust is effectively disregarded for federal income tax purposes because all of the trust's tax items are reported by the deemed owner. Accordingly, if the deemed owner is an eligible shareholder of S corporation stock, transfers of S corporation stock to a grantor trust will not jeopardize the company's S election. For purposes of the 100-shareholder limitation, the deemed owner is counted as the shareholder. IRC §1361(c)(2)(B)(i). This is true even where the trust contains *Crummey* powers that give the beneficiaries a power to withdraw some or all of the amounts contributed to the trust so that a gift of S corporation stock to the trust qualifies for the federal gift tax annual exclusion. See, e.g., PLR 200732010 (grantor trust with *Crummey* powers is an eligible shareholder of S corporation stock because the grantor's ownership of the trust under IRC §674 trumped the beneficiaries' ownership of the trust under IRC §678(a).

The fourth kind of eligible trust is a **former grantor trust**. IRC §1361(c)(2)(A)(ii). As its name implies, a former grantor trust is a trust that was a grantor trust (with a United States citizen or resident as the deemed owner) immediately before the deemed owner's death and that continues after such death. Although the trust is no longer a grantor trust because of the deemed owner's demise, the trust itself remains an eligible S corporation shareholder regardless of its dispositive scheme until the day before the second anniversary of the deemed owners death. After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. The estate of the deemed owner is counted as the shareholder for purposes of the 100-shareholder limitation. If no one is the deemed owner of the trust, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock.

The final kind of eligible trust is a **testamentary trust**. All testamentary trusts are permitted S corporation shareholders for a two-year period beginning on the date the stock is transferred to the trust. IRC §1361(c)(2)(A)(iii). After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. During the two-year grace period, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock if no one is the deemed owner of the trust. The testator is treated as the shareholder for purposes of applying the 100-shareholder limitation.

IV. PARTNERSHIPS

A. THE BASIC MECHANICS

1. Formation

Like a corporation, formation of a partnership is also a painless event. A partner will not recognize gain or loss upon a transfer to the partnership in exchange for an interest unless the contribution consists of services. IRC §721. Note that a partner does not need to be an 80-percent owner to achieve non-recognition, as does the shareholder of a corporation. To preserve any gain or loss not recognized, the partner's basis in the partnership interest equals the sum of the bases of the properties transferred to the partnership in exchange for the interest. IRC §722. The partnership also takes a carry-over basis in the property received from the partner. IRC §723.

In the active business context, the only significant risk of gain recognition at the formation of an entity taxed as a partnership occurs when a partner contributes property with debt in excess of the contributing partner's basis. Under IRC §752(b), the contributing partner is deemed to receive a cash distribution in an amount equal to any reduction in the partner's share of partnership liabilities. As explained herein, cash distributions from a partnership are taxable to the extent they exceed a partner's basis in the partnership interest.

EXAMPLE: Angelica and Eliza form a general partnership. Angelica contributes $50,000 cash and Eliza contributes land worth $90,000 that secures a $40,000 recourse mortgage. Eliza's basis in the land at contribution was $5,000. On these facts, Eliza is deemed to receive a $20,000 distribution from the partnership. Because the deemed cash distribution exceeds Eliza's basis in her partnership interest ($5,000, Eliza's basis in the contributed land), Eliza will recognize a $15,000 gain from the contribution. Eliza can avoid this result if the partners agree to form a limited partnership of which Eliza will be the sole general partner. If that is not satisfactory to Angelica and Eliza, Eliza can explore other options to reduce or eliminate the gain.

2. Operation

The tax items of a partnership pass through to the partners. IRC §§701; 702. Unlike an S corporation, however, the partners of a partnership are generally free to allocate these tax items among the partners as they wish, so long as these allocations have "substantial economic effect." IRC §704(b). Thus, equal partners in a partnership may agree to allocate all losses to one partner and all tax-exempt income to the other partner, so long as the allocations have "substantial economic effect." The flexible tax allocations make the partnership a more attractive business vehicle to most business owners.

Allocations have "economic effect" if the partnership agreement requires, for the full term of the partnership, that: (1) capital accounts be created and maintained in the manner set forth in the regulations (see Treas. Reg. §1.704-1(b)(2)(iv)); (2) liquidating distributions be made in accordance with the partners' positive capital account balances; and (3) any partner with a deficit balance in his or her capital account following liquidation of the partnership be unconditionally obligated to restore the amount of the deficit (see Treas. Reg. §1.704-1(b)(2)(ii)(b)). A partner's capital account balance is the amount he or she would be entitled to receive upon liquidation of the partnership. A capital account is increased by the net value of any contributed cash or property and the partner's share of partnership income items. It is decreased by the value of any distributions to the partner and the partner's share of partnership loss and deduction items

If the partnership agreement complies with the first two requirements but does not comply with the third requirement, the allocation can still have economic effect under an alternate test. See Treas. Reg. §1.704-1(b)(2)(ii)(d). Assuming the economic effect test is met, an allocation will be respected if it is **substantial**. While various standards for substantiality are provided in the regulations—a general rule as well as a rule for shifting and transitory allocations—the focus is whether the allocation will affect substantially the dollar amounts to be received by the partners from the partnership. See Treas. Reg. §1.704-1(b)(2)(iii).

3. Distributions

As one would expect, distributions from a partnership are generally tax-free since the partners have already taken the partnership's tax items into account on their own income tax returns. No gain is recognized upon a distribution to a partner except to the extent the amount of cash distributed exceeds the partner's outside basis immediately before the distribution. IRC §731(a)(1). No gain or loss is recognized by the partnership. IRC §731(b). If a partner receives cash or property regardless of the partnership's profitability, however, the distribution may constitute a "guaranteed payment" that will be treated as compensation income. IRC §707. Further discussion of the partnership distribution rules appears later in these materials.

4. Liquidation

The basis of property (other than money) distributed to a partner in liquidation of the partner's interest in the partnership is an amount equal to the partner's basis in the partnership interest reduced by any money distributed in the same transaction. IRC §732(b). Liquidation of a partner's interest is defined as the termination of the partner's entire interest in the partnership by means of a distribution or series of distributions. See IRC §761(d). Loss is not recognized by a partner upon a distribution *except* that loss *is* recognized on a distribution in liquidation of a partner's interest where no property other than cash, unrealized receivables, and inventory items are received by the partner. IRC §731(a)(2). The amount of the loss (which is considered to be loss from the sale or exchange of the partnership interest) is equal to the excess of the partner's basis in the partnership interest over the sum of the cash distributed to the partner and the adjusted basis of the distributed property under IRC §732.

B. PLANNING OPPORTUNITIES WITH PARTNERSHIPS

1. The IRC §754 Election and the Adjustment to Inside Basis

If the partnership makes an election under IRC §754, the partnership's basis in its assets ("inside basis") will be adjusted, but only with respect to the transferee partner. Specifically, the entity will increase its inside basis by the excess of the transferee partner's outside basis (freshly stepped-up under IRC §1014, remember) over his or her share of the partnership's inside basis. Alternatively, if the transferee partner's outside basis was stepped-*down* under IRC §1014, the entity will reduce its inside basis by the excess of the transferee partner's share of inside basis over his or her outside basis. This adjustment to inside basis affects not just the allocation of gain and loss to the transferee partner upon a disposition of a partnership asset. It determines the partner's share of inside basis for purposes of depreciation deductions and distributions, as well.

Notice that if the estate planner succeeds in claiming a significant valuation discount for the value of the partnership interest included in the deceased partner's gross estate, there is an adverse effect on the adjustment to inside basis (though usually not to such an extent that the valuation discounts have no net value).

EXAMPLE: Mom dies holding a five percent general partner interest and a 20 percent limited partner interest in a partnership. The partnership's assets have a combined liquidation value of $1,000,000 and an aggregate inside basis of $200,000. Mom's estate values the five percent general partner interest at $40,000 (assuming a 20 percent blended valuation discount against the $50,000 liquidation value attributable to the general partner interest) and it values the 20 percent limited partner interest at $120,000 (assuming a 40 percent blended valuation discount against the $200,000 liquidation value attributable to the limited partner interest). Both interests pass to Son. Son's aggregate outside basis is $160,000, the sum of the date-of-death values of the general and limited partner interests included in Mom's gross estate.

If the partnership has a valid IRC §754 election in effect, the $50,000 of aggregate inside basis (that portion of the inside basis attributable to Mom's interests) is increased to $160,000, *not* to its $250,000 liquidation value. Thus, while the IRC §754 election eliminates the disparity between inside and outside bases with respect to Son, the election does not completely eliminate the inherent gain attributable to the interests now held by Son; if the partnership sells all of its assets, $90,000 of gain will be allocable to Son. Of course, this beats the $200,000 gain that would have been allocable to Son had no IRC §754 election been made. And the estate tax savings from an aggregate $90,000 discount might well exceed the income tax burden from $90,000 of extra gain. But it shows that the higher the discount, the less beneficial the IRC §754 election becomes to the decedent's successor in interest.

Note that if the deceased partner's surviving spouse is also a partner in the partnership, and if the spouses owned their interests as community property, the surviving spouse's interest in the partnership also triggers an adjustment to inside basis if the IRC §754 election is in effect.

2. S Corporation Election

Unincorporated domestic entities (like partnerships) can elect to be treated as corporations for federal tax purposes. Treas. Reg. §301.7701-3. Any such organization that elects status as a corporation can also elect to be taxed as an S corporation. See, e.g., Priv. Ltr. Rul. 199942017. To the extent a partnership wants to avail itself of the benefits of S corporation status, the partners can simply make this two-step election to achieve the desired status.

The key obstacle, of course, is that an electing unincorporated entity must meet the eligibility requirements of an S corporation in order for the S election to become effective. The entity, for example, cannot have more than 100 owners and no owner may be a nonresident alien individual. See IRC §1361(b)(1)(A), (b)(1)(C). These are easy enough to spot, but the "single-class-of-stock" requirement for S corporations under IRC §1361(b)(1)(D) can be harder to police. The Service will not issue rulings as to whether a limited partnership qualifies as a small business corporation eligible to elect S corporation status. Rev. Proc. 2017-3, §3.01(95). No doubt this is because the varying rights and obligations of general and limited partners may well constitute a second class of stock. See Rev. Proc. 99-51, 1999-2 C.B. 760. We know that a limited partnership agreement does not create a second class of stock as long as distributions to the partners are to be made in accordance with the partners' respective cumulative interests. See, e.g., Priv. Ltr. Ruls. 200326023, 200326024, and 200326025. In the last of these private rulings, the shareholders of an S corporation (S1) formed a limited liability partnership (LLP) that made a double-election to be treated as an S corporation. The shareholders then contributed their S1 stock to LLP and S1 elected to be treated as a qualified subchapter S subsidiary corporation (or "Q-Sub"). LLP then created a wholly-owned limited liability company (LLC) that is disregarded for federal tax purposes as an unincorporated organization with only one owner. LLP transferred some of its S1 stock to LLC. Because LLC is disregarded, S1's Q-Sub election is not lost. S1 then converted to a limited partnership, with LLC as the general partner and LLP as the limited partner. As a limited partnership, S1 made a triple-election (electing to be a corporation, an S corporation, and a Q-Sub). At the end of the day, then, the shareholders owned all of the interests in LLP (an S corporation for tax purposes) which in turn held all of the limited partner interests (and, through a disregarded entity, all of the general partner interests) in a limited partnership (a Q-Sub for tax purposes). The Service approved this transaction in the ruling.

If the partnership agreement requires distributions in accordance with positive capital account balances and such capital accounts are not in proportion to the partners' percentage interests, however, the partnership likely has more than one class of stock, making the S election unavailable. See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41ST Annual Southern Federal Tax Institute Materials at J-7 (2006). Disproportionate operating distributions from the partnership should not create a second class of stock provided the entity makes corrective distributions to make distributions proportionate. See, e.g., Priv. Ltr. Rul. 200524020.

3. Allocating Items in the Year of a Partner's Death

Upon the death of a partner, IRC §706(c)(2)(A) provides that the taxable year of the partnership closes with respect to the deceased partner. The deceased partner's final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a *pro rata* allocation based on the number of days in each period. Treas. Reg. § 1.706-1(c)(2)(ii).

EXAMPLE: *A*, *B*, and *C* are equal general and limited partners in a partnership. *A* dies on July 1, Year One. The partnership's income for Year One consists of two gains: a $900 gain in March and a $300 gain in November. If the partnership makes an election to close its books on July 1, the proportionate shares of the partners would be as follows:

Partner	March Gain Share	November Gain Share
A	$300	zero
B	$300	$150
C	$300	$150

If, on the other hand, the partnership does not close its books, the proportionate shares of the partners for Year One would be as follows:

Partner	March Gain Share	November Gain Share
A	$150	$50
B	$375	$125
C	$375	$125

In this example, *B* and *C* are inclined to close the books, for their proportionate shares under a closing of the books ($450) is less than their shares if no such election is made ($500). Of course, if the November gain were larger than the March gain, the incentive would be the opposite.

The point is that the fiduciary and the surviving partners should work together to determine which approach is better. The same is generally true of S corporations. IRC §1377(a), presumes that S corporation items will be allocated *pro rata* on a daily basis unless the surviving shareholders agree to an interim closing of the books.

C. PLANNING CHALLENGES PRESENTED BY PARTNERSHIPS

1. The Estate Planning Drawbacks of Special Allocations

Partners are generally free to allocate the income, gain, loss, deduction, and credit items of the partnership among themselves however they may agree, subject to the constraint in IRC §704(b) that such allocations have "substantial economic effect." Detailed regulations give guidance for ensuring that allocations meet this amorphous standard. The regulations provide two safe harbors under which an allocation will be deemed to have "economic effect." Treas. Reg. § 1.704-1(b)(2)(ii). The first safe harbor applies where the partnership agreement requires: (1) the determination and maintenance of capital accounts in accordance with specific rules provided elsewhere in the regulations; (2) that liquidating distributions be made in accordance with the positive capital account balances of the partners; and (3) that any partner with a deficit balance in his or her capital account at liquidation be required to restore the deficit balance to the partnership within a stated period. Treas. Reg. § 1.704-1(b)(2)(ii)(b). The second safe harbor applies where the partnership agreement requires: (1) both of the first two conditions of the first safe harbor (maintenance of capital accounts according to specific rules and liquidating distributions according to positive capital account balances); (2) the operation of a "qualified income offset" provision; and (3) that no allocation to a partner may cause or increase a deficit balance to that partner's capital account in an amount greater than the amount that partner is obligated to restore upon liquidation of the entity. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

Both safe harbors require the partnership to maintain capital accounts using specific accounting rules set forth in the regulations. Treas. Reg. § 1.704-1(b)(2)(iv). In some cases, compliance with these accounting rules proves to be difficult (i.e., expensive).

Special allocations of partnership income and deduction items are common in partnerships that conduct an active trade or business in which the partners participate. From an estate planning perspective, however, they may pose two problems. First, the use of special allocations might run afoul of IRC §2701. Section 2701 values certain retained interests in a partnership at zero for purposes of valuing subordinate equity interests transferred to certain family members. If all interests in a partnership have identical distribution and liquidation rights, IRC §2701 does not apply. Accordingly, estate planners usually advise the partners to make sure all income and deduction allocations are made according to the partners' interests in the partnership, regardless of whether such interests have voting or management rights. Differences in voting and management rights (as well as differences in liability for entity debts) do not by themselves create subordinate equity interests, so creating voting and nonvoting partnership interests does not trigger application of IRC §2701's zero-value rule. Treas. Reg. § 25.2701-1(c)(3).

Second, where the planner intends to have a partner give some portion of his or her partnership interest to a donee, the planner must be cognizant of IRC §704(e)(2). It states that where there has been a gift of a limited partner interest in a partnership, the recipient's distributive share of the partnership's income is limited in two ways. *First*, the donor must be adequately compensated for any services rendered to the FLP. In other words, the donor cannot perform services at no charge for the partnership and pass along the savings to the recipient.

EXAMPLE: Parent gives Child a 40-percent limited partner interest in a partnership, retaining a ten percent general partner interest and a 50 percent limited partner interest. The partnership's taxable income for the year is $100,000. In that same year, Parent performed services for the partnership valued at $40,000. An allocation of $40,000 of the $100,000 taxable income to Child would violate IRC §704(e)(2) because it does not consider the services performed by Parent.

Instead, the $40,000 in services should be treated as compensation to Parent, leaving $60,000 to be allocated according to the partners' interests in the partnership. In sum, Parent would be allocated income totaling $76,000 ($40,000 for Parent's services plus 60 percent of the partnership's remaining $60,000 income, or $36,000), while Child would be allocated $24,000 of income (40 percent of the partnership's $60,000 income after services).

Second, if the recipient's interest was funded with donated capital, the donor and the recipient must be allocated income in proportion to the donated capital. In effect, the maximum income allocable to a recipient partner is the income allocable to the recipient partner's interest in partnership capital. Thus, if Mom and Dad form a partnership with contributed capital and gift a 20 percent limited partner interest to Child, Child must report 20 percent of the partnership's income attributable to the contributed capital. Combining the two rules under IRC §704(e)(2), the regulations state that family partnership income must be distributed proportionate to capital interests after distributing reasonable compensation to the donor for services rendered to the partnership. Treas. Reg. § 1.704-1(e)(3).

If the partnership is a holding company (one not actively conducting a trade or business), it is rare to see special income or deduction allocations. Given the risks described above, it might be better *not* to follow the capital account rules in the regulations, provided the partnership agreement requires all allocations to be in accordance with the partners' interests in the partnership. Remember: failure to fall within one of the two safe harbors for economic effect means only that the Service can reallocate items if it determines that an allocation with not made in accordance with the partners' interests in the partnership. It does not mean that all allocations are *per se* invalid.

2. Distributions within Seven Years of Capital Contributions

Normally, property distributions from a partnership are tax-free. IRC §731(a). Cash distributions from a partnership are taxable to the extent the cash distributed exceeds the recipient partner's basis in the partnership interest immediately prior to the distribution. IRC §731(a)(1). But if the partnership liquidates within seven years of a partner's contribution of property to the partnership, two Code provisions can convert a tax-free liquidation into a taxable one. For more on the federal income tax aspects of liquidating a partnership formed for estate planning purposes, see Samuel A. Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 CAP. U. L. REV. 15 (2006). Look, *someone* has to cite my works.

First, IRC §704(c)(1)(B) provides that if property distributed to one partner was contributed to the partnership by another partner within seven years of the distribution, and if that property had built-in gain at the time of contribution, then the contributing partner must recognize the built-in gain at the time of the distribution.

EXAMPLE: *A* and *B* formed a partnership in Year One when *A* contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a five percent general partner interest and a 45 percent limited partner interest, and *B* contributed cash in the amount of $500,000 for a 50 percent limited partner interest. In Year Five, the partnership distributed the farmland to *B*. Assuming the value of the land has not changed since contribution, *A* must recognize *A*'s $200,000 built-in gain from the farmland in Year Five.

Recognition of the built-in gain is avoided if the property is distributed back to the contributing partner. For this purpose, any assignee or successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain allocable to the assignee-successor's interest. Treas. Reg. § 1.704-4(d)(2).

EXAMPLE: Assume the same facts from the prior example, If in Year Four *A* gave *A*'s general and limited partner interest to *C*, and if in Year Five the partnership distributed the farmland to *C*, neither *A* nor *C* recognizes gain from this distribution under IRC §704(c)(1)(B) since *C* was *A*'s successor in interest.

Second, IRC §737 generally provides that if a partner contributes appreciated property to the partnership and, within seven years of such contribution, receives a distribution of non-cash property, the contributing partner must recognize the IRC §704(c) built-in gain (or, if less, the excess of the distributed property's value over the partner's outside basis immediately prior to the distribution minus any cash received in the same distribution).

EXAMPLE: Assume the facts from the example involving *A* and *B* and the formation of their partnership in Year One. The partnership used the cash contributed by *B* to acquire a small parcel of vacant land in the suburbs. In Year Five, the partnership distributed the suburban land to *A*. Assuming the value of the contributed properties has not changed since contribution, *A* must recognize the $200,000 built-in gain from the farmland in Year Five.

As was the case with IRC §704(c)(1)(B), an assignee-successor to a contributing partner's interest is treated as a contributing partner for purposes of IRC §737's general rule. Treas. Reg. § 1.737-1(c)(2)(iii).

EXAMPLE: Assume the same facts from the prior example. If *A* gifted *A*'s general and limited partner interests to *C* in Year Four and the partnership distributed the suburban land to *C* in Year Five, *C* "steps into *A*'s shoes" and must recognize in Year Five the $200,000 built-in gain from *A*'s contribution of the farmland in Year One.

On its face, § 737 would apply if the contributing partner received back from the partnership the appreciated property originally contributed to the partnership. Regulations recognize that because such a "return-to-sender" distribution is not taxable under IRC §704(c)(1)(B), IRC §737 does not apply if the contributing partner receives the property he or she originally contributed to the partnership. Treas. Reg. § 1.737-2(d)(1). Oddly, however, there is no rule providing that an assignee-successor to the contributing partner's interest likewise qualifies for this exception. It is therefore possible that an assignee-successor must recognize gain under IRC §737 upon receipt of property originally contributed to the partnership by the assignee-successor's predecessor in interest—even though the receipt of the contributed property by the same party is expressly *not* subject to IRC §704(c)(1)(B). For a contrary view, *see* Ellen K. Harrison and Brian M. Blum, *Another View: Responding to Richard Robinson's 'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313, 315 (2003).

The moral of the story here is to postpone any distributions of IRC §704(c) property until the partnership has held such property for seven years, as IRC §§704(c)(1)(B) and 737 only apply to distributions made within seven years of contribution.

3. Distributions of Marketable Securities Treated as Cash Distributions

Under IRC §731(a)(1), no gain is generally recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. For purposes of this rule, however, IRC §731(c) provides that marketable securities are treated as cash (valued at fair market value as of the date of distribution). That, of course, creates the risk that a distribution of marketable securities will be a taxable event to the recipient partner.

EXAMPLE: *A* and *B* formed a partnership when *A* contributed a collectible with a value of $100,000 and a basis of $20,000 and *B* contributed $100,000 cash. The partnership used $50,000 of the cash to purchase Microsoft stock. The partnership then distributed the Microsoft stock to *A*. Under IRC §731(c), the stock distribution is treated as a cash distribution in the amount of $50,000, the value of the Microsoft shares distributed. *A* must recognize a gain of $30,000 because the amount of deemed cash distributed exceeds *A*'s $20,000 outside basis.

By its terms, IRC §731(c) does not apply if: (a) the marketable securities received by the partner were those contributed by the same partner; (b) subject to some limitations, the marketable securities distributed were acquired by the partnership in a nonrecognition transaction (provided the total cash and marketable securities acquired by the partnership in the nonrecognition transaction is less than 20 percent of the value of the assets transferred by the partnership in such transaction and further provided that the distribution of the marketable securities occurs within five years of the partnership's acquisition of the securities (or, if later, within five years of the date when the securities became marketable)); (c) the distributed securities were not marketable when first acquired by the partnership and did not become marketable for at least six months (the partnership must distribute the securities within five years of the date upon which they became marketable and the issuer of the securities must not have issued any marketable securities prior to the time the partnership first acquired the distributed securities); or (d) the partnership is an "investment partnership" and is making a distribution to an "eligible partner."

This last exception requires elaboration. A partnership will qualify as an investment partnership if it has never been engaged in a trade or business and 90 percent or more of its assets, measured by value, have always consisted of portfolio assets. Treas. Reg. § 1.731-2(c)(3)(i). And an eligible partner is any partner that contributed nothing but such portfolio assets to the partnership. Treas. Reg. § 1.731-2(e)(2)(i).

Now let's return to the first exception: marketable securities will not be treated as cash for purposes of IRC §731 if they are distributed to the same partner that contributed them to the partnership. This is consistent with the "return-to-sender" exceptions under IRC §§704(c)(1)(B) and 737 described above. But here, as with IRC §737, there is no rule extending the exception to a distribution of marketable securities to an assignee-successor to the contributing partner's partnership interest. Regulation § 1.731-2(d)(1) states, in relevant part that "section 731(c) and this section do not apply to the distribution of a marketable security if-(i) the security was contributed to the partnership by the distributee partner…." No mention is made of a successor in interest here.

In short, then, those who receive a partnership interest by gift may have to recognize gain upon a distribution of marketable securities from the partnership even if those securities were contributed to the partnership by the donor. And the application of this rule does not expire after seven years.

One solution is to effect a proportionate distribution of any marketable securities. By doing so, one makes better use of the limitation in IRC §731(c)(3)(B), which reduces the amount of the deemed cash distribution by the recipient partner's share of gain on the distributed securities.

EXAMPLE: In Year One, *A*, *B*, and *C* formed a partnership when *A* contributed stock in Starbucks Corporation worth $900,000 (in which *A* had a basis of $720,000) in exchange for a four percent general partner interest and an 86 percent limited partner interest, while *B* and *C* contributed their undivided, one-half interests in a parcel of raw land worth a total of $100,000 (in which each had a basis of $20,000) in exchange for a ten percent limited partner interest (five percent held by *B* and five percent held by *C*. *A* died in Year Ten, leaving *A*'s general and limited partner interests in equal shares to *B* and *C*. At the date of *A*'s death, the Starbucks stock is worth $1.5 million, and the raw land is worth $500,000. *A*'s estate claims a 50 percent combined discount on the value of the partnership interests passing to *B* and *C*, reporting a combined value of $900,000 on *A*'s federal estate tax return (90 percent interest in a total liquidation value of $2 million, less 50 percent). Each beneficiary's aggregate outside basis in FLP is now $470,000 ($450,000 attributable to the 90 percent interest from *A* that was stepped-up under IRC §1014 plus $20,000 attributable to the ten percent interest acquired through their contribution).

If the partnership distributes the Starbucks stock in equal shares to *B* and *C*, each is deemed to receive a cash distribution of only $360,000 (not $750,000), because the $390,000 gain that would be allocated to each child from partnership's sale of the stock reduces the deemed cash distribution pursuant to IRC §731(c)(3)(B). (For convenience, this example assumes no IRC §754 election is in place.) This deemed distribution is not taxable to either *B* or *C* because each has an outside basis in excess of the deemed distribution amount. The distribution will reduce each of *B*'s and *C*'s outside basis to $110,000 ($470,000 minus $360,000 deemed cash). Note that IRC §704(c)(1)(B) does not apply in this example because the distribution occurs after the seven-year period during which IRC §704(c)(1)(B) is alive.

If, instead, the partnership distributes the raw land plus $500,000 of the Starbucks stock to *B* ($1 million total) and the remaining $1 million of Starbucks stock to *C*, the result changes. *C* is deemed to receive a cash distribution of $610,000 (not $1 million), because the $390,000 gain that would be allocated to *C* from the partnership's sale of the stock reduced the deemed cash distribution under IRC §731(c)(3)(B). Because *C*'s outside basis immediately prior to the distribution is $470,000, *C* must recognize $140,000 of gain thanks to the deemed cash distribution. The disproportionate distribution of the Starbucks stock to *C* in this case forced the recognition of gain that would not have occurred in a proportionate distribution of the stock. Notice here that the IRC §754 election might be detrimental to the successors in interest. An increase in inside basis lessens the benefit of the IRC §731(c)(3)(B) reduction for the distributee's distributive share of gain on the property. If the partnership would realize no gain if it sold the distributed property, there is no reduction in the amount of the deemed cash distribution. Thus, while the IRC §754 election is generally beneficial in the context of IRC §§704(c)(1)(B) and 737, it can be disadvantageous for purposes of IRC §731(c).

The IRC §731(c)(3)(B) gain limitation is handy where the partnership distributes marketable securities with a low inside basis. Partners should therefore be reluctant to distribute freshly-purchased marketable securities with an inside basis (nearly) equal to their value. Likewise, marketable securities that have recently declined in value are less attractive candidates for distribution to donee-partners.

While a proportionate distribution of marketable securities may be helpful in avoiding IRC §731(c), it presents problems outside of the tax realm. Beneficiaries are often reluctant to hold assets as tenants in common (proof that the minority interest discount and, to a greater extent, the marketability discount are quite real). If so, then perhaps the best solution to the IRC §731(c) problem lies back in the exceptions: where possible, a partnership holding a substantial amount of marketable securities should own only portfolio assets at all times and care should be taken to make sure each partner is an "eligible partner." One *bad* solution would be to reallocate the partnership's gain to the distribute partner in an effort to maximize use of the IRC §731(c)(3)(B) gain limitation. Regulations give the Service the power to disregard a blatant attempt to avoid IRC §731(c)(1) through a change in partnership allocations. Treas. Reg. § 1.731-2(h)(1).

4. Sales of Partnership Interests Can Yield Ordinary Income

Subchapter K uses a hybrid aggregate-entity approach for the sale of an interest in a partnership. Generally, the sale gives rise to capital gain or loss because the selling partner is disposing of a capital asset. IRC §741. But the portion of the gain or loss allocable to "unrealized receivables" or "inventory items" will be treated as ordinary income or loss. IRC §751(a). This rule applies no matter whether the partner sells all or part of the partner's interest.

Unrealized receivables are any rights to payments for goods or services that have not previously been included in the partnership's gross income. The term also includes any gain attributable to assets the sale of which would give rise to ordinary income. IRC §751(c). **Inventory items** are any assets that are neither capital assets nor IRC §1231 assets. IRC §751(d). Accordingly, "inventory" means not only inventory but also supplies used in the partnership's business, hedging transactions, and everyone's favorite: government publications.

EXAMPLE: *A* owns a one-third interest in the *ABC* Partnership, a cash method partnership that develops real estate. *ABC* both constructs buildings for sale to customers and holds real estate for rental purposes. On January 1, *A* sells her partnership interest to *D* for $180,000 cash. *ABC*'s balance sheet at the time of the sale is as follows:

Asset	Basis	Value	Capital	Basis	Value
Cash	$ 45,000	$ 45,000	*A*	$110,000	$180,000
Accounts Receivable	$ 0	$ 60,000	*B*	$110,000	$180,000
Building for sale	$150,000	$180,000	*C*	$110,000	$180,000
Building for rent	$135,000	$240,000			
Goodwill	$ 0	$ 15,000			

	$330,000	$540,000		$330,000	$540,000

A’s realized gain from the sale is $70,000. To determine the character of this gain, we must pretend *ABC* sold *A*’s share of all partnership assets for fair market value. Treas. Reg. §1.751-1(a)(2). The accounts receivable are “unrealized receivables” under IRC §751(c), and *A*’s share of the $60,000 partnership gain from a sale of the receivables is $20,000. In addition, the building held for sale is an inventory item of the partnership under IRC §751(d), and *A*’s share of the $30,000 gain to the partnership is $10,000. Accordingly, *A* must recognize $30,000 of ordinary income from the sale of her partnership interest ($20,000 from the receivables and $10,000 from the building for sale). The building held for rent is not IRC §751(a) property because it is not held for sale to customers. The property qualifies as IRC §1231 property under IRC §1231(b), so it is not an “inventory item” of the partnership. The remaining $40,000 of *A*’s $70,000 realized gain may be long-term capital gain, provided *A* held her partnership interest for more than one year.

5. No Tax-Free Mergers with Corporations

Only corporations can participate in tax-free reorganizations with other corporations. A merger between a partnership and a corporation is treated as a taxable exchange. If the partners anticipate selling their business to a corporation and wish to participate in a tax-free reorganization transaction, they may be tempted to “check the box” so that the partnership is taxed as a corporation. But if the partners make the election only shortly before engaging in the reorganization, there is a high risk that the transaction will not qualify for nonrecognition. This risk arises under the common law step transaction doctrine, where a proposed reorganization planned prior to the formation of a target corporation can be deemed a taxable exchange because there is no other business purpose for the corporation and because the transaction is, in substance, a taxable exchange. *West Coast Marketing Corp. v. Commissioner*, 46 TC 32 (1966).

There is no magic amount of time after electing corporate status that a former partnership should wait before the reorganization occurs. Instead, the principal focus should be on making sure there is some separate business purpose for converting the partnership to a corporation beyond qualifying the exchange for nonrecognition. See Robert R. Keatinge, *Tax Considerations in Choice of Business Entity*, 31ST ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 9, at 71 (2007). If the partners anticipate that the business might be acquired by a corporation, it is a good idea to create a corporation well in advance of discussions with a particular buyer. The partners can then move the business assets from the partnership to the corporation as discussions become serious. There is authority to suggest that funding a shell corporation followed shortly by the shell’s acquisition by another corporation can qualify as a tax-free reorganization. *Weikel v. Commissioner*, T.C. Memo. 1986-58. *Weikel* has been criticized by other courts. See *Long Term Capital Holdings v. U.S.*, 330 F. Supp. 2d 122 (D. Conn. 2004); *Associated Wholesale Grocers v. U.S.*, 927 F.2d 1517 (10th Cir. 1990). Both of these cases observe that courts can still apply the step transaction doctrine to transactions even where the business purpose for the entity is established.

It is important to note that no such risk exists where the partners wish to take the business public instead of selling it to an acquiring corporation. A last-minute conversion or incorporation of the business on the eve of a public offering does not disqualify the conversion from nonrecognition. This is because the conversion qualifies for nonrecognition under IRC §351, which does not have a continuity of interest requirement that applies to reorganizations under IRC §368(a).

6. The Built-in Gain Problem Under IRC §704(c)

If a partner contributes “built-in gain property” to the partnership, subchapter K and corresponding regulations insure that the contributing partner’s built-in gain cannot be shifted to another partner. Built-in gain property is property which, on the date of contribution to the partnership, has a fair market value greater than its tax basis. IRC §704(c)(1)(A); Treas. Reg. §1.704-4. When the partnership disposes of the built-in gain property, the built-in gain *must* be allocated to the contributing partner. IRC §704(c)(1)(A).

Fundamentals Program

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Introduction

This article will provide practical tips with some discussion on recent developments in audits and case law related to privileges applicable to estate planning, with a particular focus on drafting audit responses related to transfer tax returns with closely held interests.

I. Anticipate Your Potential Audience During Planning Stage

A. Preparation for Transfer Tax Audit or Dispute Begins at Estate Planning Level

The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer's file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work product doctrine may not protect all contents in the planner's file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help the taxpayer's case with the examiner or in litigation. With that goal in mind, when working on a client's estate plan, estate planners should assume that every document prepared by the lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in litigation (sometimes a jury).

Preparation for the transfer tax dispute begins at the estate planning level. When writing letters or internal memoranda, estate planners should think about how each document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in litigation. Have all relevant reasons for the transaction been discussed? Or only the estate and gift tax savings that might be achieved through the transaction? The client and the client's advisors, such as accountants or stockbrokers who are involved in the estate planning process, should be aware that their files may be subject to production in a tax audit or in litigation. And, in some circumstances, the client may wish to waive the relevant privileges and voluntarily produce those files.

B. Understand IRS's Broad Summons Power

The IRS has broad summons powers that can be used to require documents or compel testimony from a taxpayer, the taxpayer's representative, or a third party. For the purpose of "ascertaining the correctness of any return, making a return where none has been made, [or] determining the liability of any person for any internal revenue tax," the IRS is authorized to: (i) examine any books, papers, records, or other data that may be relevant or material to such an inquiry; and (ii) summons: the person liable for tax or required to perform the act; any officer or employee of such person; any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act; or any other person that the IRS may deem proper to produce such books, papers, records, or other data. I.R.C. § 7602(a).

Subject to any applicable privileges, the IRS can summons the taxpayer, the taxpayer's attorney, the taxpayer's accountants, and other third parties to produce books, papers, records, or other data and to testify on matters relevant or material to the IRS's inquiry. This summons power includes lawyers, accountants, and advisors involved in the planning process. It also includes doctors and other health care providers. The range of discoverable documents is also very broad and generally includes all documents in any form (including, for example, electronically stored information such as emails and voicemails).

To enforce a summons, the IRS must demonstrate that the summons: (1) was issued for a legitimate purpose; (2) seeks information relevant to that purpose; (3) seeks information that is not already within the IRS's possession; and (4) satisfies all administrative steps required by the Internal Revenue Code. *United States v. Powell*, 379 U.S. 48, 57-58 (1964). However, the IRS's broad summons power remains subject to traditional privileges and limitations. *United States v. Euge*, 444 U.S. 707, 714 (1980). Thus, if the attorney-client privilege attaches to documents requested by the IRS, the IRS has no right to issue a summons to compel their production.

C. Put Client in Position to Produce Correspondence or Documents in Files if in Client's Best Interest to Do So

The assertion of privileges at the audit or Tax Court level may lead to an inference that the taxpayer is hiding something. Arguing that a document should be shielded from discovery by an examining agent or district counsel because it is either subject to the attorney-client privilege or was prepared in anticipation of litigation may have evidentiary implications. *See, e.g., Estate of Shoemaker v. Comm'r*, 47 T.C.M. (CCH) 1462, 1464 n.7 (1984) ("Prior to trial, respondent sought discovery of estate planning files of Mr. Parsons' law firm pertaining to decedent. The attorney-client privilege was asserted and sustained by us, although we invited attention to the possibility that an unfavorable inference could be drawn from this assertion of the privilege.").

In cases in which the IRS questions the motives or business purpose for forming a closely held entity, the best evidence of those motives can come from the contemporaneous correspondence prepared in connection with the transaction at issue. Well-drafted correspondence outlining the business and financial reasons (*i.e.*, the non-tax reasons) for the transaction can serve as wonderful evidence to rebut an argument from the IRS that an entity lacks business purpose or was created as "a device solely to avoid taxes." *See, e.g., John J. Wells, Inc. v. Comm'r*, 47 T.C.M. (CCH) 1114, 1116 (1984) ("While obviously the true facts can never be known with complete certainty by an outsider, . . . we base our conclusion upon our view of the spoken testimony and how that testimony, coupled with the documentary evidence, comports with human experience."). Of course, certain documents may be withheld from production due to one or more applicable privileges. Thus, every estate planner should have a solid understanding of the relevant privileges.

D. Understand and Preserve All Privileges

Perhaps most importantly, the production of thoughtfully drafted estate planning correspondence or similar documents in response to an IRS request can actually help the taxpayer state his case with the examiner or in litigation. With that goal in mind, while a planner works on a client's estate plan, she should assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, IRS counsel, or the finder of fact in tax litigation (perhaps a judge or even a jury).

Whether a privilege exists in the context of an IRS examination is a question of federal law. *Jaffee v. Redmond*, 518 U.S. 1 (1996); FED. R. EVID. 501. There are four privileges of which estate planners should be especially aware: (i) the attorney-client privilege; (ii) the attorney work product doctrine; (iii) the tax practitioner's privilege; and (iv) various medical privileges. Each is addressed in turn below.

II. Attorney-Client Privilege

The attorney-client privilege exists to encourage the complete and truthful exchange of all sensitive information between a lawyer and her client, by ensuring that the confidential information will remain in confidence. Like the Fifth Amendment protection against compelled self-incrimination, the policy behind this privilege recognizes that encouraging complete and honest disclosures to a lawyer is more important than requiring lawyers to testify against their clients.

A. Definition

Professor Wigmore's definition of a communication covered by the attorney-client privilege is set forth in VIII Wigmore, Evidence § 2292:

1. **Where legal advice of any kind is sought**
2. **from a professional legal advisor in his capacity as such and**
3. **the communication is made**
    - a. **in confidence**

b. by the client

c. for the purpose of securing legal advice,

the communication will be protected from disclosure, subject only to waiver by the client.

B. Two-Way Communications

Arguably, the privilege also works in the other direction: it protects communications from the lawyer to the client. *Alexander v. Fed. Bureau of Investigation*, 198 F.R.D. 306, 309 (D.D.C. 2000) ("The attorney-client privilege must protect 'a client's disclosures to an attorney,' and 'the federal courts extend the privilege also to an attorney's . . . communications to a client, to ensure against inadvertent disclosure, either directly or by implication, of information which the client has previously confided to the attorney's trust.'") (quoting *Coastal States Gas Corp. v. Dept. of Energy*, 617 F.2d 854, 862 (D.C. Cir. 1980)).

C. Not Necessarily the Facts

The privilege attaches to the communication but does not necessarily insulate the underlying facts against disclosure. *Rhone-Poulenc Rorer, Inc. v. Home Indem. Co.*, 32 F.3d 851, 862 (3d Cir. 1994) (holding while documents may be protected from disclosure if containing privileged confidential communications, protection may be inapplicable to underlying facts incorporated in communication).

D. Confidence

Above all else, in order to be privileged, the communication must be made in confidence and must be intended to remain in confidence. A communication between a client and a lawyer may not be privileged if it is made "in the presence of a third party" who is outside of the privilege umbrella. *United States v. Evans*, 113 F.3d 1457, 1462 (7th Cir. 1997). Specifically, no privilege attaches to any letter that shows a "cc" or "bcc" to someone outside the attorney-client relationship or its extended protection. And, conversely, adding a "cc" to a lawyer extends no privilege to a letter to a third party. *Andritz Sprout-Bauer, Inc. v. Beazer E., Inc.*, 174 F.R.D. 609, 633 (M.D. Pa. 1997) ("What would otherwise be routine, non-privileged communications . . . do not attain privileged status solely because . . . counsel is 'copied in' on correspondence or memoranda."); *United States v. Davis*, 636 F.2d 1028, 1041 (5th Cir. 1981) ("documents created outside the attorney-client relationship should not be held privileged in the hands of the attorney unless otherwise privileged in the hands of the client"). However, communications with third parties, such as accountants or financial advisors, made to "assist the attorney in rendering advice to the client" also are generally protected. *See, e.g., Segerstrom v. United States*, 2001 WL 283805 (N.D. Cal., Feb. 06, 2001). How to ensure that communications with third parties can be cloaked with the attorney-client privilege is discussed below.

E. Bills and Invoices

Danger arises when IRS agents ask for invoices relating to all payables, and attorneys' invoices describing all manner of confidential information are produced without thought given to privilege issues. Generally, the fact of receipt and payment of a lawyer's bill is not privileged. *United States v. Ellis*, 90 F.3d 447, 450-51 (11th Cir. 1996) ("receipt of attorney's fees normally [is] not [a] privileged matter"); *Chaudhry v. Gallerizzo*, 174 F.3d 394, 402 (4th Cir. 1999) (holding that attorney-client privilege does not typically extend to billing records and expense reports). However, descriptions in the invoices may very well (and usually do) reflect privileged communications – provided that privilege is not waived. *Clarke* v. *Am. Commerce Nat'l Bank*, 974 F.2d 127, 129 (9th Cir. 1992) ("[C]orrespondence, bills, ledgers, statements, and time records which also reveal the motive of the client in seeking representation, litigation strategy, or the specific nature of the services provided . . . fall within the privilege.").

F. Not Business Advice

The attorney-client privilege only extends to communications relating to soliciting and receiving legal advice – as opposed to general business advice. *In re Grand Jury Subpoena Duces Tecum Dated Sept. 15, 1983*, 731 F.2d 1032, 1037 (2d Cir. 1984) ("[T]he privilege is triggered only by a client's request for legal, as contrasted with business, advice."); *Olender v. United States*, 210 F.2d 795, 806-07 (9th Cir. 1954) (holding communications with lawyer who merely fills out form deeds and deposits client's money at bank not confidential attorney-client communications).

G. Dual Purpose Advice

What about dual purpose communications involving legal and business communications? The minority view is that any non-legal purpose precludes the privilege, but the stronger view looks to the dominant purpose. *See, e.g.*, *Neuder v. Battelle Pac. Nw. Nat'l Lab.*, 194 F.R.D. 289, 292 (D.D.C. 2000) ("Where business and legal advice are intertwined, the legal advice must predominate for the communication to be protected."); *Pippenger v. Gruppe*, 883 F. Supp. 1201, 1207 (S.D. Ind. 1994) (holding conversations conducted "primarily for the purpose of securing legal opinions and legal services" not subject to discovery).

H. Fiduciaries

The attorney-client privilege extends to the fiduciary role, not necessarily to the person serving as a fiduciary. What happens when a fiduciary is removed and a successor fiduciary is appointed? The former fiduciary must provide the successor fiduciary with all of its files related to the estate or trust. But what if the former fiduciary sought legal advice regarding possible personal liability for its conduct as fiduciary? Unless the former fiduciary has taken affirmative steps to preserve its right to rely upon the attorney-client privilege as the basis for withholding from any successor fiduciary confidential documents maintained in the estate or trust's legal files, the privilege may not protect the former fiduciary's communications with counsel. *See Fiduciary Trust International of California v. Klein*, 9 Cal. App. 5th 1184 (2017). In *Fiduciary Trust*, the court analyzed the purpose of the attorney-client relationship, not the purpose of the individual communication in question and whether, at the time the legal advice was sought, the purpose for obtaining the legal advice was, on the one hand, for protection against personal liability or, on the other, the administration of the trust or estate in order to determine whether communications were protected by privilege. *Id*. at 1202.

I. Loan Officer/Lawyer

A rebuttable presumption may arise where the lawyer works in the General Counsel's office, as opposed to in management. *Boca Investerings P'ship v. United States*, 31 F. Supp. 2d 9, 12 (D.D.C. 1998) ("There is a presumption that a lawyer in the legal department or working for the general counsel is most often giving legal advice, while the opposite presumption applies to a lawyer . . . who works for the Financial Group or some other seemingly management or business side of the house.").

J. Tax Opinions

Tax advice and tax opinions by counsel are arguably privileged. *United States v. Tel. & Data Sys, Inc.*, No. 02C0030, 2002 WL 2023767, at *3 (W.D. Wis. Jul. 16, 2002); *Wojdak v. First W. Gov't Sec.*, No. 83-1076, 1991 WL 160249, at *1 (E.D. Pa. Aug. 16, 1991) (finding that draft tax opinions were protected by attorney-client privilege because they "were for the purpose of giving legal advice to a client, and were expressly treated by the sender and the recipient as confidential"). However, when the client seeks to rely on the Section 6664 defense to penalties (reasonable cause and good faith reliance on advice of tax professional), the tax opinion may be the very piece of evidence necessary to show the client's reliance. *See, e.g.*, *In re G-I Holdings, Inc.*, 218 F.R.D. 428 (D.N.J. 2003) (holding that privilege is waived in its entirety by raising "reliance upon tax counsel" as "reasonable cause" penalty defense under I.R.C. § 6664).

K. Return Preparation May Not Be Privileged

In many cases, lawyers may serve as the preparer of tax returns. A question arises as to what extent the work performed by the lawyer/preparer may fall under the attorney-client privilege. Courts have disagreed on whether tax return preparation by a lawyer is privileged.

1. Return Preparation Not Legal Advice?

Some courts have held that the preparation of a tax return is not the rendering of legal advice. *See United States v. Richey*, 632 F.3d 559, 567 (9th Cir. 2011); *In re Grand Jury Investigation (Schroeder)*, 842 F.2d 1223 (11th Cir. 1987); *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981); *United States v. Gurtner*, 474 F.2d 297 (9th Cir. 1973); *Canaday v. United States*, 354 F.2d 849 (8th Cir. 1966). *But see Colton v. United States*, 306 F.2d 633, 637 (2d Cir. 1962) ("There can, of course, be no question that the giving of tax advice and the preparation of tax returns . . . are basically matters sufficiently within the professional competence of an attorney to make them prima facie subject to the attorney-client privilege.").

2. Return Preparation as Confidential?

Other courts acknowledge an element of legal advice in the preparation of a return, but deny privilege based on a lack of expectation of confidentiality or a waiver. *United States v. Lawless*, 709 F.2d 485, 487 (7th Cir. 1983) (noting no expectation of confidentiality in information to be included on return); *In Re Grand Jury Subpoena Duces Tecum (Dorokee)*, 697 F.2d 277, 280 (10th Cir. 1983) (holding that even where privilege might protect communications related to preparation of income tax returns, privilege did not apply to documents given to attorney for inclusion in income tax return because information was not intended to remain confidential due to inclusion in tax return); *United States v. Cote*, 456 F.2d 142 (8th Cir. 1972) (holding disclosure waives privilege not only as to disclosed data but also as to details underlying information on return); *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982) (holding waiver by inclusion on return).

Yet other courts have held such information privileged. Although the IRS has argued that information provided to an attorney for the purpose of preparing tax returns is outside the scope of the privilege, various courts of appeal have rejected this contention, holding that material provided in the context of return preparation may also have been for the rendition of legal advice and may be protected by the privilege. *See, e.g.*, *United States v. Abrahams*, 905 F.2d 1276, 1282-83 (9th Cir. 1990), *partially overruled on other grounds*, *United States v. Jose*, 131 F.3d 1325, 1329 (9th Cir. 1997); *United States v. Bornstein*, 977 F.2d 112, 116-17 (4th Cir. 1992); *United States v. Davis*, 636 F.2d 1028, 1043 (5th Cir. 1981).

3. Legal Advice v. Information Disclosed on Return.

In light of the inconsistency among jurisdictions, advisors should consider whether to separate files for a given client based on whether the primary purpose of the engagement is for tax preparation or for legal advice.

L. Communications with an Entity

Special problems arise when the client is an entity, as a divergence exists between federal law and the law of some states. Since the Supreme Court's holding in *Upjohn Co. v. United States*, 449 U.S. 383, 392-97 (1981), counsel's communications with any corporation employees (though not shareholders) may be privileged under federal law, while some states still limit the privilege to those between counsel and the company's "control group" of employees. Even communications between counsel and former employees of the corporate client may be treated as privileged. *In re Allen*, 106 F.3d 582, 605-06 (4th Cir. 1997). And communications between counsel for the corporate parent and counsel for the subsidiary are generally privileged. *In re Westinghouse Elec. Corp. Uranium Contracts Litig.*, 76 F.R.D. 47, 58 (W.D. Pa. 1977).

Beware that disclosure of privileged corporation communications to shareholders may constitute a waiver. *Cf.*, *Garner v. Wolfinbarger*, 430 F.2d 1093, 1103-04 (5th Cir. 1970). By contrast, communications with and disclosures to the general partners of a partnership client are generally privileged. *Abbott v. Equity Group*, 1988 WL 86826 (E.D. La. 1988).

M. Crime/Fraud Exception

The privilege attaches to communications relating to completed crimes, but not to ongoing or future crimes and frauds. This "crime-fraud" exception to the privilege requires a prima facie showing (as opposed to mere suspicion) that (i) the client is in the process of planning or committing a crime or civil fraud, and (ii) the attorney-client communication furthers that crime or fraud, generally by giving direction to it. *In re Grand Jury Subpoena*, 223 F.3d 213, 217 (3d Cir. 2000). Note that the exception applies even if the lawyer doesn't know about the crime or fraud. *In re Grand Jury Proceedings*, 604 F.2d 798, 802 (3d Cir. 1979).

N. Beware Of Waiver

Any action inconsistent with the maintenance of a privilege may constitute waiver, and that waiver may extend to the entire subject matter. *In re Sealed Case*, 676 F.2d 793, 818 (D.C. Cir. 1982). *But see, e.g.*, *Long-Term Capital Holdings v. United States*, 2003 WL 1548770 (D. Conn. 2003) (finding disclosure of gist of "more-likely-than-not" tax opinion to auditors did not constitute waiver as to entire opinion); *In re von Bulow*, 828 F.2d 94 (2d Cir. 1987) (holding subject matter waiver occurs where privileged information is disclosed to mislead/gain advantage); FED. R. EVID. 502(a) (providing that subject matter waiver occurs only if waiver was intentional; disclosed and undisclosed information concerned same subject; and disclosed and undisclosed information should, in fairness, be considered together).

At least in the Tax Court, the party asserting the privilege bears the burden of proving that he has not waived it. *Hartz Mountain Indus., Inc. v. Comm'r*, 93 T.C. 521, 525 (1989). Under the precedent of the D.C. Circuit – which governed evidentiary rulings in Tax Court cases up until December 16, 2015 – even an inadvertent waiver by the lawyer (or the *Kovel* CPA) could constitute an enforceable waiver. *In re Sealed Case*, 676 F.2d at 807. Thus, even though the privilege always belongs to the client and the lawyer is not free to waive it without her client's authorization, a third party may be entitled to enforce a waiver based on the actions of that same lawyer as an agent with apparent authority. *Id*.

Also beware of "witness waiver." Adverse parties may be entitled to inspect anything shown to a witness at any time to refresh his recollection for the purpose of testifying. FED. R. EVID. 612; FED. R. CIV. P. 26; *Nutramax Labs., Inc. v. Twin Labs, Inc.*, 183 F.R.D. 458, 468-72 (D. Md. 1998); *Bailey v. Meister Brau, Inc.*, 57 F.R.D. 11, 13 (N.D. Ill. 1972); *In re Pioneer Hi-Bred Int'l Inc.*, 238 F.3d 1370, 1375 (Fed. Cir. 2001) ("[D]ocuments and information disclosed to a testifying expert in connection with his testimony are discoverable by the opposing party, whether or not the expert relies on the documents and information in preparing his report."). *But see* FED. R. EVID. 26(b)(4)(C), (D) (protecting communications with consulting experts, as well as communications with trial expert, as long as not relied on by trial expert in forming opinion).

Furthermore, the advice of counsel cannot be used as a sword and then cloaked with a privilege. *Columbia Pictures Television, Inc. v. Krypton Broad. of Birmingham, Inc.*, 259 F.3d 1186, 1196 (9th Cir. 2001) ("The privilege which protects attorney-client communications may not be used both as a sword and a shield. Where a party raises a claim which in fairness requires disclosure of the protected communication, the privilege may be implicitly waived."); *In re G-I Holdings, Inc.*, 218 F.R.D. 428 (D.N.J. 2003) (holding that privilege is waived in its entirety by raising "reliance upon tax counsel" as "reasonable cause" penalty defense under I.R.C. § 6664).

Finally, the client may wish to waive privileges in order to assert the defense that any underpayment of tax was made in good faith and due to reasonable cause. Reliance on the advice of tax advisors constitutes reasonable cause and good faith if, under all circumstances, such reliance was reasonable and the taxpayer acted in good faith. In order to demonstrate reasonable reliance, the taxpayer may need to disclose what might otherwise have been privileged information. Accordingly, each case should be viewed individually to determine whether the client might benefit from disclosure. This disclosure could include producing to the IRS all of the client's advisors' legal opinions and correspondence – a possibility that few lawyers may consider when preparing opinion letters or other correspondence.

Note, however, that waiver of the attorney-client privilege does not necessarily waive the work product doctrine. *See Rhone-Poulenc Rorer*, 32 F.3d at 866.

O. Inadvertent Waiver

Under relatively recent amendments to Rule 502 of the Federal Rules of Evidence, inadvertent disclosure will not waive the attorney-client privilege where the disclosure was inadvertent, where the holder of the privilege took reasonable steps to prevent disclosure, and where the holder promptly took steps to rectify the error, including following Federal Rule of Civil Procedure 26(b)(5)(B), if applicable. FED. R. EVID. 502(b).

But how does inadvertent waiver apply in the technological world in which we practice law today? In *Harleysville Ins. Co. v. Holding Funeral Home*, No. 1:15-cv-00057, (W.D. Va. Feb. 9, 2017) (mem. op.) (slip copy), an investigator for an insurance company ("Harleysville") uploaded a video showing surveillance footage of a fire at a funeral home to an internet-based, electronic file sharing service operated by Box, Inc. The investigator then sent an email with a hyperlink to the shared file to a third party. *Id*. at *2-3. The e-mail containing the hyperlink sent to the third party included a confidentiality notice, which stated (in summary) that the e-mail contained information that was privileged and confidential. *Id*. at *3. The hyperlink was not password protected. *Id*. Months later, the investigator uploaded all of his files about the fire incident to this same hyperlink and sent an email containing the hyperlink to Harleysville's legal counsel. *Id*. at *4. Counsel for the funeral home ("Holding") sent a subpoena duces tecum to the third party requesting the third party's entire file related to the fire incident. *Id*. The third party provided the requested documents including a copy of the email received from the insurance company investigator's documents. *Id*. Upon receipt of the investigator's email, Holding's legal counsel, without the knowledge or permission of Harleysville's counsel, accessed the link, and downloaded and reviewed all the investigator's documents. *Id*. at *4-5. Harleysville was never notified and did not find out about this access until Holding sent a discovery response referring to files uploaded by the investigator to the hyperlink. *Id*. at *5. Four days later, Harleysville's counsel contacted Holding's counsel and requested the files be destroyed. *Id*. Harleysville also disabled the hyperlink. *Id*. at *6. Harleysville filed a motion requesting the disqualification of Holding's counsel for their improper access to privileged documents. *Id*. In response, Holding's counsel argued Harleysville waived any claim of privilege or confidentiality because the privileged documents were uploaded to the hyperlink where it could be accessed by anyone. *Id*.

A magistrate judge ("the Magistrate") noted that application of the attorney-client privilege was a matter of state law because federal jurisdiction was based on diversity of citizenship and the claims raised by Harleysville were state law claims, but that the work product doctrine was a qualified immunity and governed by federal law. *Id*. at *6-7. The Magistrate, following a Virginia Supreme Court seminal case on attorney-client privilege, opined that the disclosure in this case was inadvertent because Harleysville provided access to information by failing to implement sufficient precautions to maintain its confidentiality. *Id*. at *10. The Magistrate then applied a three-factor test to determine whether Harley waived the privilege, took reasonable steps to prevent disclosure, and took steps to rectify the error. *Id*. at *10-11. The Magistrate concluded that Harleysville had waived the attorney-client privilege because it did not take any precautions to prevent disclosure, their investigator intentionally uploaded the documents to the hyperlink, their investigator knew or should have known that documents on the hyperlink were not protected and could be accessed by anyone who knew of the hyperlink, the documents remained accessible for six months after they were uploaded, and no action was taken by Harleysville's counsel even after counsel accessed the files and knew or should have known the information was easily and readily accessible. *Id*. at *11-13. The Magistrate went on to analyze whether Harleysville could make any claim under the work product doctrine, concluding that the work product doctrine had also been waived. *Id*. at *14-17. The Magistrate noted that under federal law, for the disclosure to be inadvertent, the act of disclosure must be unintentional. In this case, the investigator uploaded the documents intentionally. *Id*. at *16-17. Ultimately, the Magistrate judge denied the motion for disqualification. *Id*. at *23. Meanwhile, the Magistrate ordered monetary sanctions against Holding for Harleysville's attorney's fees and costs because Holding's counsel disregarded the confidentiality notice contained in the email with the hyperlink and did not disclose to Harleysville that it accessed the documents. *Id*. at *22-23.

Both sides filed objections to the Magistrate's decision and a new evidentiary hearing was held in district court. *See Harleysville Ins. Co. v. Holding Funeral Home, Inc.*, No. 1:15-cv-00057, (W.D. Va. Oc. 2, 2017). The District Court agreed with the Magistrate that the disclosure of documents was inadvertent for purposes of attorney-client privilege. *Id*. at *14-16. However, the District Court concluded that disclosure in this manner was not a waiver of such privilege. *Id*. at *24. The District Court determined that Harleysville took reasonable precautions to prevent disclosure, noting that the hyperlink was not searchable by Google or any other search engine and the hyperlink contained 32 randomly-generated alphanumeric characters, both of which together provided inherent security. *Id*. at *18-19. The District Court was persuaded that the investigator believed that the hyperlink was a unique link and that it expired several days after being sent. *Id*. at *20. The District Court opined that the confidentiality notice in the e-mail and the fact that the documents were identified as privileged and confidential reflected reasonable precautions taken by Harleysville to prevent disclosure. *Id*. at *21. The District Court further pointed out that counsel for Harleysville took action within four days of discovering that the documents had been disclosed, which weighed against a finding of waiver because Harleysville attempted to rectify the error in such a short time after discovery of disclosure. *Id*. at *22.

The District Court did not agree that counsel for Harleysville should have known the documents were not protected because they were able to readily access the documents. *Id*. Finally, the District Court pointed out that counsel for Holding was the only party to whom the documents were disclosed; the Court did not believe Harleysville was responsible for any subsequent disclosures. *Id*. at *23-24. Therefore, the District Court determined that the attorney-client privilege had not been waived. *Id*. at *24. With regard to work product claim, the District Court also overturned the Magistrate's decision. *Id*. at *29. The District Court held that Harleysville intended and attempted to maintain the confidentiality of the documents, even though it failed to do so, and was not aware the documents were accessible by anyone other than its own counsel. *Id*. at *27-28. The District Court then concluded that there was no waiver of the work product protection. *Id*. at *29. The District Court vacated the monetary sanctions, instead imposing evidentiary sanctions by ruling the privileged documents or any information derived from the privileged documents could not be used by Holding, in the case at hand or any other civil litigation matter. *Id*. at *47-49.

Clearly, this is a constantly changing area of the law. Practitioners should always be on the lookout, playing it safe when it comes to sharing privileged documents and information by dropbox or other potentially unsecure methods.

III. Work Product Doctrine

The work product of an attorney or her staff in anticipation of litigation is protected from disclosure. *Hickman v. Taylor*, 329 U.S. 495 (1947); FED. R. CRIM. P. 16(b)(2); FED. R. CIV. P. 26(b)(3). In fact, the attorney work product doctrine is not a privilege, although some courts (and many practitioners) refer to it as one. Unlike the attorney-client privilege, its purpose does not lie in protecting confidential communications; its purpose is to encourage lawyers to thoroughly prepare for litigation (whether or not actually pending) through investigation of the good and the bad, without fear of being forced to aid their adversaries at the expense of their clients. In addition to its focus on anticipated litigation, this doctrine also differs from the attorney-client privilege in that its protection can be pierced (in very limited circumstances) through no fault of the lawyer or her client.

A. Definition

The doctrine is defined by the narrow scope of its exception in this passage from the Federal Rules of Civil Procedure:

> [A] party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if: (i) they are otherwise discoverable under Rule 26(b)(1); and (ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means. If the court orders discovery of those materials, it must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation.

FED. R. CIV. P. 26(b)(3)(A).

B. Scope

Note that the protection extends beyond just the work prepared by the attorney to work prepared by the client and the client's employees, agents, etc., at the direction of the lawyer. *In re Perrigo Co.*, 128 F.3d 430, 437 (6th Cir. 1997).

C. Categories

The rule contemplates two types of work product: (i) factual and (ii) opinion or "core" work product. Under unusual circumstances, factual work product is discoverable as described in the above-quoted Rule. *See also In re Allen*, 106 F.3d 582, 607 (4th Cir. 1997). By comparison, opinion work product "enjoys a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances." *Cox v. Adm'r U.S. Steel & Carnegie*, 17 F.3d 1386, 1422 (quoting *In re Murphy*, 560 F.2d 326, 336 (8th Cir. 1977) (11th Cir. 1994), *modified on reh'g by* 30 F.3d 1347 (11th Cir. 1994). In very rare and extraordinary circumstances, core or "opinion work product" is discoverable. For example, at least one court has found that if legal opinions and observations made by counsel are at issue in the case, and such information is needed by opposing counsel to substantiate the defense, the work product is discoverable. *See, e.g., Bird v. Penn Cent. Co.*, 61 F.R.D. 43, 46 (E.D. Pa. 1973) ("Since the relevant inquiry is into what plaintiffs knew or should have known concerning grounds for their rescission action, only through discovery of information in the hands of plaintiffs, and their agents, can defendants substantiate their defense.").

Some courts have gone so far as to decline to declare opinion work product to be absolutely immune from disclosure. *See, e.g., Duplan Corp. v. Moulinage et Retorderie de Chavanoz,* 509 F.2d 730 (4th Cir. 1974); *United States v. Leggett & Platt, Inc.*, 542 F.2d 655 (6th Cir. 1976). Others have demurred, indicating that there may be circumstances (as yet unseen) that would call for production of even opinion work product. *See, e.g., In re Murphy*, 560 F.2d 326, 336 (8th Cir. 1977); *Bio-Rad Labs, Inc. v. Pharmacia, Inc.*, 130 F.R.D. 116, 121 (N.D. Cal. 1990) ("The Supreme Court declined to rule whether opinion work product was absolutely protected."), *citing Upjohn Co. v. United States*, 449 U.S. 383, 401 (1981). A more conservative rule, thus, may be that opinion work product may be discoverable "where such information is directly at issue and the need for production is compelling," *see Bio-Rad Labs, Inc.*, 130 F.R.D. at 122, or where the party waives work product protection by disclosing some or all of a document otherwise protected by the work product doctrine. *See, e.g., Am. Family Life Assur. Co. v. Intervoice*, 560 Fed. Appx. 931 (M.D. Ga. 2010); *In Re EchoStar Communs. Corp.*, 448 F.3d 1294 (Fed. Cir. 2006).

Note, however, that the subject-matter waiver doctrine does not extend to materials protected by core work product doctrine where the work product is core, rather than factual. *See Cox*, 17 F.3d at 1422 ("subject-matter waiver doctrine does not extend to materials protected by the opinion work product privilege").

D. Anticipation of Litigation

To qualify for work product protection, work need not be done after litigation has been filed; indeed, the *certainty* of litigation need not even exist. Rather, litigation must be only *anticipated*. And the required level of anticipation varies by jurisdiction. *See, e.g., ServiceMaster of Salina, Inc., et al., v. United States*, 2012 U.S. Dist. LEXIS 53399, at *8 (D. Kan. Apr. 17, 2012) (holding "neither the audit nor the IRS investigation processes make litigation imminent"); *Energy Capital Corp. v. United States*, 45 Fed. Cl. 481, 485 (2000) ("Litigation must at least be a real possibility at the time of preparation."); *United States v. Frederick*, 182 F.3d 496, 502 (7th Cir. 1999) ("An audit is both a stage in the determination of tax liability… and a possible antechamber to litigation."); *A. Michael's Piano, Inc. v. Fed. Trade Comm.*, 18 F.3d 138, 146 (2d Cir. 1994) (holding that document must be created "with an eye toward litigation"); *Schiller v. N.L.R.B.*, 964 F.2d 1205, 1208 (D.C. Cir. 1992) (holding that document must be created "in anticipation of foreseeable litigation"); *United States v. Rockwell Int'l*, 897 F.2d 1255, 1266 (3d Cir. 1990) (holding that document must be created "because of the prospect of litigation"); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.*, 709 F.2d 1109, 1119-20 (7th Cir. 1983) (stating that party asserting work product protection must show that "some articulable claim, likely to lead to litigation, [has] arisen"); *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981) (holding doctrine applied where document was created "to aid in possible future litigation").

E. What About Proposed Transactions?

The fact that the work product relates to a proposed transaction is just one factor that suggests it was not prepared in anticipation of litigation and is not, in and of itself, dispositive. *United States v. Adlman*, 68 F.3d 1495, 1500-01 (2d Cir. 1995) (finding that corporate officer obtained tax memorandum regarding proposed reorganization from accountant/lawyer).

F. Protection Is Not Absolute

Work product is not absolutely immune from disclosure, and some work product may be obtained by an adverse party upon a showing of substantial need. *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

G. Audit or Tax Return Work Papers Generally Are Not Protected

Historically, an accountant's work papers and work product were not protected. Under current law, however, while an accountant's tax return preparation materials may remain the subject of discovery, a tax practitioner's advice to a taxpayer may be protected from discovery under the moderately new (and fairly limited) tax practitioner privilege protection found in I.R.C. § 7525. See full discussion in Section VI below.

H. "Because of" vs. Primary Purpose Test

Litigation need not be imminent or even the primary reason that protected documents were prepared in order for the work product doctrine to apply. As long as the facts demonstrate that the documents were prepared "because of" anticipated litigation, the doctrine should attach. *United States v. Adlman*, 134 F.3d 1194, 1203-05 (2d Cir. 1995).

Transactional lawyers should be aware that their work product may qualify for privilege protections as well; it is not necessary that litigation be certain. The required level of anticipation varies by court, but it is clear that in many jurisdictions, a court action need not be imminent. For example, courts have extended work-product doctrine protection even to proposed transactions. One found that the work product doctrine applied to tax accrual work papers of a company, as the company's counsel believed that certain transactions entered into by the company would eventually be challenged by the IRS. *United States v. Textron*, 507 F. Supp. 2d 138 (D.R.I. 2007). However, the district court was reversed. *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009). This issue continues to be the subject of litigation, however. *See, e.g.*, *Schaeffler v. United States*, 22 F. Supp. 3d 319 (S.D.N.Y. 2014), *vacated and remanded*, 806 F.3d 34 (2d Cir. 2015).

IV. Physician-Patient Privilege

IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce a summons issued under federal statutory authority, federal privilege rules generally apply. *See*, *e.g.*, *United States v. Moore*, 970 F.2d 48, 50 (5th Cir. 1992).[1] The Fifth Circuit has held that there is no physician-patient privilege under federal law. *Id*. No other circuit has adopted such a privilege. Although the Supreme Court has not yet directly addressed the issue, our highest Court has determined that federal courts should recognize a psychotherapist-patient privilege under Federal

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[1] When Congress adopted the final version of the Federal Rules Evidence in 1975, it rejected the nine enunciated privileges in the proposed rules (which included a physician-patient privilege) in favor of a single rule authorizing federal courts to apply "the principles of common law. . . in the light of reason and experience" in determining whether a privilege exists under the common law. Const. Rep. No. 93-1597, Statement by House Subcommittee Chairman, Dec. 18, 1974, *as reprinted in* 1974 U.S.C.C.A.N. 7108, 7110. The Senate Report accompanying the adoption of the Rules indicates that Rule 501 "should be understood as reflecting the view that the recognition of a privilege based on a confidential relationship . . . should be determined as a case-by-case basis." S. Rep. No. 93-1277 (1974), *as reprinted in* 1974 U.S.C.C.A.N. 7058, 7059.

Rule of Evidence 501. *Jaffee v. Redmond*, 518 U.S. 1, 10 (1996). In *Jaffee*, the Supreme Court held that confidential communications between a licensed psychotherapist and a patient in the course of diagnosis or treatment are protected from compelled disclosure under Rule 501. In reaching its holding, however, the Court noted that:

> Like the spousal and attorney-client privileges, the psychotherapist-patient privilege is 'rooted in the imperative need for confidence and trust.' [ ] Treatment by a physician for physical ailments can often proceed successfully on the basis of a physical examination, objective information supplied by the patient, and the results of diagnostic tests. Effective psychotherapy, by contrast, depends upon an atmosphere of confidence and trust in which the patient is willing to make a frank and complete disclosure of facts, emotions, memories, and fears. Because of the sensitive nature of the problems for which individuals consult psychotherapists, disclosure of confidential communications made during counseling sessions may cause embarrassment or disgrace.

Id. While the *Jaffee* Court did not rule on the applicability of a physician-patient privilege, the cited language indicates that medical records based primarily upon physical examination and other objective information supplied by the patient or that result from diagnostic tests may not be considered privileged.

V. Tax Practitioner Privilege

Section 7525(a)(1), enacted in 1998, extends the same common law protection of confidentiality to a communication between a taxpayer and any "federally authorized tax practitioner" involving tax advice that would have been privileged if it were a communication between a taxpayer and an attorney. This privilege may be asserted only in non-criminal tax matters before the Internal Revenue Service or any non-criminal tax proceeding in federal court brought by or against the United States.

A. Definitions.

1. Federally Authorized Tax Practitioner.

The term "federally authorized tax practitioner" means any individual who is authorized to practice before the IRS if such practice is subject to federal regulation under 31 U.S.C. § 330 (also often referred to as "Circular 230"). In other words, the phrase includes CPAs, enrolled agents, and enrolled actuaries.

2. Tax Advice.

The term "tax advice" means any advice given within the scope of the individual's authority to practice before the IRS, including both tax advice and tax representation.

3. Exception for Tax Shelters.

The Tax Practitioner Privilege does not apply to written communications between tax practitioners and directors, shareholders, officers, employees, agents, or representatives of a corporation in connection with the promotion of the direct or indirect participation in any corporate tax shelter as defined in I.R.C. § 6662(d)(2)(C)(ii).

4. Effective Date.

The privilege may be asserted only as to communications made on or after July 22, 1998.

B. Limitations of Section 7525: Uncovered Return Preparers

By its terms, Section 7525 is applicable only to communications between a taxpayer and a "federally authorized tax practitioner." Other accountants, bookkeepers, and possibly agents of otherwise qualified federally authorized tax practitioners do not appear to be included.

1. Scope.

The extension of the privilege to "any non-criminal tax proceeding in Federal Court brought by or against the United States" in Section 7525(a)(2)(B) was inserted by the Senate (or the conference committee) and was designed to be broader than the House version of the bill, which had only covered tax litigation.

a. Non-Criminal.

The statute is specifically inapplicable in criminal proceedings before the Internal Revenue Service and in criminal proceedings in a Federal Court. Note that today's privileged communication loses its Section 7525 privilege protection upon commencement tomorrow by the IRS of a criminal investigation.

b. Bankruptcy Covered?

Bankruptcy is not a non-criminal federal court matter "by or against the United States" until an adversary proceeding is filed.

c. All Bankruptcy Covered?

Does the provision cover all bankruptcy cases in which the United States is a party, or just cases in which a determination of tax liability is involved?

2. Tax Shelters.

The statute specifically carves out written communications between practitioners and representatives of a corporation in connection with the promotion of the direct or indirect participation in any tax shelter.

a. Ambiguous at Best.

Although reference is made to Section 6662, the definition of tax shelter in that section is far from precise.

b. Legal Advice Still Privileged as to Shelters.

The tax shelter exception originally was designed to remove privilege protection from attorneys who advised regarding tax shelters as well. In the conference committee bill, lawyers were carved out of the exception. Senate judiciary committee chair Orrin Hatch and House judiciary committee chair Henry Hyde pressured the conference committee to drop all references to the attorney-client privilege in the corporate tax shelter exception. The district court for the District of Columbia has also issued several important decisions in the arena of tax shelter litigation. In *United States v. KPMG LLP*, 237 F. Supp. 2d 35, 38-39 (D.D.C. 2002), *citing United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999), the court determined that the Section 7525 privilege did not extend to opinion letters issued to an accounting firm's client because such letters were prepared in connection with the preparation of a tax return. In a subsequent decision, the court determined that some of the documents claimed to be protected by Section 7525 were actually protected. *United States v. KPMG LLP*, No. 02-0295, 2003 WL 22336072 (D.D.C. Oct. 10, 2003); *see also United States v. BDO Seidman, LLP*, 225 F. Supp. 2d 918 (N.D. Il. 2002), *aff'd*, 337 F.3d 802 (7th Cir. 2003) (holding name of clients not privileged under Section 7525); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (holding accounting firm's advice not privileged because accounting firm's communications with company were not delivered to facilitate communications between company and its attorney).

3. Tax Return Preparation May Not Be Covered.

The privilege for tax advice is the same as if the professional were an attorney. This means, among other things, that if the privilege does not protect communications if made to an attorney, it likewise does not protect those same communications to a tax practitioner. Consequently, tax practitioners and clients alike should be aware that tax return preparation communications are unlikely to be privileged.

VI. Privileges in the Appraisal Process

A. Attorney to Hire Appraiser?

In the transfer tax area, valuation appraisals often serve as the basis for a taxpayer's position on the value of transferred property. Working with appraisers is an everyday event for most transaction planning attorneys. On the other hand, working with appraisers can be something of a rarity for most clients, many of whom have dealt with appraisers only in the purchase of real estate.

In most cases, the attorney, rather than the client, should hire the appraiser for a planning transaction. The attorney can offer guidance both to the client and to the appraiser on how similar transactions have been handled in the past by the IRS and the courts. Having the attorney hire the appraiser will also provide the taxpayer with an argument that any unused reports or correspondence are privileged, as the work of the appraiser was intended to assist the attorney in rendering legal advice.

However, if the appraiser ultimately produces a report used by the taxpayer, any documents in the appraiser's file, including correspondence, notes, or appraisal drafts may be subject to disclosure to the IRS. *See, e.g., United States v. Richey*, 632 F.3d 559, 567 (9th Cir. 2011) (holding appraiser's work papers not privileged where referred to in appraisal as additional material relied on but not attached to report and where appraisal was required by Code to qualify for deduction sought).

In *Richey*, the taxpayers made a charitable gift and sought a charitable deduction. In order for the gift to qualify for the charitable deduction, the Code required that the taxpayers obtain and attach to their income tax return an appraisal of fair market value for the value of the deduction sought. They did so.

In his report, the appraiser indicated that he relied on materials attached to his report, as well as other documents and information contained (not in the report but) in his work papers. The IRS summonsed the work papers. The attorney, relying on *Kovel* and its progeny, declined to produce the work papers, asserting both the work product doctrine and attorney-client privilege.

The trial court ruled in favor of the IRS, finding that the appraisal was not sought (and the appraiser engaged) to assist the attorney in rendering legal advice. Rather, the appraisal was sought in order to allow the taxpayers, in compliance with the Code, to qualify for the charitable deduction. Implicit in the court's analysis was the conclusion that the work of an appraiser – even if hired by the attorney – is not privileged if the appraisal is required to be submitted with the tax return in order for the taxpayer to take the position sought. On appeal, the Ninth Circuit reasoned that while there could be privileged information in the appraiser's file, the taxpayer had not, according to the evidence rules, identified specific communications that the privilege should protect. (The court also rejected the attorney's contention that the file was work product, prepared in anticipation of litigation.)

The Ninth Circuit opined that the appraiser should testify about the non-privileged documents contained in the work file and remanded the case to the trial court for an in-camera review of the documents in the appraiser's work file. The Appellate Court specified, "any communication related to the preparation and drafting of the appraisal for submission to the IRS was not made for the purpose of providing legal advice, but, instead, for the purpose of determining [ ] value . . . ." Further, to the extent the files contain documents that were not communications, they are not protected by the attorney-client privilege." *Id.* at 567.

The work product doctrine and attorney-client privilege in this context only protect those communications necessary to assist the attorney in rendering legal advice – often read as allowing the attorney to understand the client's communications themselves. Once again, consider who the audience may ultimately be and understand that the appraiser's file may be reviewed by the examining agent, an appeals officer, district counsel, or the ultimate finder of fact in tax litigation. In any event, the planning lawyer may wish to have an oral discussion with the appraiser after he or she determines the value range but before he or she prepares a first draft of a written report so that differences of opinion or relevant law may be discussed freely. In large and/or complex valuation cases, the planning lawyer may want to consider engaging two appraisers: one to aid the lawyer in his or her analysis of the appraisal (whose work as a consulting expert will not be disclosed), and one whose appraisal will ultimately be disclosed to the IRS, either as support for the value reported on the transfer tax return or at trial.

B. The *Kovel* Accountant: Solution?

In part because of the limits of the Tax Practitioner Privilege, attorneys (rather than accountants or taxpayers directly) often engage experts and advisors, such as accountants, to assist them in rendering legal advice, while also ensuring that the consultant's work in assisting the attorney will remain confidential. This engagement is often referred to as a "Kovel Agreement," named after a landmark case on this issue. *See United States v. Kovel*, 296 F.2d 918, 921 (2d Cir. 1961); *see also United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972); *Cavallaro v. United States*, 284 F.3d 236, 246 (1st Cir. 2002).

Under *Kovel*, in order to demonstrate that a consultant is assisting an attorney in providing legal services, a written engagement letter is important. Such a letter, if drafted with an eye toward *Kovel*, can serve as evidence sufficient to preserve the privilege. Such a *Kovel* engagement letter should include terms that focus on the following factors:

1. Control.

Consultant is engaged by the attorney and is working under the attorney's direction.

2. Not Pure Return Preparation.

Consultant's work is for the purpose of rendering legal advice, not simply for the preparation of tax returns. For example, the consultant is assisting the attorney in determining whether delinquent federal income tax returns should be prepared and filed and what positions to take on those returns.

3. Ownership.

Work of the consultant belongs to the attorney.

4. Purpose.

Any communications with the consultant are made solely for the purpose of enabling the attorney to provide legal advice to the client.

Attorneys often extrapolate the accountant concept to appraisers, attempting to cloak their communications with appraisers in the attorney-client privilege. However, if an appraiser is engaged to provide the taxpayer's rationale for a reporting position on a tax return, particularly if attaching the appraisal to the tax return is required, the appraiser's work papers may be considered tax return preparation materials and therefore discoverable, even if the appraiser was hired by the attorney. *See United States v. Richey*, 632 F.3d 559 (9th Cir. 2011).

Likewise, if an appraiser is engaged as a testifying expert, some or all communications (depending on which Rules of Evidence apply) with the appraiser may be discoverable. *See, e.g.*, FED. R. EVID. 502 (requiring all data relied upon by testifying appraiser to be disclosed, but not other communications with attorney); TAX CT. R. 70(c) (historically requiring disclosure of all requested communications with testifying expert to be disclosed but now protecting from disclosure communications between attorney and expert regardless of form, unless communication: (1) relates to expert's compensation; (2) identifies facts or data considered by expert in forming opinion; or (3) identifies assumptions considered by expert in forming opinion. FED. R. CIV. P. 26(b) (protecting trial experts' drafts from discovery); *see also United States v. Veolia Environment North Amer. Op., Inc.*, Civ. No. 13-mc-03-LPS (2013) (requiring production of materials containing facts or data considered by experts in forming opinions). An expert is not required to produce facts known or opinions held in anticipation of litigation or in preparation of trial if that witness is not expected to be called as a witness at trial, unless the expert's facts and opinions on the same subject matter cannot be obtained elsewhere. *See Veolia Environment North Amer. Op., Inc.*, Civ. No. 13-mc-03-LPS.

C. Discussing Methodology Before Conclusions Are Memorialized

Yet, regardless of the applicability of the attorney-client privilege, hiring a qualified appraiser is only the first step. Estate planners should examine the underlying assumptions, analysis, and conclusions of the appraiser and ensure that they are logical. Appraisers can and do make mistakes. Planners should discuss with appraisers the methodology of examination perhaps even before any analysis is put to paper. Attorneys should not "coach" the appraiser or dictate the desired result. That said, attorneys should be comfortable that the appraiser's assumptions and analyses are correct. If questions or concerns arise, the attorney should discuss those concerns with the appraiser at length, if needed. If the concerns cannot be addressed, the taxpayer and her attorney should consider choosing another appraiser. If a second appraiser is engaged before the first appraiser has reduced his findings to writing, there will be no documents from the first appraiser to produce in response to an examining agent's request for "copies of all appraisals."

VII. Effect of Asserting Attorney-Client Privilege on Burden of Proof in Disputed Cases

In certain situations, the taxpayer can shift the burden of proof from the taxpayer to the government in court. *See* I.R.C. § 7491. Section 7491 provides:

A. Burden Shifts Where Taxpayer Produces Credible Evidence

1. General Rule.

If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.

2. Limitations.

Paragraph (1) shall apply with respect to an issue only if **–**

a. the taxpayer has complied with the requirements under this title to substantiate any item;

b. the taxpayer has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews; and

c. in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).

Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent's death and before the applicable date (as defined in section 645(b)(2)).

3. Coordination.

Paragraph (1) shall not apply to any issue if any other provisions of this title provides for a specific burden of proof with respect to such issue.

I.R.C. § 7491.

To shift the burden of proof, the taxpayer must comply with the substantiation requirements of the Internal Revenue Code and keep all required records. In addition, the taxpayer must have cooperated with "reasonable requests"[2] by the IRS for "witnesses, information, documents, meetings, and interviews" and must present "credible evidence" in court on the factual matters at issue. If all of these conditions are met, Section 7491 provides that the burden of proof shifts to the IRS.

Moreover, filing a motion to quash a summons does not (in and of itself) indicate lack of cooperation such that the burden of proof cannot shift to the IRS. In *Estate of Kohler,* the Tax Court determined that a taxpayer did not fail to reasonably cooperate simply because it filed a motion to quash a summons that the IRS had issued to obtain certain documents during discovery. The Tax Court found that the taxpayer:

> had a good faith belief that some of the documents respondent sought were irrelevant, sealed, or contained sensitive . . . business information and filed a motion to quash the summons to protect its rights. Once the court denied the estate's motion to quash the summons, the estate provided the documents respondent requested. Respondent has not argued that respondent's investigation was impaired by any lack of documentation.

Estate of Kohler v. Comm'r, 92 T.C.M. (CCH) 48, 52 (2006). Consequently, the burden of proof shifted in *Kohler* to the IRS.

If the taxpayer complies with Section 7491, the IRS has another layer of litigation hazards to consider, which could aid in resolving more cases before trial.

[2] The question yet to be addressed by the courts is whether a request that seeks privileged information can ever be "reasonable."

VIII. Conclusion

In sum, there are numerous protections of communications among advisors and between advisors and their clients. To best protect those communications from discovery or, if produced, from misinterpretation, it is important to understand the differences among those protections and to ensure that the communications are documented in the context of the broader goals of the clients, such that tax and non-tax reasons for the transaction are clearly indicated. Keeping these protections in mind at all times can assist the client's advisors in rendering advice to the taxpayer and in accomplishing the client's goals. And, although privileges generally are thought to protect communications with attorneys, anticipating that at some point the client might find it advantageous to waive these privileges and, as a result, deliberately documenting communications that could be helpful in the event of a tax audit or dispute could be the lynchpin for the client's case.

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Introduction

The steps that partners and their advisors take in forming and operating a family limited partnership[1] can impact a court's view on valuation to such a great extent that valuation evidence can become irrelevant. In transfer tax cases addressing legal issues such as indirect gifts and the applicability of § 2036,[2] courts may conclude that the facts in a given case are such that it is a proportionate share of the assets of the partnership, rather than the transferred partnership interest, that is to be valued for transfer tax purposes. In other words, if the existence of the partnership is judicially disregarded, the question of the value of the transferred partnership interest need not be reached – only the value of the underlying assets of the partnership matters. The result to the taxpayer in such a situation is that although he transferred a partnership interest subject to various duties and restrictions found in the governing partnership agreement, for transfer tax purposes, those duties and restrictions are ignored, and the resulting discounts for lack of marketability and lack of control are disregarded. Thus, when the existence of a partnership is judicially ignored, the value that is used for transfer tax purposes is the portion of the underlying assets of the partnership attributable to the transferred interest, without regard to the fact that a hypothetical buyer would take into account the terms of the partnership agreement when deciding on the price that he would be willing to pay for the interest. *Levy v. United States*, 2008 WL 4004695 (W.D. Tex.), *aff'd*, 402 Fed. Appx. 979 (5th Cir. 2010) (the control and marketability questions was shown to the jury by control of Partnership's assets). However, in a few cases, it was ruled that the plaintiffs' expert's calculations and analysis pertaining to discounts were acceptable. The Court did not accept government's expert's opinion regarding those discounts because he either did not provide convincing arguments or plaintiffs' expert's calculations and analysis were more reasonable. *Adams v. United States*, 218 F.3d 383 (5th Cir. 2000, *judgment entered by*, 88 A.F.T.R.2d 6057 (N.D. Texas 2001); *Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016); *Estate of Dailey v. Comm'r*, 82 T.C.M. (CCH) 710 (2001).

As the Internal Revenue Service ("the IRS") increases its efforts to deprive taxpayers of the tax benefits that family limited partnerships offer, a pattern of issues raised by the IRS has emerged. For instance, in recent cases, the IRS has focused on whether Internal Revenue Code § 2703 applies to disregard rights of first refusal and buy-sell provisions when determining the value of a partnership interest that was transferred. *Fisher v. United States*, 2010 WL 3522952 (S.D. Ind. Sep. 1, 2010); *Holman v. Comm'r*, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010). The IRS also generally argues that the fair market value of partnership interests reported on various transfer tax returns is too low – that the valuation discounts applied were too aggressive or simply were not applicable.

In the gift tax context, the IRS has focused on whether gifts of partnership interests can qualify for the annual gift tax exclusion and whether gifts of partnership interests made close in time to the partnership's formation are, instead, gifts of underlying assets of the partnership that were then contributed to the partnership by the gift recipient (the indirect gift theory). For instance, in a case where a father and his two sons created a partnership, and the father, at creation, transferred all of the assets to the partnership (and the sons made no individual capital contribution), the Tax Court held that the father had not made gifts of partnership interests, but rather made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent that those properties were attributed to his sons' capital accounts. *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd,* 283 F.3d 1258 (11th Cir. 2002). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. *See also Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009); *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Holman v.*

[1] Although this article refers to limited partnerships, many of the suggestions contained herein also apply to other closely held entities, such as limited liability companies.

[2] The author has attempted to provide a thorough analysis, for educational purposes only, of the arguments that the IRS has made and the courts have sometimes adopted in addressing certain "pitfalls" in the structure and operation of family entities. However, no statement herein should be construed as a concession of the legal sufficiency of those analyses or that any such "pitfall" precludes recognition of the entity for any federal tax purposes.

Comm'r, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010); *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008). In another case, the Court rejects the Government's argument that the difference in value between the partnership interests Mrs. Church received on formation, and the value of interest transferred upon her death should be the measurement of consideration she received for her contribution of partnership assets. The Court continues stating Mrs. Church receiving "full and adequate consideration" is based on whatever the value of the Partnership interest, at formation, is "directly proportionate to the contributions the Partnership interests of the other partners to a Partnership that had a bona fide business purpose." *Church v. United States,* 85 A.F.T.R.2d 804 (W.D. Texas 2000), *aff'd,* 268 F.3d 1063 (5th Cir. 2001).

And in the estate tax context, the IRS has increasingly raised the spectre of IRC § 2036(a). Typically, the IRS has argued that all assets contributed by a decedent to a limited partnership during lifetime should be included in the decedent's gross estate under § 2036(a)(1), arguing that the decedent retained rights to assets contributed. Most recently, the IRS successfully argued that a decedent's retention of the right to dissolve a partnership, in conjunction with another person, caused § 2036(a)(2) inclusion – an argument on which the IRS had not been successful since *Estate of Strangi*, 85 T.C.M. (CCH) 1331 (2003), aff'd 417 F.3d 468 (5th Cir. 2005). The IRS's most recent attack on partnerships is becoming commonly referred to as "the marital deduction mismatch." *See, e.g., Estate of Turner v. Comm'r*, 138 T.C. No. 14 (2012) (limiting the decedent's marital deduction to the actual value of the property passing to the wife, where the will provided for a calculation based upon the actual, rather than discounted value, of the assets); *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010) (declining to reach the marital deduction mismatch argument because the exception to § 2036 applied).

In determining fair market value for transfer tax purposes, the value of a transferred interest is determined according to the "hypothetical willing buyer/willing seller" test found in § 2031 (for estate tax purposes) and § 2512 (for gift tax purposes) and the related Treasury Regulations. *See Ludwick v. Comm'r*, 99 T.C.M. (CCH) 1424 (2010) (determining fair market value of undivided interest for gift tax purposes). *See Temple v. United States*, 423 F. Supp. 2d 605 (E.D. Tex. 2006) (for gift tax purposes, the value of property is "the price at which such property would change hands between a willing buyer and a willing seller"). Therefore, the fair market value of the transferred interest is not a proportionate share of the partnership's assets, because a hypothetical willing buyer would not be willing to pay for a pro rata share of the underlying assets of the partnership, in part because the buyer would not own the underlying assets and in part because the terms of the partnership agreement burden the assets. Consequently, the fair market value of a partnership interest is almost certain to be less than the proportionate value of the assets of the partnership. And it is the fair market value of the transferred partnership interest that is used to determine the amount of tax due as a result of the transfer.

With regard to estate tax cases, the IRS has been successful in its efforts largely in cases where taxpayers have failed to respect the integrity of the entities that they form. In these cases, the Tax Court has applied § 2036(a) to bring the value of the assets of the partnership back into decedents' estates as retained life interests. Section 2036(a) provides as follows:

> (a) GENERAL RULE—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.

I.R.C. § 2036.

This material is intended to assist practitioners in advising their clients at each step of forming, operating, and defending a partnership to avoid pitfalls that the courts and the IRS are pointing to when opining that, in essence, the existence of a partnership should be disregarded for valuation purposes.

I. Consider Appropriateness of Partnership

A. Keep Potential Future Audience in Mind

Preparing for a potential estate tax examination really begins at the estate planning level. Keep in mind that anything that you write or your client writes (even if protected from discovery by one or more privileges) may later be viewed by the IRS, a judge, or even a jury. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009) ("Guess we have to be real straight on who borrowed what etc. so the partnership looks very legit."), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011); *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009) ("[Y]ou have to get the assets into the LLC first so it's the owner of the assets before you start making transfers."), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011). For instance, in cases where the IRS has asserted that § 2036 applies (and thus the person who formed a partnership has passed away), the only evidence of non-tax reasons for forming the partnership may be contained in privileged documents.

While advisors should not shy away from explaining the tax effects of forming a limited partnership, it is preferable to have such discussions take place in the context of a discussion of the non-tax reasons, as well. The best evidence of a taxpayer's rationale for forming a partnership often comes from the correspondence prepared in connection with the decision to create the entity.

In attempting to establish the non-tax reasons for forming a partnership, it is helpful if the documentation is such that the taxpayer feels comfortable waiving the attorney-client privilege and producing requested communications that would otherwise be protected from discovery under the attorney-client privilege.

B. Consider Whether Clients Are Ready for Partnership

Family limited partnerships are like blowfish sushi – handled with precision and care, they can be wonderful; handled carelessly, they are downright dangerous. Limited partnerships can be confusing, and, at a minimum, they are complex. Therefore, it is important to evaluate whether the people who are considering forming a limited partnerships are up to the task. Can they get along? Are they willing to abide by the rules? Are they prepared to pay the legal and accounting fees that tend to come along with the entity? These questions and others are important to address in determining whether your clients are ready for a partnership.

C. Evaluate Potential Assets

1. Maintain Assets Outside of the Partnership

The courts and the IRS have opined that partners should retain enough assets outside of the partnership to support their lifestyles. The IRS has often asserted that a contributing partner's failure to retain sufficient assets outside of a partnership to maintain his or her standard of living is evidence of an implied agreement of that partner to retain rights to the income from the assets contributed to the partnership. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009); *Estate of Jorgensen v. Comm'r*, 97 T.C.M. (CCH) 1328 (2009), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367(3d Cir. 2004). *But see Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277 (2008) (declining to apply § 2036 where decedent anticipated funding lifestyle with partnership distributions). In combating, for instance, a § 2036 argument, it is helpful to have contemporaneous documentation of the fact that a contributing partner had sufficient cash flow outside of the partnership to support his or her lifestyle without depending on extraordinary distributions from the partnership.

2. Refrain from Contributing Personal Use Assets

In determining whether formation of a partnership is appropriate, partners should consider the nature of the assets to be contributed to the partnership. For instance, the IRS and the courts have, in their consideration of whether a partnership is to be respected, considered as a negative factor the contribution of "personal use" assets to partnerships (in great part because those assets, on contribution to the partnership, become partnership property but may not be treated as such). *See, e.g.*, *Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Bigelow v. Comm'r*, 503 F.3d 955 (9th Cir. 2007); *Estate of Korby v. Comm'r*, 471 F.3d 848 (8th Cir. 2006), *aff'g* 89 T.C.M. (CCH) 1150 (2005); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd* 417 F.3d 468 (5th Cir. 2005); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002); *Estate of Reichardt v. Comm'r*, 114 T.C. 144 (2000). Such assets include personal residences, vacation homes, and recreational equipment. If the partners feel strongly about contributing such assets to the partnership, care should be taken to minimize the possibility of IRS attack by ensuring that the partnership is compensated for individuals' (including and perhaps most importantly, partners') use of those assets, *i.e.*, rent should be paid to the partnership for use of the partnership's assets. Failure to do so may lead the IRS to assert, for instance, that § 2036 should apply at death, in light of the fact that a contributing partner retained the right to use partnership property without paying for it.

3. Secure Appraisals for Hard-to-Value Assets

In recent cases, the courts have examined the propriety of partners' capital accounts on formation as a factor in whether § 2036 should be applied to various partnership interest transfers. In that regard, advisors should keep the full and adequate consideration element of the exception to § 2036 in mind and ensure that capital accounts of all partners are properly created, credited, and maintained. Consequently, if partners intend to contribute assets to the partnership that are hard to value (*e.g.*, real estate, oil and gas interests, interests in closely held entities), it is advisable to obtain appraisals of the fair market value of those assets so that the calculation of initial ownership interests in the partnership is as accurate as possible. *See generally Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011) (exhibiting value of using two appraisals for hard-to-value assets). It is equally important to follow the appraiser's fair market value calculations. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). For instance, obtaining and relying on the reasonable opinion of a professional appraiser can help the client avoid penalties. *See Giustina v. Comm'r*, 101 T.C.M. (CCH) 1676 (2011).

Likewise, if assets subject to debt or non-liquid assets (such as real estate) are to be contributed to the partnership, the partners should make sure to fund the partnership with sufficient cash to support those assets, such that the partnership can service its debt[3] and pay real estate taxes and other expenses related to its property. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007) (concluding that decedent retained economic benefit of contributed real estate where property continued to secure decedent's debts and rental income was used to pay decedent's expenses). Doing so may help to minimize fuel for an IRS argument that a contributing partner's debt service or payment of maintenance costs related to assets contributed to the partnership evidences an implied agreement under § 2036 of that partner's right to use those partnership assets.

4. Review Transfer Restrictions

Finally, when determining which assets are to be contributed to the partnership, be sure to review any transfer restrictions that might be applicable to those assets. If the documents governing a particular asset do not permit transfer of that asset without, for instance, written authorization of a certain person or entity, try to begin that authorization process sooner rather than later (or to avoid contributing that asset to the partnership, if it is determined that the transfer restrictions are too onerous).

D. Evaluate Potential Partners

First, potential partners should consider with whom they wish to be partners. Family limited partnerships often have long terms of existence. It is a good idea to consider whether partners think that they will be able to work together throughout the term of the partnership. Evidence of discussion of such considerations is helpful in establishing that the terms of the partnership agreement were negotiated, a factor that is considered, for instance, in determining whether the bona fide sale element of the exception to § 2036 is applicable.

On a similar note, participants should consider the health of their proposed partners. The IRS likes to point to "deathbed partnerships" as evidence of its assertion that the only reason for forming the partnership was tax avoidance. If one or more of the potential partners is seriously ill, the partners might reconsider whether to include her. *See, e.g.*, *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012) (91 years old but in good health); *Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009) (bad health); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009) (stable health for first contribution; steep decline for second contribution); *Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277 (2008) (stable health); *Estate of Erickson v. Comm'r*, 93 T.C.M (CCH) 1175 (2007) (bad health); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007) (bad health); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006) (bad health); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005) (bad health); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003) (good health). And beware forming a partnership with a person who is not competent to execute the partnership agreement himself; when determining whether partnerships were formed for bona fide, non-tax reasons, the IRS and the courts have taken into account the fact that an agent, rather than the partner, executed the formation documents. *See, e.g., Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002).

[3] Keep in mind, however, that relief of the contributing partner's debt in this regard may require consideration of income tax issues for that partner.

Second, participants should consider whether the partners will be individual family members, trustees of trusts for family members, entities formed by family members (such as a limited liability company), or some combination of any or all of the above.

In choosing partners, the participants should consider who will be able to make meaningful capital contributions to the partnership. *See Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005). To the extent possible, it is preferable to have each partner make a meaningful contribution to the partnership so as to establish that a real pooling of assets and services occurred and to avoid the IRS's argument that, for instance, a child's proportionately small contribution had no real impact – that creation of the partnership was a "mere recycling of value," as that term is used in *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002). (Beware, though, the implications of the investment company rules when determining the nature and amount of the assets to be contributed to a partnership. *See, e.g.*, I.R.C. §§ 721, 351, 368; Priv. Ltr. Rul. 200931042.)

Finally, in determining who the partners will be, forming partners should consider what roles each of the partners will play, if any, in partnership management. Do the partners intend to have the parent manage the partnership? Is the partnership to be used as a tool to progressively teach the next generation? Or is management to be passed immediately to the children? A parent's considerations in this regard and a written record of those considerations can play a pivotal role in later establishing the non-tax reasons for which a partnership was formed.

E. Avoid Gift Planning Until Partnership is Up and Running

In an ideal world, the entity would be formed, funded, and functioning before discussion of gift planning even began. However, most clients want to understand all of the pros and cons related to formation of an entity, and most estate planners want to explain all of the possibilities at the outset. The likelihood that the concept of gift planning with partnership interests will not even be mentioned until after the entity is up and running is minimal at best.

However, the risk that advisors and clients take when discussing (and perhaps beginning to implement) gift planning at the outset is that the IRS will assert the indirect gift theory – or even the step transaction doctrine.

That said, it is clear that even the courts anticipate that the tax benefits of an entity will be discussed and explored. *See Estate of Turner v. Comm'r*, 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012) ("We are particularly struck by the implausibility of petitioner's assertion that tax savings resulting from the family limited partnership were never discussed. . . . We do not find testimony to that effect to be credible and that lack of credibility infects all of the testimony petitioner offered."). As long as the tax savings discussions are had within the context of the non-tax considerations, later gifts (occurring *after* formation and funding) should withstand scrutiny, barring other negative factors.

Compare Pierre v. Comm'r, 133 T.C. 24 (2009), *supp. by* 99 T.C.M. (CCH) 1436 (2010), *Holman v. Comm'r*, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010), *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008), *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005), *Estate of Jones v. Comm'r*, 116 U.S. 212 (2001), *and Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002), *with Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011), *Heckerman v. United States*, No. C08-0211-JCC, 2009 WL 2240326 (W.D. Wash. Jul. 27, 2009), *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006), *and Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

II. Partnership Formation

In the IRS's view, and more importantly, that of the courts, it is critical that partners in a partnership respect the entity as an entity (*i.e.*, comply with the terms of the governing partnership agreement, treat assets of the partnership as partnership assets, etc.). If the partners fail to do so, it is highly unlikely that the IRS or a court will. In that regard, it is important to dot all of the Is and cross all of the Ts. Some suggestions follow:

A. Consider Separate Counsel for Participants

Although having each partner represented by separate counsel may be expensive, it also goes a long way toward ensuring that the interests of each partner are considered when forming the partnership and that the terms of the partnership agreement will be reviewed by and discussed among the partners at that time. It also serves to evidence the arm's-length nature of the creation of the partnership. *See, e.g., Estate of Jorgensen v. Comm'r*, 97 T.C.M. (CCH) 1328 (2009), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Rector v. Comm'r*, 94 T.C. M.

(CCH) 567 (2007); *Estate of Rosen v. Comm'r,* 91 T.C.M. (CCH) 1220 (2006); *Estate of Stone v. Comm'r,* 86 T.C.M. (CCH) 551 (2003).

B. Engage/Consult with Experienced Advisors

It is important to hire an attorney and an accountant who are experienced in partnership issues to assist in the decision-making processes, and hiring such advisors should happen sooner rather than later. The earlier that experienced advisors are involved, the less likely the partners are to make a misstep in a potential minefield. Beware of simplified "kit" partnerships that do not take into account the partners' individual reasons for and goals in forming the partnership. *See, e.g.*, *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002).

C. Discuss Partnership Terms

In establishing that the creation of the partnership is a bona fide sale as that term is used in § 2036, it is important to document any facts evidencing the arm's-length nature of the transaction. Negotiation of the terms of the partnership agreement by the intended partners is precisely the type of evidence that can be used to establish that the bona fide sale element of the § 2036 exception is met, as was the case in *Estate of Stone v. Comm'r*, 86 T.C.M (CCH) 551 (2003). Furthermore, all partners should be included and participate in these negotiations. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). Governing agreements generally should not allow senior family members to maintain 100% management control, nor should the sole power to change partnership terms rest in those senior family members, as these provisions could cause the IRS to argue that the right to possess and enjoy the property was retained by the transferor, thus triggering § 2036 inclusion. *See Estate of Turner v. Comm'r*, 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012).

Using a "kit" partnership may play into the hands of the IRS, as such pre-formulated documents rarely leave room for the tailoring that an attorney with experience in family partnerships can provide. *See, e.g., Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

Some of the partnership agreement terms that family members might consider important to negotiate and discuss in this regard are:

- Purpose – what are the family-specific reasons that this taxpayer and her family have for forming the partnership?
- Management structure – who will serve as general partner(s)? Will there be a managing partner(s)? Will unanimity be required for management decision-making if more than one person or entity is managing the partnership?
- Management powers – what actions may partnership management take without the approval or **input of the other partners?**
- Compensation to managers – will the general partners/managing partners be compensated? If so, at what level?
- Investment policy – what will the partnership's investment policy be? *See Estate of Jorgensen v. Comm'r*, 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). *But see Estate of Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353 (2005).
- Books and records – what books and records will the partners be required to keep? Do partners wish to prepare annual financial statements?
- Distribution policy – will the partnership make regular distributions? Will it make distributions sufficient to cover each partner's income tax liability attributable to his partnership interest?
- Transfer restrictions – what transfer restrictions should be included in the partnership agreement? How will those transfer restrictions impact each partner?
- Partnership term – how long should the partnership stay in existence?

· Use of partnership assets – under what terms may a partner or third party rent a partnership asset?

D. Encourage Partners to Discuss Purposes of Partnership

Some of the partnership purposes that family members might consider important are:

· Joint enterprise for profit; s*ee Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003).

· Centralized management; *see, e.g., Estate of Purdue v. Comm'r*, 110 T.C.M. (CCH) 627 (2015); *Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012).

· Furtherance of family investment strategies; *see, e.g., Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009); *Estate of Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353 (2005); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009). *But see Estate of Turner v. Comm'r*, 102 T.C.M. 2011, *supp. by* 138 T.C. No. 14 (2012) (management of passive investments not a legitimate non-tax purpose).

· Preservation of the family business*; see Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010).

· Division of control, financial benefits among children; *see, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012)*; Estate of Murphy v. United States,* 104 A.F.T.R.2d 7703 (W.D. Ark. 2009).

· Marriage protection; *see Keller v. United States*, 2009 WL 2601611 (S.D. Tex. August 20, 2009), *aff'd,* 697 F.3d 238 (5th Cir. 2012).

· Bankruptcy protection.

· Creditor protection.

While the sole purpose of the partnership should not be to save on estate taxes or facilitate gift giving, the existence of these motives, in conjunction with valid, non-tax reasons for forming the partnership, should not preclude the application of the bona fide sale exception to § 2036. *See, e.g., Estate of Stone*, 103 T.C.M. (CCH) 1237 (2012); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009); *Estate of Murphy v. United States*, 104 A.F.T.R.2d 7703 (W.D. Ark. 2009).

E. Ensure Agreement's Schedules Are Complete

Most partnership agreements refer to an attachment, schedule, or exhibit that is intended to list all of the assets that the partners agree to contribute to the partnership at formation and the resulting partnership interests to be received by the partners in return. In some states, such attachments are required by statute; and in some of those states, the attachments must also detail the fair market value of the assets to be contributed. In combating IRS arguments that the formalities of a partnership were not respected, it is important that any such attachments to a partnership agreement be complete at the time that the partnership agreement is signed. And in order to best anticipate questions in audit, such attachments should accurately set forth the assets contributed to the partnership, the fair market value of those assets, and the resulting ownership interests of each partner of the partnership.

Sometimes, it is impossible to know the fair market value of contributed assets – and thus the amount of the resulting percentage interests – at the time that the partnership agreement is formed. This situation can occur if, for instance, there are hard to value assets such as real estate for which an appraisal as of the formation date is being obtained. This can also occur with regard to securities, for which the value cannot be known until the close of business on the day of formation. If necessary, an amendment to the partnership agreement can be executed once accurate fair market values are known.

F. Reflect Contributions in Capital Accounts in Proportion to Fair Market Value of Assets Contributed

Creating capital accounts timely is critical in establishing that the transfer of assets in exchange for partnership interests was a transfer for full and adequate consideration, as that term is used in the exception to the application of § 2036, or was not an indirect gift of the assets contributed to the partnership. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016). To avoid IRS attack, each partner's capital account should reflect the value of the assets that he contributed to the partnership and the percentage interest received by the partner in return. Consider creating capital accounts prior to preparation of the entity's first tax return. *See Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009) ("The tax return itself . . . does not constitute contemporaneously prepared evidence as to the sequence of transactions resulting in the capital account balances."), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011). In order to refute the application of, among other theories, § 2036, the percentage interests received by the partners should be proportionate to the fair market value of the assets that each contributed. *See, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012).

G. Prepare Transfer Documents in Advance and File with Relevant State Authorities

As referenced above, in disputing the IRS's assertions that a partnership should not be respected, it is important to establish that the formalities surrounding formation (and operation) of a partnership are respected. One of those formalities is the transferring of assets to the partnership that the partners agreed to contribute when creating the partnership. In that regard, it is most efficient to have the transfer documents ready at the time that the partnership agreement is signed, so that partners can sign all of the relevant documents necessary to form the partnership agreement and transfer title to the assets into the partnership's name all at once. Doing so also ensures that this very important step does not get overlooked. *See Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008) (finding that partnership formalities were disregarded by significant delays in contributing assets to the partnerships); *Estate of Hillgren v. Comm'r*, 87 T.C.M. (CCH) 1008 (2004) (finding that the taxpayer delayed in transferring property to the partnership); *Estate of Rosen v. Comm'r,* 91 T.C.M. (CCH) 1220 (2006) (finding that decedent made no contribution to partnership until more than two months after formation).

Typically, a limited partnership is not formed until a certificate of limited partnership or similar document is filed with the relevant state authority (often, the Secretary of State). Be sure to file such required documentation with the state (and obtain any state licenses or registrations) timely. Delays between the date that a partnership agreement is executed and the date that the partnership is actually formed under state law can be problematic when the IRS gets involved. *See, e.g., Estate of Hillgren v. Comm'r,* 87 T.C.M. (CCH) 1008 (2004*); Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); *Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

H. File for Employer Identification Number

Likewise, in order to avoid IRS attack, once a partnership is formed, it is important to apply to the IRS for a federal employer identification number ("EIN") as quickly as possible, *e.g.*, as soon as the certificate of limited partnership is filed and returned by the relevant state authority. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004). *But see Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009). As with the failure to timely file certificates of limited partnership, the IRS has pointed to delays in obtaining EINs as evidence that partnership formalities were not respected.

I. Establish Bank/Brokerage Accounts Timely

It is important to set up partnership bank and brokerage accounts and transfer contributed assets to those accounts as soon as possible after formation for two reasons: first, to establish that the partnership entity is being respected by its partners and the partners understand that the partnership's assets are just that – partnership assets; second, to ensure that any income earned on partnership assets is credited to the partnership – not to the contributing partner. Otherwise, the door is left open for the IRS to assert the applicability of § 2036, on the grounds that the contributing partner had an implied agreement to retain the income from the assets contributed to the partnership. *See, e.g., Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.2d 367 (3rd. Cir. 2004).

J. Engage Partnership Accountant

Accounting issues can make or break a court's view of whether to respect the existence of a partnership. In that regard, it is important to hire an experienced partnership accountant who has knowledge of, among others, such partnership issues as capital accounts, the impact of distributions on partners' respective basis in their partnership interests, the impact of additional capital contributions, redemptions, and sales on ownership interests, § 754 elections, protective claims, audit procedures, etc. *See, e.g., Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010); *Estate of Jorgensen v. Comm'r*, 97

T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011).

K. Consider Deducting Partnership Set-Up Fees

The IRS consistently examines the identity of the payor of partnership set-up fees. If a partner has paid the legal and accounting fees related to creation of the entity and has not been repaid by the partnership, the IRS typically asserts that the partnership has not been respected; that, if it were truly a business entity (and not merely an entity created for tax avoidance purposes), the paying partner would have sought reimbursement by the partnership. *See Estate of Jorgensen v. Comm'r*, 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). Keep in mind that a partnership that pays for (or reimburses) set-up fees may, in most cases, deduct those fees for income tax purposes, although, depending on the amount, it may have to do so by way of amortizing them.

L. If Necessary, Amend Partnership Percentages as Quickly as Possible After Formation

In order to minimize IRS attack, if assets were contributed to the partnership but the precise fair market value of some or all of those assets was not known on the date of formation (as is likely to be the case with hard-to-value assets such as real estate or mineral interests), the partnership agreement (or its attachments) should be amended as soon as information on all contributed assets becomes available. If such amendments are not made, the IRS is likely to assert that the capital accounts of the contributing partners are not proportionate to the fair market value of the assets contributed and, as a result, the exception to § 2036 cannot apply.

M. Consider Whether to Establish Partnership Office

Increasingly, in its attacks on partnerships, the Service has pointed to entities' lack of physical office space, telephone numbers, and phone book listings as evidence of no "business purpose" for the creation of the partnership. While the purported requirement of business purpose is disputed, obtaining a phone number and perhaps even office space could facilitate a partnership's operations.

III. Partnership Maintenance

A. File Accurate Returns and Registration Statements For Each Year In Existence

It seems common sense – a legal entity has been established; thus, at the appropriate time, a tax return for the partnership must be filed, right? But what if the entity is formed on December 27? Should a tax return for those four days be filed? And what if the entity has no income for the first two or three years that it exists (perhaps it holds only cash and non-income producing real estate, or non-dividend paying stock)? What then?

In both examples, it may be tempting to forgo filing a partnership return. However, to minimize avenues of IRS attack, it is advantageous to file, despite the apparent lack of necessity to do so. First, partnerships often rely on the information contained in the partnership return to document partners' capital accounts. If no partnership return is filed in the partnership's first year of existence, it may be difficult to evidence that the capital accounts were properly created, reflecting the proportionate exchange of assets for partnership interests. Second, even if the partnership has no income, the IRS has been known to assert that the failure to file a return reflects the partners' intent in forming the partnership only as a transfer tax device. Consequently, despite the fact that doing so may seem unnecessary, it is advisable to file returns for partnerships consistently from inception.

In addition, it is important to maintain the partnership in good standing with the relevant state authorities. It is not uncommon for IRS litigators, as their first step in reviewing a transfer tax case, to check with the state authorities for all documents on file for the relevant partnership. It is often at this stage that it is first discovered that an entity's good standing has been revoked for the simple failure to send in annual updates or confirmations of the partnership's address. The IRS typically argues that such revocations are indications that the entity is an entity without any purpose other than transfer tax avoidance.

B. Comply with Terms of Partnership Agreement

This suggestion seems only common sense. However, the IRS consistently reviews partnership agreements with a fine-toothed comb. If the partners have not themselves done so, they may have neglected to comply with some of the more straightforward requirements of the partnership agreement. Consider reading the partnership agreement with a fresh eye and making a list of all periodic administrative requirements. For instance, are regular meetings required? If so, in light of the IRS's frequent assertions that partnerships are nothing other than transfer tax avoidance devices, partners might choose to take minutes, even if not required (although continuing to keep in mind the eventual potential audience), to establish the business approach taken by the partnership. *See, e.g.*, *Estate of Purdue v. Comm'r*, 110 T.C.M. (CCH) 627 (2015); *Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011). Are annual statements (other than returns) required? Are annual distributions required? Are payments on preferred interests required? Is documentation of the partners of the partnership required to be kept in a certain manner? In order to avoid IRS attack, it is important to ensure that partners treat the entity as a business entity and comply with the terms governing that entity. *See Estate of Bigelow v. Comm'r,* 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007) ("The parties' failure to respect the provisions of the agreement governing their transaction tends to show that the transaction was not entered into in good faith.").

C. Comply with Loan Terms, If Loans Are Made

Beware of lending from the partnership to family members. The IRS and the courts have not looked kindly on partnerships where such loans were made, particularly where the terms of the loans were either undocumented or, where documented, were not complied with. *See Estate of Malkin v. Comm'r,* 98 T.C.M. (CCH) 225 (2009). According to the IRS, such loans indicate that partners continue to have access to the assets contributed to the partnership. To minimize IRS attacks, any loans made by the partnership should be properly documented and should comply with the terms of the governing partnership agreement. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004). Loan terms should be reasonable, and payments should be made timely. In addition, both the partnership and the debtor should comply with the terms of the loans, including foreclosure, if necessary. As noted in various discussions in this chapter, it is important to treat the partnership for what it is – a separate, legal entity.

D. Distributions, If Made, Should Be Pro Rata

In order to minimize avenues of IRS attack, and assuming that the partnership agreement requires pro rata distributions (as most do), make sure that any distributions made by the partnership are proportionate to the percentage interests held by the partners in the partnership. In cases under IRS scrutiny where non-pro rata distributions have been made (typically to the parent partner), the IRS typically has argued that the partner receiving distributions retained rights to the assets contributed to the partnership such that § 2036 applies. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011). If a prohibited non-pro rata distribution has been made, consider making "make-up" distributions to the remaining partners, perhaps with interest at a reasonable rate. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004).

E. Refrain from Use of Partnership Assets for Partners' Personal Obligations

Once contributed to the partnership, partnership assets belong to the partnership – not to the contributing partner and not to any of the other partners. As such, partnership assets should not be used for partners' personal expenses, nor should partners personally pay partnership obligations. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011). Consequently, in order to avoid IRS scrutiny, it is important that partnership assets be treated as such. Where partners may have used partnership funds to pay for their individual expenses or used partnership real estate without contemporaneously paying fair rental value, the IRS has often asserted the application of § 2036, on the grounds that there was, at a minimum, an implied agreement that the contributing partner retained the right to use the assets contributed. *See Estate of Disbrow v. Comm'r,* 91 T.C.M. (CCH) 794 (2006). *But see Estate of Stewart v. Comm'r*, 92 T.C.M. (CCH) 357 (2006), *vacated and remanded*, 617 F.3d 148 (2d Cir. 2010), (holding § 2036 was not applicable despite decedent remaining in residence when co-occupied by family member who received 49% interest as gift). To this end, it is important for the partners to maintain sufficient assets outside of the partnership to fulfill their personal needs. *See Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012). As discussed above, where § 2036 is held to apply, the existence of the partnership is essentially disregarded, and evidence as to the value of a transferred partnership interest becomes irrelevant, as it is the value of the underlying assets, rather than the partnership interest itself, on which the transfer tax is imposed. *See, e.g., Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009) (payoff of margin debt of founding partner is not personal expense)*; Estate of Hurford v. Comm'r,* 96 T.C.M. (CCH) 422 (2008); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Gore v. Comm'r*, 93 T.C.M. 1436 (2007); *Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007); *Estate of Abraham v. Comm'r,* 87 T.C.M. (CCH) 975 (2004), *aff'd*, 408 F.3d 26 (1st Cir. 2005); *Estate of Strangi v. Comm'r,* 85 T.C.M. (CCH) 1331 (2003), *aff'd,* 417 F.3d 468 (5th Cir.

2005). *But see Estate of Mirowski v. Comm'r*, 95. T.C.M. (CCH) 1277 (2008) (declining to apply § 2036 where decedent anticipated funding lifestyle with partnership distributions).

As indicated above, it is important to keep the partnership's assets separate from the partners' assets. This suggestion applies as well at the death of any of the partners. Often, death causes financial hardship, in that a decedent's assets may be frozen for the time between date of death and the date that a personal representative for the estate is appointed and has collected sufficient assets to begin paying the decedent's debts. If expenses of the decedent must be paid in the interim (beware of personal liability of the personal representative), and no one has access to the decedent's assets, the partnership's checking account should not be used to pay those expenses. (In such cases, despite objections that post-death facts are irrelevant to valuation of the decedent's partnership interests, the IRS has argued that the fact that partnership funds were used to pay a decedent taxpayer's debts is evidence of an implied agreement by the decedent to retain the right to use assets contributed to the partnership, such that § 2036 should apply.) If absolutely necessary, the partnership may wish to make a loan to the estate of the decedent so that the estate's representative can take care of business.

Alternatively, perhaps beneficiaries of the estate or a third-party lending institution could loan funds to the estate. *See, e.g.,* Estate of Purdue v. Comm'r, 110 T.C.M. (CCH) 627 (2015); *Estate of Duncan v. Comm'r*, 102 T.C.M. (CCH) 421 (2011) (upholding deduction of interest on loan taken from family trust to pay Federal estate tax as necessary administrative expense under § 2053); *Keller v. United States*, 104 A.F.T.R.2d 6105 (S.D. Tex. 2009), *aff'd*, 697 F.3d 238 (5th Cir. 2012); *Estate of Murphy v. United States*, 104 A.F.T.R.2d 7703 (W.D. Ark. 2009); *Estate of Graegin v. Comm'r*, 56 T.C.M. (CCH) 387 (1988) (upholding loan – and allowing deduction of interest – made to estate by related entity for purpose of paying estate taxes). *But see Estate of Stick v. Comm'r*, 100 T.C.M. (CCH) 194 (2010) (denying interest deduction on loan from decedent's foundation where estate failed to show loan was necessary).

F. Maintain Current and Accurate Books and Records

It is important for partners to maintain a partnership's records, as failure to do so may allow the IRS to argue that the partnership was formed solely for tax purposes. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). In addition, keeping good books and records should allow partners to demonstrate that the partnership was operated as the business that it is, formed with valid non-tax reasons in mind.

G. Avoid Multiple and Irregular Transactions Between Partners and Partnership

When asserting that § 2036 should apply, the IRS looks for any facts that it can find to indicate an implied agreement that a taxpayer retained rights related to assets transferred to a partnership. For example, where a partnership has redeemed numerous partnership interests held by a partner, or made multiple loans, non-regular distributions, or non-pro rata distributions to that partner, the IRS may argue that the facts indicate an implied agreement that the taxpayer retained rights to the assets that he transferred to the partnership, such that § 2036 should apply to, in effect, disregard the existence of the partnership for valuation purposes. *See, e.g., Estate of Beyer v. Comm'r,* 112 T.C.M. (CCH) 356 (2016). In order to avoid such arguments by the IRS, numerous transactions of this type between the partnership and its partners should be avoided.

H. Keep in Mind Non-Tax Reasons Stated for Forming Partnership

As the partnership grows and the partners develop a working relationship, keep in mind the non-tax reasons that were given for forming the partnership at the outset. *See Estate of Purdue v. Comm'r,* 110 T.C.M. (CCH) 627 (2015); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). To the extent possible, try to implement them. Doing so can help undercut an IRS attack that the partnership was formed only for tax savings. Rote listing of standard non-tax purposes in the partnership agreement will not necessarily be considered definitive; the partnership agreement should include partnership-specific purposes, and the partnership (and its partners) should implement and fulfill those purposes. *C.f., e.g., Estate of Holliday v. Comm'r,* 111 T.C.M. (CCH) 1235 (2016) (failing to sufficiently identify non-tax reasons); *Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016); *Estate of Turner v. Comm'r,* 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012).

IV. Transfers of Partnership Interests

A. Generally

When partnership interests are transferred, it is a good time to review the books and records of the partnership to ensure that they are in order. Due diligence at this stage (and at all others) bolsters the defensibility of the partnership – it is a respected, stand-alone entity.

It is also important to consider whether a transfer of a partnership interest triggers any rights of first refusal; if so, it is important in warding off IRS attacks to comply with any such transfer restrictions.

It is helpful at the audit stage in particular if partnership management (and its accountants) have kept careful track of changes in partnership interests (perhaps through keeping a historical spreadsheet outlining each transfer of partnership interests) and to update the partnership books and records to reflect any such changes. Doing so concurrently with transfers assists at the audit level, as such a record provides contemporaneous evidence of the transfers and can, again, bolster the position that the partnership is an entity separate from its partners. If necessary, consider restating the applicable schedule or exhibit to the governing partnership agreement to reflect the change.

Regardless of the nature of the transfer, it is important to document the transfer of partnership interests. In order to minimize IRS attacks, such transfer documents should be executed by transferor and transferee, and the document should be dated on the date that they are signed (though the effective date may be different). *See, e.g., Estate of Lockett v. Comm'r*, 103 T.C.M. (CCH) 1671 (2012); *Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009*), rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011); *Holman v. Comm'r,* 130 T.C. 170 (2008), *aff'd,* 601 F.3d 763 (8th Cir. 2010).

Ensure that the Certificate of Limited Partnership for the partnership is amended, if necessary, and filed with the relevant state authority. Failure to do so may give the IRS room to argue that the entity was not respected by its partners.

Finally, consider whether to make a § 754 election. Many factors should be taken into account when determining whether a § 754 election should be made when an interest in a partnership is transferred (whether by sale or by transfer at death). *Temple v. United States*, 423 F. Supp. 2d 605 (E.D. Tex. 2006) (it is reasonable for a partnership and buyer to negotiate a § 754 election into the partnership acquisition). One such consideration, however, is whether any transfer tax return related to the transfer may be audited by the IRS. If the return is audited, to the extent that it is finally determined that the value of any partnership interest is greater than the value reported on the estate tax return, an election by the partnership under § 754 may be advantageous, as it could apply to cause a step-up in the partnership's inside basis in the decedent's proportionate share of the partnership's assets. Be sure to use the stepped-up basis resulting from a timely made § 754 election. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). Thus, any finally determined increase in value of the decedent partner's partnership interest, where such an election has been made, may allow the partnership to seek an income tax refund related to sales of partnership assets since date of death, as any capital gains related to such sales will have been reduced. (Keep in mind that protective claims may need to be filed if the statute of limitations is close to running on the income tax returns but the examination of the transfer tax return has not been completed.)

B. By Gift or Sale

In addition to the considerations discussed in paragraph A above, when the transfer is to occur by gift, it is important to refrain from gift planning until the partnership is formed and operating in order to avoid (as much as possible) the indirect gift theory discussed above. *Compare Pierre v. Comm'r*, 133 T.C. 24 (2009), *supp. by* 99 T.C.M. (CCH) 1436 (2010), *Holman v. Comm'r*, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010), *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008), *Estate of Strangi* v. *Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005), *Estate of Jones v. Comm'r*, 116 U.S. 212 (2001), and *Estate of Strangi v. Comm'r,* 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002) *with Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011), *Heckerman v. United States*, 2009 WL 2240326 (W.D. Wash. Jul. 27, 2009), *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *and Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002). *But see Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277, 1289-91 (2008) (declining to apply § 2036 even where gift planning occurred simultaneously with entity planning due to fact that (1) taxpayer had sufficient funds outside partnership to pay gift taxes related to gift of partnership interests; (2) taxpayer's capital account was properly credited with assets contributed; and (3) taxpayer would have been entitled to distribution in accordance with capital account upon dissolution of partnership).

Additionally, gifts of entity interests may not qualify for the gift tax annual exclusion if the present interest test is not satisfied. To satisfy the present interest test, a donee must have a right to either the immediate enjoyment of the property (including the ability to immediately transfer it) OR the immediate enjoyment of the income from the property. *See, e.g., Estate of Wimmer v. Comm'r,* 103 T.C.M. (CCH) 1839 (2012); *Fisher v. United States*, 2010 WL 935491 (S.D. Ind. Mar. 11, 2010); *Price v. Comm'r*, 99 T.C.M. (CCH) 1995 (2010).

When a transfer occurs by sale, be sure to consider the income tax implications of such a transfer.

C. At Death

When the transfer of partnership interests occurs as a result of a partner's death, it is especially important to review the transfer to determine whether a lapse occurs under Chapter 14 of the Internal Revenue Code and to report the interest transferred accordingly. While many partnership agreements are written with an eye toward avoiding the application of Chapter 14, not all have incorporated this concept.

Further, in order to simplify estate administration and potential audit, consider maintaining the partnership interest in the hands of the Executor, subject to estate administration, until a closing letter is received from the IRS. Once an IRS closing letter is received and the partnership interest is to be transferred into the hands of the appropriate beneficiary, document the transfer from the estate to the beneficiary, and that transfer document should be executed by both the executor and the recipient beneficiary.

D. By Redemption

When a partnership interest is transferred by way of redemption from a partner by the partnership, be sure to review the partnership agreement to ensure that the partnership is not prohibited from redeeming the interest from the interest holder. Next, be sure to document the redemption, to be executed by partnership management and the transferring partner. Consider having other partners consent, given that a redemption may affect them economically. Finally, be sure that the books and records of the partnership reflect a decrease in the transferring partner's interest and a corresponding proportionate increase to all remaining partners' interests. Taking these steps will help avoid IRS attack.

V. Transfer Tax Reporting

In order to ensure that any gift, estate, or generation-skipping transfer tax return is prepared in a manner that is most defensible in audit, the taxpayer should engage an experienced attorney or accountant to prepare such return.

A. Obtain Appraisal from Independent, Qualified Appraiser

To minimize IRS attack, the taxpayer should select an appraiser who will provide an independent and qualified appraisal of the fair market value of the transferred interest. In that regard, consider whether the selected appraiser is independent from the taxpayer, is credible, is experienced in the area of partnership valuation, and has the appropriate certifications. In addition, attaching an appraisal to a tax return can be a way to satisfy adequate disclosure requirements and to start the running of statutes of limitations. Perhaps most importantly, the appraiser should not act as an advocate for the taxpayer. *Knight v. Comm'r*, 115 T.C. 506, 519 (2000).

B. Encourage Communication among Appraiser, Client, and Advisors

Strong communication between the client, the client's advisors, and the appraiser should greatly improve the quality (and defensibility) of an appraisal. A high-quality appraisal, which is more often the product of thorough communication, improves the odds that a case involving good legal facts will achieve the best result possible.

C. Confirm with the Appraiser the Interest to Be Valued

Depending on the terms of the partnership agreement and the identity of the transferee, the interest transferred by the taxpayer may be a general partnership interest, a limited partnership interest, or an assignee interest in a partnership interest (and, depending on the terms of the partnership agreement, there may be classes within one or more of these types). It is important to identify the nature of the interest transferred, as each type carries with it specific rights and responsibilities that are likely to impact value.

D. Consider Whether to Aggregate Interests

If the transferred partnership interests include more than one class (*i.e.*, general partnership interests *and* limited partnership interests), be sure to clarify with the appraiser as to whether those interests should be aggregated for valuation purposes. For instance, if a general partnership interest and a limited partnership interest are transferred by the decedent, certain real authority suggests that the interests should be aggregated. If, however, the general partnership interest was held by the decedent, and the limited partnership interest is held in a marital trust created by the decedent's pre-deceasing spouse, the taxpayer may be able to take the position that the interests should *not* be aggregated. *See, e.g., Estate of Bonner v. United*

States, 84 F.3d 196 (5th Cir. 1996); *Estate of Bright v. United States,* 658 F.2d 999 (5th Cir. 1981); *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999).

E. Consider Whether Tiered Discounts Might Be Appropriate

Depending on the nature of the asset transferred, two layers of discounts might be merited. *See, e.g., Astleford v. Comm'r*, 95 T.C.M. (CCH) 1497, 1502 n.5 (2008). If the transferred asset is a minority interest in an entity that holds a minority interest in another entity, two sets of discounts could apply to each of the two separate entities. *Id.* (*citing Estate of Piper v. Comm'r*, 72 T.C. 1062, 1085 (1979); *Janda v. Comm'r*, 81 T.C.M. (CCH) 1100 (2001); *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680, 1690-91 (2000), *aff'd*, 19 Fed. Appx. 90 (4th Cir. 2001); *Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316, 1320-21 (1974)). However, where the transferred asset constitutes a significant portion of the parent entity's assets or where the transferred asset is the parent entity's "principal operating subsidiary," the Service may argue that only one level of discounts should be applied. *Id.* (*citing Estate of O'Connell v. Comm'r,* 37 T.C.M. (CCH) 822, 825, 833 (1978), *aff'd on this point and rev'd on other grounds*, 640 F.2d 249 (9th Cir. 1981)).

F. Promote Defensibility of Valuation Reports

A readily defensible partnership valuation report does not arise by happenstance, but rather by the conscientious efforts of the appraiser, advisors, and the client. The more thorough the valuation report, the more defensible it likely will be should a dispute arise. The appraiser should conduct due diligence, discussing with the general partner issues such as the partnership's investment philosophy, asset allocation, and return targets. The appraiser should review and consider the appraisals of the partnership's underlying assets. The valuation report should be supported by empirical data that is clearly understood by the appraiser, such as restricted stock studies and discussion of comparables, and the comparative factors employed should be relevant and useful. The report should fully describe the partnership's assets and financial history. Throughout the valuation report, care must be taken to avoid typos and errors, as they may call into question the competence of the author of the report. Finally, a non-appraiser should be able to understand the analysis and conclusions of a valuation report.

G. Review Appraisal Closely for Facts

In opining as to fair market value, the appraiser will likely take into account numerous partnership-specific facts, such as the terms of the governing partnership agreement, the fair market value of the partnership's underlying assets, cash flow to the partnership, and the distribution policy of partnership management. As a result, when reviewing the appraiser's conclusions, it is important to confirm that the appraiser has properly reflected these facts in his report so that his valuation conclusions are not based on incorrect factual assumptions. It is also helpful to make sure that a copy of the partnership agreement is included with the final appraisal, perhaps as an exhibit. *See Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 56 (2006) (declining to rely on IRS appraisal where expert "did not understand Kohler's business").

H. Try to Live by Factual Information Provided to Appraiser

Once the appraiser has completed his appraisal, it is helpful in defending his conclusions if, after the valuation date, the partnership is operated in the manner reported to the appraiser, for example, in such areas as the distribution policy, anticipated cash flow, etc. Arguably, post-valuation date facts are irrelevant to valuation conclusions. However, the IRS may assert that deviation from the factual assumptions by the appraiser indicate that the appraiser's conclusions were faulty, especially if the partners anticipate at the time of the transfer that such an occurrence might take place. Living with the factual information provided to the appraiser may help avoid such assertions.

I. Beware of Rounding on Appraisals and Tax Returns

If there is a reason to round value up or down, be sure that the appraiser explains his reasons in the appraisal. If the appraiser cannot explain why the value should be rounded up or down, he likely will not be able to do so on the stand either. And the courts are increasingly examining and parsing practically each and every valuation conclusion of appraisers of limited partnership interests. Unexplained rounding may cause a court to question other conclusions that the appraiser has made in the appraisal.

J. Understand IRS Settlement Guidelines

In early 2007, the IRS issued new settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation. *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25. *See, e.g., Lappo v. Comm'r,* 86 T.C.M. (CCH) 333 (2003); *McCord v. Comm'r,* 120 T.C. 358 (2003), *rev'd,* 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm'r,* 86 T.C.M. (CCH) 412 (2003).

VI. Preparing to Respond to IRS Audits

A. Consider Bringing in Litigation Counsel

Once the audit begins, it is particularly helpful to involve litigation counsel sooner rather than later, even if litigation counsel does not meet with the IRS and only serves as a consultant to the taxpayer. Doing so allows the litigator to be involved from step one, assisting in determinations related to the assertion or waiver of various privileges, responsiveness of documents and information, and consideration of the eventual burden of proof under § 7491.

B. Determine Whether a Document Destruction Policy Exists; If So, Suspend

Some corporate trustees and executors have document destruction policies. It has become advisable for attorneys whose clients are involved in litigation to ensure that their clients suspend document destruction policies. The consequence of failure to do so may include sanctions against the attorney and the client for spoliation of evidence. *See, e.g*., *Phoenix Four, Inc., v. Strategic Resources Corp*., 2006 WL 1409413 (S.D.N.Y.); *Qualcomm Inc. v. Broadcom Corp.*, No. 05CV1958-B, 2008 WL 66932 (S.D. Cal. Jan. 7, 2008).

C. Implement Your Own "Audit"

At this stage (or even before an IRS audit begins), it may be beneficial to your client to review the taxpayer's books and records to determine which issues the IRS may identify as problematic. Test the strengths and weaknesses of the planning, reviewing both the legal authorities (new and old) and any post-planning administration that may impact the analysis of the validity of the plan or entities within the plan.

Assess the strength of the IRS's position. Has the IRS obtained an appraisal? Or is the IRS relying only on an engineer's report? Is the examining agent in a position to review the merits of the case? Does the agent have authority to negotiate settlement? Or will you need to consider requesting a meeting with the agent's supervisor?

D. Consider the Burden of Proof

Until the late 1990s, the burden of proof in a tax case fell on taxpayers. In other words, if a court could not decide who should win in light of the evidence, the taxpayer lost. For examinations beginning after July 22, 1998, however, it became possible for taxpayers in certain circumstances to shift the burden of proof to the IRS, so that if a court cannot decide who should win in light of the evidence, the taxpayer will win. Under § 7491, if a taxpayer (who is not a partnership, corporation, or trust) maintains all required records under the Code and complies with the IRS's reasonable requests for documents, information, and interviews, the burden of proof shifts to the IRS, and, if a court is undecided, the taxpayer wins. Although cases in which a court weighs the evidence and still comes down on the fence are very rare, the IRS has, in recent years, been very reluctant to agree that taxpayers meet the factual requirements of § 7491.

E. Consider the Impact of Privileges

Various privileges apply in the context of estate planning, the most familiar of which is the attorney-client privilege (often referred to simply as "the privilege"). As a general rule, the privilege covers client communications made to the attorney with the purpose of seeking legal advice. *See Scott v. Beth Israel Medical Center, Inc.*, 847 N.Y.S.2d 436 (N.Y. Sup. 2007) (holding that employer's e-mail monitoring policy caused e-mails sent to attorney from work to lose attorney-client privilege because they were not confidential, and work product privilege does not apply where careless conduct suggests no concern for protecting privilege). *But see Sims v. Lakeside School*, 2007 WL 2745367 (W.D. Wash.) (holding that web-based e-mails and other materials prepared for communicating with counsel on employer-provided laptop were protected by attorney-client privilege). Keep in mind that the privilege is the client's (rather than the attorney's) to waive.

The work-product doctrine, on the other hand, protects an attorney's thoughts and work *in preparation for litigation*. The work product of an attorney or his or her staff prepared in anticipation of litigation is protected from disclosure. In fact, the attorney work product doctrine is not a privilege, although some courts (and many practitioners) refer to it as one. The purpose of the work product doctrine is to encourage lawyers to thoroughly prepare for litigation (even if not yet pending) through investigation of the good and the bad, without fear of being forced to disclose their thoughts and analysis. *See* Fed. R. Civ. P. 26(b)(3). Contrary to common misconception, the work-product doctrine only begins to apply to an attorney's work that is done "in anticipation of litigation." The required level of anticipation varies by court, but it is clear that in many jurisdictions, a court action need not be imminent. *See United States v. Adlman,* 68 F.3d 1495 (2d Cir. 1995). According to the Seventh Circuit, audit can be the antechamber to litigation, and thus, the work-product doctrine may apply to an attorney's work even during the audit process. *See United States v. Frederick*, 182 F.3d 496, 502 (7th Cir. 1999). Courts have extended work product doctrine protection even to proposed transactions. Recently, one district court found that the work product doctrine applied to tax accrual work papers of a company because the company's counsel believed that certain transactions entered into by the company would eventually be challenged by the IRS. *United States v. Textron,* 507 F. Supp. 2d 138 (D.R.I. 2007), *aff'd in part, vacated in part, and remanded,* 553 F.3d 87 (1st Cir. 2009).

More recently, the U.S. Congress enacted a new federal privilege under § 7525 – the tax practitioner privilege. This privilege applies only in non-criminal tax cases, and it protects from discovery communications that, if communicated to an attorney, would have been protected from discovery under the attorney-client privilege.[4] *See also Schaeffler v. United States,* 806 F.3d 34 (2nd Cir. 2015). Note, however, that in some jurisdictions, the tax practitioner privilege has been interpreted not to cover advice related to tax return preparation. *See United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

While privileges can be waived, and often waiver is highly recommended (particularly in cases where the IRS is asserting the application of § 2036 and/or penalties), beware of subject matter waiver. Once the privilege has been waived on a particular subject matter, that waiver covers all communications on that subject matter. *See* FED. R. EVID. 502 (addressing effect of inadvertent waiver as well). Unfortunately, you cannot just pick and choose to waive the privilege with regard to favorable documents.

F. Consider Whether Production of Privileged Information May Help Your Case

Various privileges may apply in any given situation – the attorney-client privilege; the work product doctrine; and the tax practitioner's privilege under § 7525. As discussed above, however, there are often times when, if appropriate, it is helpful if the taxpayer waives such privileges, such that documents and information that would otherwise be protected from discovery are produced. This is particularly true in estate tax cases, where the best person with personal knowledge – the decedent taxpayer – is not available to testify. Beware, though, of subject matter waiver. In essence, you cannot pick and choose what to produce. If the taxpayer waives the privilege as to one document with regard to, for instance, formation purposes, you cannot refrain from producing another document on the same subject that may contain potentially harmful discussion as well.

G. Provide Responses to the IRS that Are True and Correct, to the Best of the Taxpayer's Knowledge

The taxpayer's duty is to provide responses to IRS requests that are true and correct to the best of the taxpayer's knowledge. Be precise when responding to the IRS. For instance, if the partnership owns primarily real estate, but has a small equity portfolio, be sure to disclose the existence of both (and in detail) when asked by the IRS for the assets of the partnership. It is also important to keep in mind that the examiner involved may not have the authority to negotiate a settlement. When determining how much information to reveal voluntarily, the strength of the IRS's position must also be considered.

H. Keep in Mind that Anything Stated or Written Can Be Treated as an Admission

It is important to keep in mind that a judge or a jury might eventually read what is written related to the taxpayer's planning. Anything stated or written to the IRS at this stage can be treated as an admission. Further, anything written to the appraiser or any expert may be discoverable by the IRS.

I. Produce Responsive Documents in the Taxpayer's Possession, Custody, or Control

It is the taxpayer's duty to produce responsive documents in his possession, custody, or control. While documents held by the taxpayer's attorney, accountant, or bank are likely to be construed as within his possession, custody, or control, documents held by others may not. Be sure to consider the relationship between the taxpayer and the advisor in analyzing this issue.

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[4] "With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." I.R.C. § 7525.

However, the taxpayer need produce *only* those responsive documents in his possession, custody, or control; generally, there is no need to *create* documents to respond to IRS requests. If necessary, indicate in responding to the IRS that the taxpayer has no such documents in his possession, custody, or control that are responsive to the request.

J. Keep Careful Track of Documents and Electronic Files Produced to the IRS

Particularly if litigation counsel becomes involved at some point, it is helpful to have a precise record of the documents and electronic files that have been provided to the IRS, from inception of the audit through the close of discovery. In that regard, consider Bates-labeling every page produced to the IRS, such that there is a number associated with every page. Doing so also helps in the stipulations process, as each exhibit can be identified by Bates-label number, ensuring that everyone (including the judge) is literally on the same page.

K. Understand the IRS's Broad Summons Power

The IRS has a very broad power to summons any information, books, and records that it deems necessary to carry out is mission. The IRS may examine or summons a laundry list of items and people for the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax." I.R.C. § 7602(a); *see also, e.g., United States v. Richey*, 632 F.3d 559 (9th Cir. 2011); *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002). As might be expected, however, this broad power is subject to traditional privileges.

L. File Protective Claims If Necessary

Keep in mind that sometimes resolutions of estate tax issues may impact income tax issues related to the partnership or the estate. Be sure to analyze whether the resolution of the estate tax issue might come too late to file a claim for refund (Form 843) on the income tax side. *See Estate of Beyer v. Comm'r*, 112 T.C.M. (CCH) 356 (2016). If so, you may find it necessary to file protective claims for refund or administrative adjustment requests (AARs) if the partnership is a TEFRA partnership to protect rights to income tax refunds that may eventually be due. *See* I.R.C. §§ 6031(A), 6222-6231. Keep in mind the Variance Doctrine as you formulate your protective claims.

M. Consider Whether it is Feasible to Keep Partnership in Place

At least until the examination of the transfer tax return has been closed and the taxpayer's tax liability finally determined, it is better if the partnership remains in place. Although facts that occur after the valuation date are arguably irrelevant, the IRS does not hesitate to use those facts when doing so might increase the value of the transferred interest (and resulting transfer tax); and terminating the partnership could play into the IRS's hands in this regard. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007).

N. In the Estate Context, Beware of Distributing Entity Interests

Beware of advising your client executor to make distributions of partnership interests from the estate (or other estate assets for that matter) prior to receiving an IRS closing letter. Among other reasons, under I.R.C. § 6324, a special federal estate tax lien immediately attaches to the entire gross estate of a taxpayer at her death. Under 31 U.S.C. § 3713, an executor has personal liability to pay estate taxes to the extent that he has paid any debts of the decedent or made any distributions to beneficiaries of the estate prior to payment in full to the IRS of the estate tax owed. An executor may request a release of personal liability from the IRS under I.R.C. § 2204 upon the payment in full of estate taxes owed.

O. Treat Informal Interviews as Depositions

Although interviews by the IRS can be quite informal, neither the taxpayer nor the advisor should be caught off guard. These interviews are, in essence, depositions. In order to ensure that any additional requests for documents and information are provided in writing, such interviews likely ought to be held at an advisor's office (that of the attorney or accountant), rather than at the taxpayer's office or home. Consider also having a court reporter present to ensure that the taxpayer's responses are not misconstrued.

P. Understanding the IRS's Settlement Guidelines

In early 2007, the IRS issued settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation. *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25; *see also, e.g., Lappo v. Comm'r*, T.C. Memo 2003-258; *McCord v. Comm'r*, 120 T.C. 358 (2003), *rev'd*, 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm'r*, 86 T.C.M. (CCH) 412 (2003).

VII. Conclusion

In conclusion, many of the suggestions considered here should assist estate planners to fine-tune interactions with clients to ensure that creation of an entity fits with and implements clients' goals – both tax and non-tax in nature. A practical approach that the courts seem to rely on, whether explicit or implicit, is the smell test. Does the transaction "smell bad" or "look bad"? If so, you might re-structure, explore further with the client, or even recommend against a partnership structure to accomplish the client's goals. Use your olfactory senses to assist the client in addressing his needs in the most tax-efficient manner, all the while keeping in mind that anything you say or write may be discoverable (despite the attorney-client privilege). Work with your appraiser to ensure that she has all relevant information, thereby ensuring the most defensible appraisal. When done right, implementation of an entity can accomplish numerous client goals, while at the same time saving taxes. When done wrong, the same structure can save no taxes and cost the client time, money, and emotional drain. To avoid this result, help your clients treat entities as the business structures that they are. And ensure that your appraisers understand the nature of the clients' business and goals.