Transitioning Businesses to Key Employees (Including Children)

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Review of Materials

- Slides
- Several thousand page PDF, “Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications,” available here (takes some time to open, because it is large)

Navigate between Slides and Materials

- Open both documents
- Highlight cross-reference in slides
- Ctrl-c to copy
- Go to FULL TABLE OF CONTENTS in big PDF
- Crtl-f to find
- Ctrl-v to paste
- Click ENTER to execute search (might need to specify “exact” or “whole word” search
- ***Browsing the FULL TABLE OF CONTENTS is often faster than executing a search***

Type of Entity

- Preferred structure and moving into preferred structure
- Limited partner exception to self-employment tax; grouping to avoid net investment income tax
- Intrafamily sales; redemption strategies
- Deferred compensation
- Profits interests
- Intrafamily loans

Type of Entity

- Corporation
  - C Corporation
  - S Corporation
- Partnership
  - Limited Liability Company
  - Limited Partnership
- Limited Liability Company
  - Partnership or Disregarded Entity
  - S or C Corporation

Distributing 100% of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,00
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Distributing 50% of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,00
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

Distributing None of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

Distributing None of Corporate Net Income After Income Tax	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities – Moderate State Income Tax (II.E.1.)

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

C corporation deducts state income tax on business operations; pass-through owners have limited state income tax deduction (but unlimited business property tax deductions). Reinvested C corporation earnings will be taxed later when the company is sold, which just changes the timing of the 47.3% or 40.8% rate above, unless held until death or qualify for Code § 1202 exclusion (II.Q.7.k.), the latter which applies for federal income tax but might or might not for state income tax. Reinvested pass-through earnings add to tax basis.

Declaring Dividends

- Personal holding company tax (II.A.1.e.)
- Accumulated earnings tax (if not a personal holding company) (II.Q.7.a.vi.)
- Professional firms tend to distribute all profits

Declaring Dividends

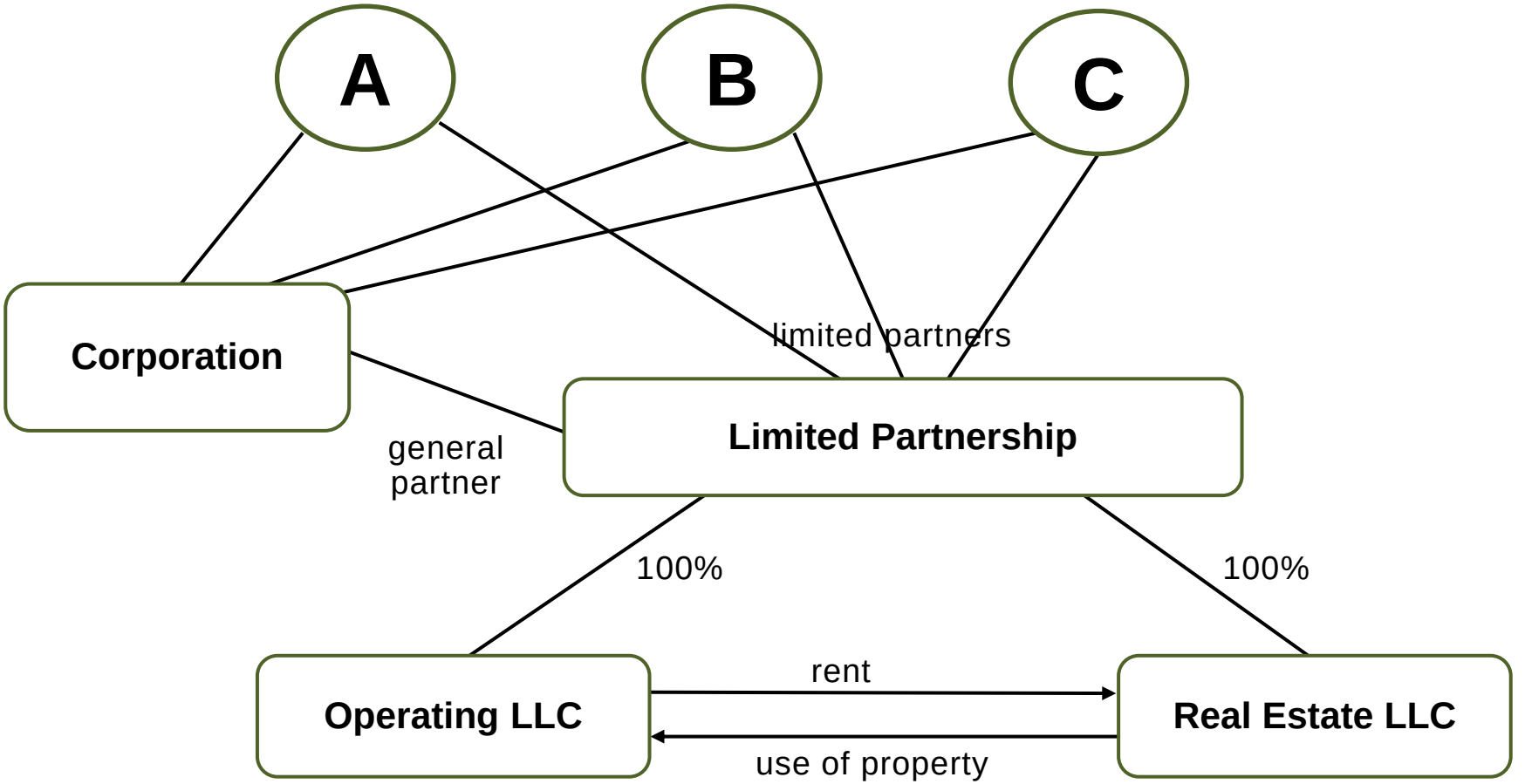
Sale to irrevocable grantor trust (II.E.2.a., III.B.2.b.)

- Entity makes “tax distribution” to trust, which does not pay tax and therefore uses the distribution to pay down the note.
- Grantor uses note payment to pay tax, making the note a disappearing asset
- C corporations pay tax instead of making tax distributions; any dividends undermine favorable C corporation taxation
- Grantor not taxed on C corporation income

Which Entity for Which Stage

- Simple LLC (II.E.3.)
  - ➢ Start-up losses (II.G.4.)
  - ➢ Profitable, but not overly so
    - ❑ Little or no earnings in excess of taxable wage base (II.L.2.a.i.) ($184,500 in 2026)
    - ❑ Generous equipment write-offs (II.G.5.)
- Transition to limited partnership when significant earnings in excess of taxable wage base

Recommended Structure
(II.E.5. and II.E.6.)



Self-Employment Tax and Limited Partners

(II.L.4.)

- *Soroban* held that Congress "intended for the phrase 'limited partners, as such' used in section 1402(a)(13) to refer to passive investors"
- Legislative history: "if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law"

Self-Employment Tax and Limited Partners (II.L.4.)

- My view is that "limited partner, as such" refers to legislative history distinguishing between role as general partner from role as limited partner
- My view plus $5 will buy cup of coffee at Starbucks
- Any way to be limited partner and avoid 3.8% tax on net investment income (NII) that applies to passive business income (II.I.8.)?

Suggested Limited Partner Structure

(II.E.5., II.E.6.)

- Example: each of individuals A, B, and C own 33% interests as limited partners, for total of 99%
- Each of them owns one-third (or collectively all) of S corporation that is general partner
- In their capacity as employees of S corporation – not based on their status as partners – they run limited partnership

3.8% Tax on Net Investment Income (NII) (II.I.3.)

- 3.8% of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount
- Threshold amount:
  - $250K married filing jointly
  - $125K married filing separately
  - $200K single
  - Trust $15,200 for 2024 (indexed)

3.8% Tax on Net Investment Income (NII) (II.I.3.)

- Lower than SE tax to extent below taxable wage base
- Higher than SE tax above that – even in higher levels, ability to deduct employer's share of SE tax reduces the rate

Planning for 3.8% Tax on Net Investment Income (NII) (II.I.8.)

- General Application of 3.8% Tax to Business Income - passive vs. nonpassive income (II.I.8.a.)
- What is Net Investment Income Generally - investments (II.I.5.)
- Working Capital Is NII (II.I.8.a.v.)

3.8% NII Tax – Nonrental Income

Material participation ideal (II.K.1.a.ii.)

- More than 500 hours current year
- More than 500 hours 5/10 past years
- Professional service – any 3 years
- Other exceptions apply

3.8% NII Tax – Nonrental Income

Significant participation (II.I.8.a.i., II.K.1.i.)

- More than 100 hours
- Recharacterizes income but not loss
- Some credits disallowed due to mismatch (II.K.1.i.i.(b).)

3.8% NII Tax – Rental Income

Per se passive (II.I.8.c., II.K.1.e.), except:

- Real estate professional
- Self-rental plus more than 500 hours
- No significant participation exception (other than structure in II.E.5. and II.E.6.)

3.8% NII Tax – Participation (II.K.1.a.)

- Includes spousal work (II.K.1.a.iii.)
- Excludes investor work (II.K.1.a.v.)
- Make-work: excluded for loss but included for income (II.K.1.a.v.)

3.8% NII Tax – Participation by Nongrantor Trust (II.K.2.b.)

"An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating."

- IRS treats as exclusive test
- *Mattie Carter* did not accept IRS' view

3.8% NII Tax – Participation by Nongrantor Trust (II.K.2.b.)

- Audit manual - relaxed
- National office and litigation position - strict
- Impossible for traditional corporation per TAM 201317010

3.8% NII Tax – Participation by Nongrantor Trust (II.K.2.b.)

Way to comply (II.K.2.b.ii.)

- Authorize shareholders to manage, bypassing board
- Management contract to trust
- Trustee fee; Form 1099-MISC

3.8% Tax – Participation by Grantor Trust (II.K.2.a.)

- Look to deemed owner's participation
- No IRS roadblocks
- QSST or regular grantor trust

3.8% Tax –Grantor Trust

Plan for nongrantor trust:

- QSST sale of stock, business assets, etc.
- Turning off grantor trust powers

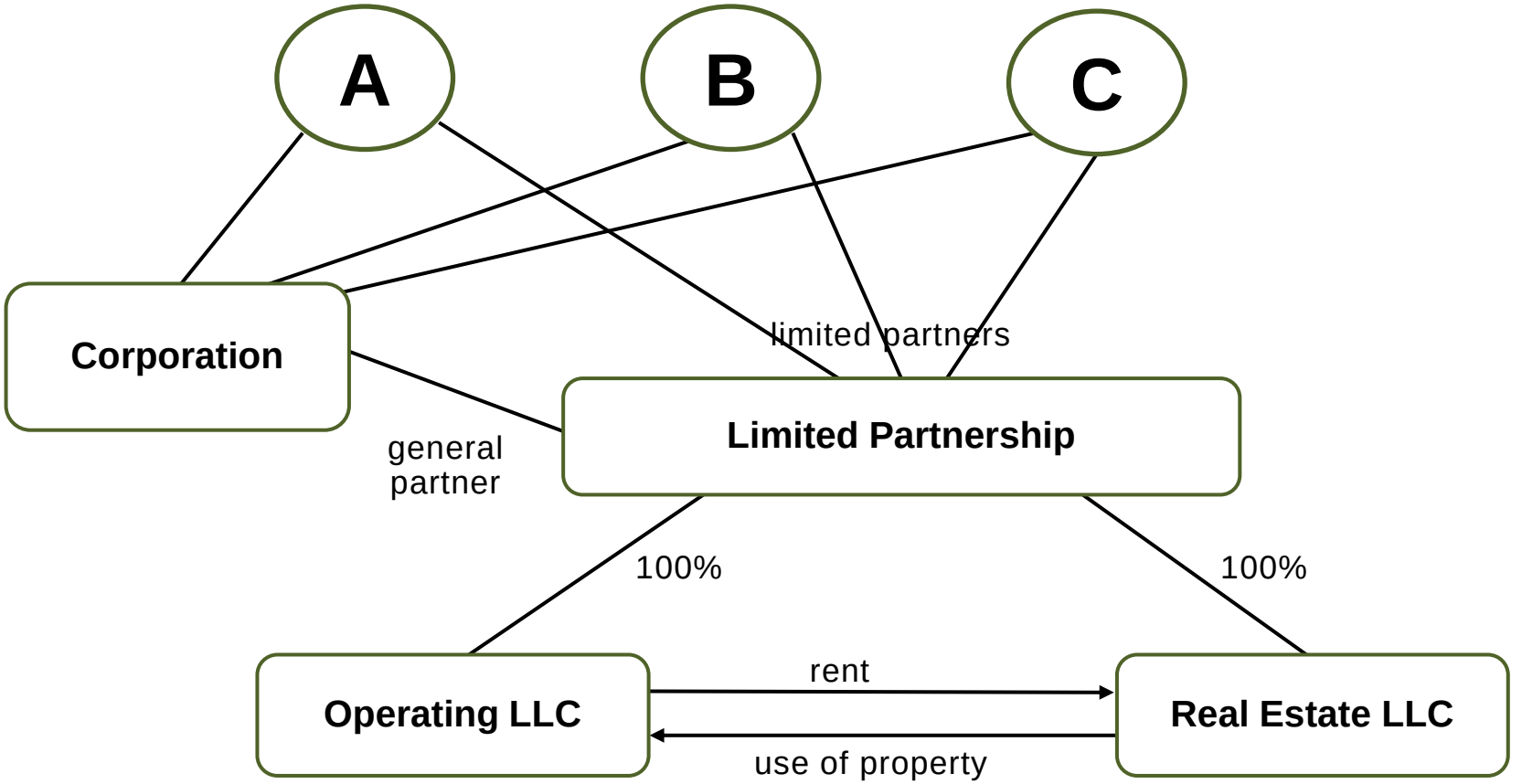
Need trustee to participate while grantor trust?

State of Guidance on Trust Participation

- Comments (II.K.2.b.i)
- Timeframe for guidance
- Approach until guidance

Suggested Limited Partner Structure

(II.E.5. and II.E.6.)



Suggested Limited Partner Structure

(II.E.5.d.)

- Participation of limited partner attributed through his or her ownership of S corporation general partner and related work in business in that capacity may make that person treated as participating for all interests that person owns in underlying partnership
- Taxpayer must own an interest in the business to count work in the business (II.K.1.a.i.)
- Grouping election (II.I.8.a.ii., II.K.1.b.)

NII Grouping (II.I.8.a.ii)

- Grouping rules apply to determine scope of taxpayer's trade or business to determine whether trade or business is a passive activity
- But proper grouping of rental activities with other trade or business activities will not convert gross income from rents into other gross income derived from trade or business (rent must qualify as trade or business to avoid NII tax)

Passive Activity Grouping (II.K.1.b.i.)

- Entity decides how to group its activities
- Once entity groups activities, owner may group them with each other, with activities conducted directly by owner, and with activities conducted through other entities
- For example, owner may group activity conducted through one entity with activity conducted through another entity

Passive Activity Grouping (II.K.1.b.i.)

Reg. § 1.469-4(c)(3), Example (2):

- Taxpayer B, an individual, is partner in business that sells non-food items to grocery stores (partnership L)
- B also is partner in partnership that owns and operates trucking business (partnership Q)
- The two partnerships are under common control
- The predominant portion of Q's business is transporting goods for L, and Q is only trucking business in which B is involved
- B appropriately treats L's wholesale activity and Q's trucking activity as a single activity

How to Report Grouping (II.K.1.b.iii.)

- Taxpayer must file written statement with original income tax return for first taxable year in which two or more trade or business activities or rental activities are originally grouped as single activity
- If taxpayer adds new trade or business activity or rental activity to existing grouping for taxable year, taxpayer must file written statement with taxpayer's original income tax return for that taxable year
- If determined that original grouping was clearly inappropriate or material change in facts and circumstances has occurred that makes original grouping clearly inappropriate, taxpayer must regroup activities

How to Report Grouping (II.K.1.b.iii.)

- If taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether activities have been grouped as single activity as described above, then each trade or business activity or rental activity treated as separate activity
- However, timely disclosure is deemed made by a taxpayer who has filed all affected income tax returns consistent with claimed grouping and makes required disclosure on income tax return for year in which failure to disclose first discovered by taxpayer
- Partnerships and S corporations instead comply with tax return disclosure instructions for grouping activities

Suggested Limited Partner Structure

(II.E.5.d.)

- Possible suboptimal results regarding the 20% deduction for qualified business income under Code § 199A (II.E.5.c.ii.)
- Saving tax on a seller-financed sale of the business (II.E.5.a.)
- More flexibility in separating the business among siblings (II.E.5.e.)
- Other Aspects of Recommended Structure (II.E.5.g.)

Soroban Capital Partners LP v. Commissioner, T.C. Memo. 2025-52

- From Service P'ship – SE Tax and Other Issues; 2025 Tax Law Changes; QSBS Update
- *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023), the Tax Court held that limited partner may be subject to self-employment (SE) tax if sufficiently active in business
- Trial followed by May opinion that limited partners were sufficiently active to subject themselves to SE tax
- Opinion provided insight into what cannot escape SE tax and what may qualify for exclusion

Self-Employment Tax Exclusion for Limited Partners' Distributive Shares (II.L.4.)

Limited partner's income not subject to SE tax, except for guaranteed payments for services rendered to partnership engaged in trade or business; subparts:

- Tax Court Disregards Status as Limited Partner under State Law (II.L.4.a)
- Cases Not Involving Limited Partnerships (II.L.4.b)
- IRS Approach to Limited Partner Exception (II.L.4.c)
- Relying on Limited Partner Exception Going Forward (II.L.4.d)

Soroban Capital Partners LP v. Commissioner (II.L.4.a)

Corporate Transparency Act; Self-Employment Tax and Limited Partners; Discharge of Debt; and Grantor Trust Tax Reimbursement (4th quarter TCLE 1/30/2024):

- *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023): partner could qualify for limited partner exclusion from self-employment tax only if partner was passive investor
- At first glance, qualifying for this exception may prevent partner from avoiding 3.8% net investment income tax on business income, but perhaps way to avoid both taxes
- My solution might not work after 2025 holding

Soroban Capital Partners LP v. Commissioner, T.C. Memo. 2025-52 (II.L.4.a)

- General partner of limited partnership was LLC, whose owners were also the only limited partners
- Court held:

  A partner labeled a limited partner who works for the business full time, whose work is essential to generating the business's income, who is held out to the public as essential to the business, and who contributes little or no capital, is not functioning as a limited partner regardless of the label placed on that partner.

Soroban Capital Partners LP v. Commissioner, T.C. Memo. 2025-52 (II.L.4.a)

Continuing:

Petitioner relies on the fiction that the Principals did not serve Soroban in their individual capacities as limited partners. Instead, petitioner argues, they acted with authority delegated to them by the general partner, which they in turn had the authority to manage. This type of legal fiction is precisely why application of federal tax law to the economic arrangement of the parties controls, and not mere state law classifications.

Soroban Capital Partners LP v. Commissioner, T.C. Memo. 2025-52 (II.L.4.a)

Continuing:

Soroban's limited partners were limited partners in name only. They were essential to generating the business's income, they oversaw day-to-day management, they worked for the business full time, and they were held out to the public as essential to the business. Their capital accounts make clear that their earnings were not of an investment nature. They are not limited partners within the meaning of section 1402(a)(13), and their earnings constitute net earnings from self-employment for the years in issue.

Soroban Capital Partners LP v. Commissioner, T.C. Memo. 2025-52 (II.L.4.a)

- Court might very well say that, in my model, service as officer of S corporation general partner would be imputed to them in their individual capacities
- One could argue that employee of S corporation general partner is different than being member (taxed as a partner) in LLC general partner, but trial court here would probably have looked past that distinction

Relying on Limited Partner Exception Going Forward (II.L.4.d)

- First, structure entity as limited partnership
- Perhaps someone will successfully appeal to higher court Tax Court's blatant disregard of legislative history implying that general partner status does not taint partner's status as limited partner

Relying on Limited Partner Exception Going Forward (II.L.4.d)

Second, to extent possible, try to establish that earnings are from investment in business rather than partners' personal efforts and oversight

- In corporate arena, many courts use independent investor test (C corp II.A.1.b, S corp II.A.2.c)
- Capital is a material income-producing factor – service businesses (II.E.5.h)

Relying on Limited Partner Exception Going Forward (II.L.4.d)

- I was hoping to tie limited partner exclusion into net earnings from self-employment (SE) used for purposes of retirement plan contributions, but Reg. § 1.401-10(c)(3)(i) clearly provides that "earned income" for purposes of retirement plan contributions is narrower than SE income (II.L.9)
- That regulation was not focusing on limited partner exception, so perhaps analogy would work for limited partner

Relying on Limited Partner Exception Going Forward (II.L.4.d)

- Consider not materially participating (generally more than 500 hours) and instead significantly participating (more than 100 hours) in the business to avoid the 3.8% tax on net investment income while satisfying Prop. Reg. § 1.1402(a)-2(h)(2)(iii)
- That may be challenging when the business owner actively works in the business....

Relying on Limited Partner Exception Going Forward (II.L.4.d)

- If one wants to rely on Prop. Reg. § 1.1402(a)-2(h)(2) if business owner is below this threshold, business owner also must not have personal liability for debts of or claims against partnership by reason of being partner and must not have authority to contract on behalf of partnership
- However, if not relying on Reg. § 1.1402(a)-2(h)(2), still argue that Prop. Reg. § 1.1402(a)-2(h)(2)(iii) makes working not more than 500 hours be safe harbor under Tax Court's test

Relying on Limited Partner Exception Going Forward (II.L.4.d)

- SE Tax N/A to Qualified Retiring or Deceased Partner (below) (II.L.7)
- Retirement Payments to Insurance Salesmen (II.L.8)

Retired Partner Exception To Self-employment (SE) Tax (II.L.7)

Self-employment tax does not apply to amounts received by partner pursuant to a written plan of partnership, which:

- satisfies IRS requirements and
- provides for payments on account of retirement, on periodic basis, to partners generally or to class or classes of partners, such payments to continue at least until such partner's death

Retired Partner Exception To Self-employment (SE) Tax (II.L.7)

- Such payments likely characterized as Code § 736(a) payments (II.Q.8.b.ii)
- Although Code § 736 payments are generally excluded from draconian Code § 409A nonqualified deferred compensation rules (II.M.4.d), payments under this provision are not excluded from Code § 409A

Service Partnership Avoids 3.8% Net Investment Income Tax (II.E.5.h, II.K.1.a.ii.)

Partner in service business avoids net investment income tax if that partner materially participated for at least three years. Service business include:

- health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting
- any other trade or business in which capital is not a material income-producing factor

Relying on Limited Partner Exception Going Forward (II.L.4.d)

- If any strategy does not clearly work, consider putting tangible and – to extent possible –intangible personal property in S corporation and lease to business
- Rental of tangible personal property would be self-employment income, so S corporation is needed
- To extent tangible personal property, exit strategy from S corporation may be to abandon once past useful life
- Then no need to distinguish between income from capital from income from services
- Might abandon limited partner exclusion (or, if use limited partnership, simply reduces amount at risk)

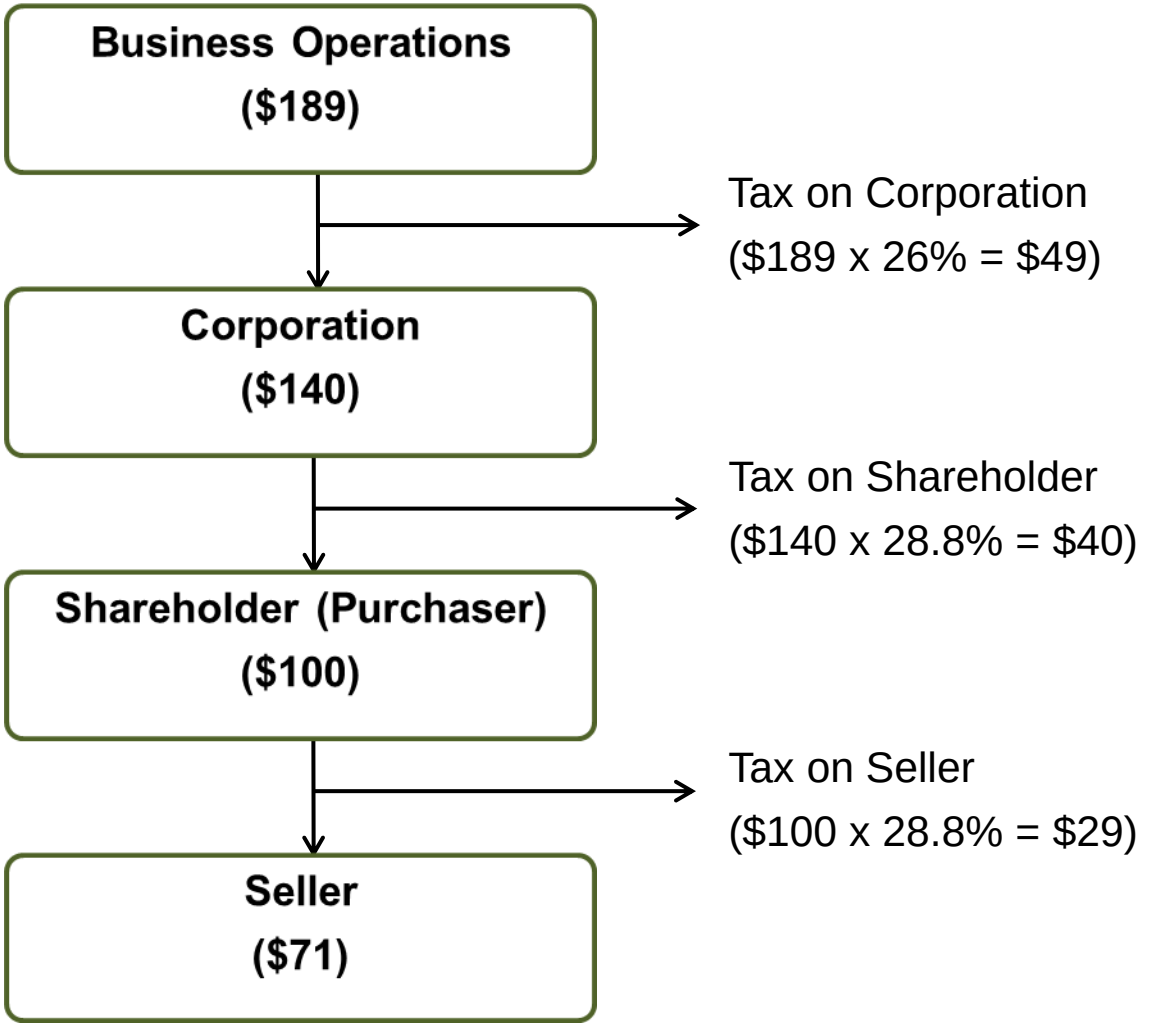
Seller – Financed Sale of Goodwill

Part II.Q., especially II.Q.1.a.i.

- C Corporation Triple Taxation and Double Taxation
- S Corporation Double Taxation
- Partnership Single Taxation
- Partnership Use of Same Earnings as S Corporation

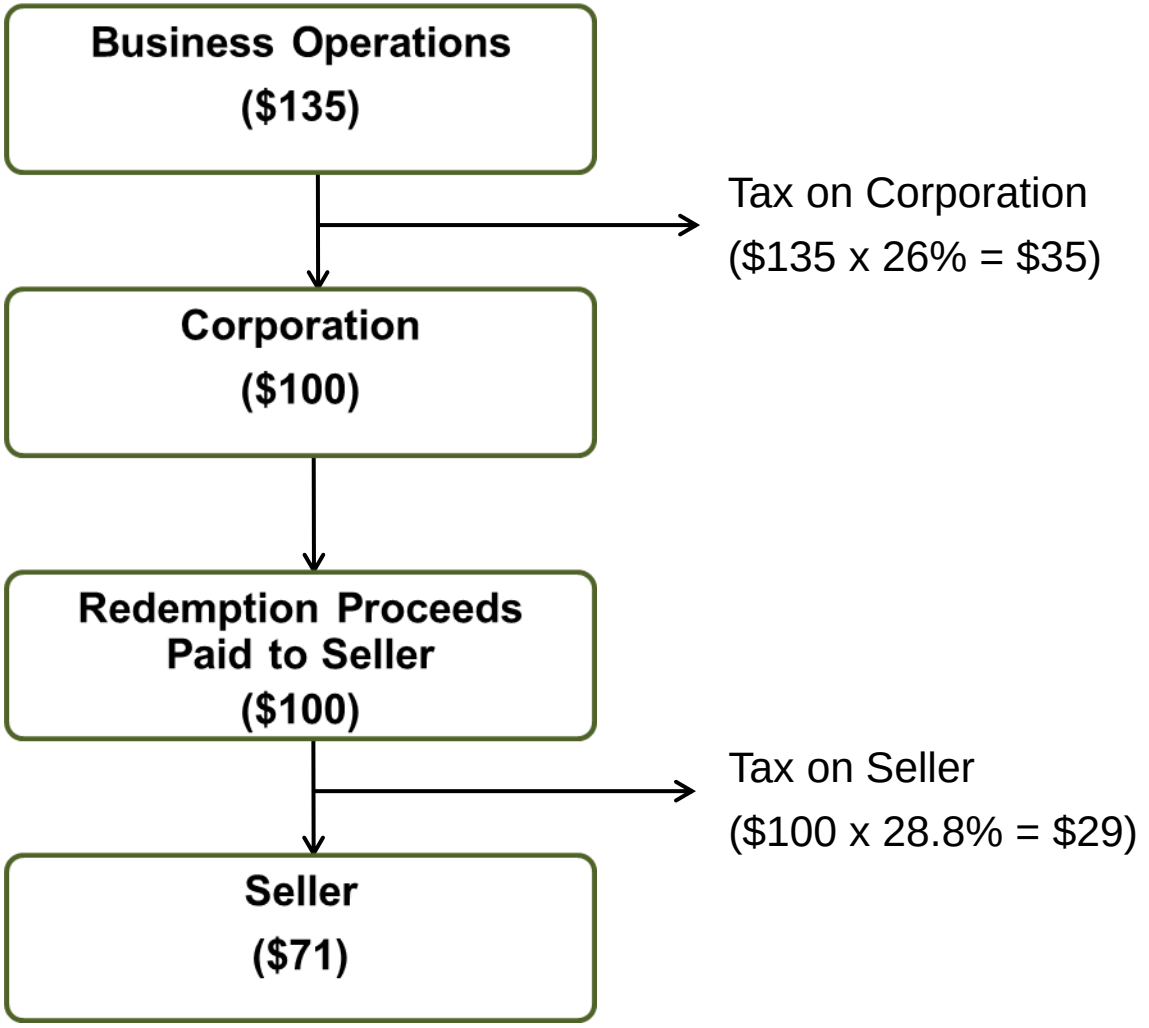
C Corporation Triple Taxation (II.Q.1.a.i.(a).)

(moderate state income tax)



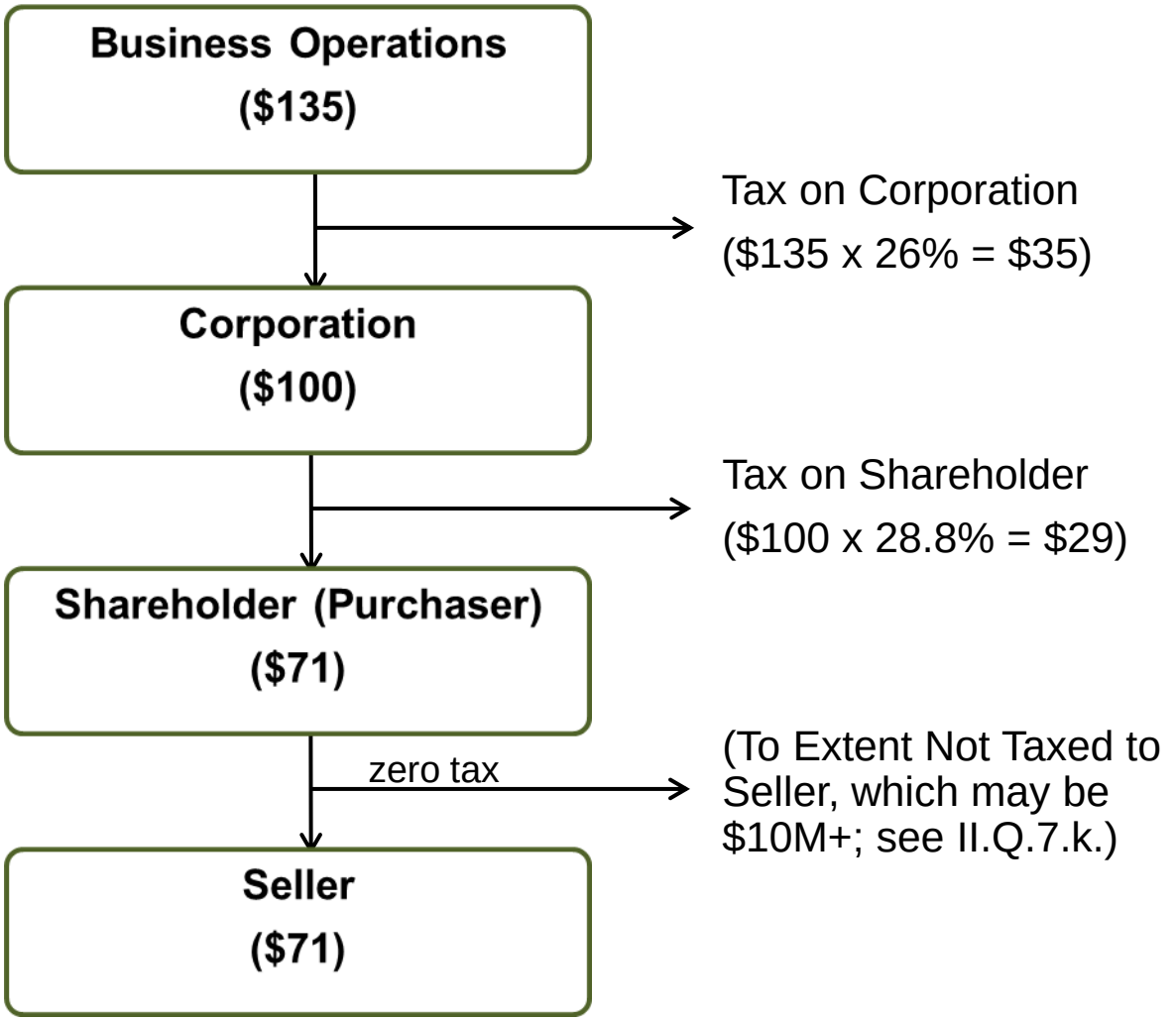
C Corporation Redemption

(II.Q.1.a.i.(b).) (moderate state income tax)

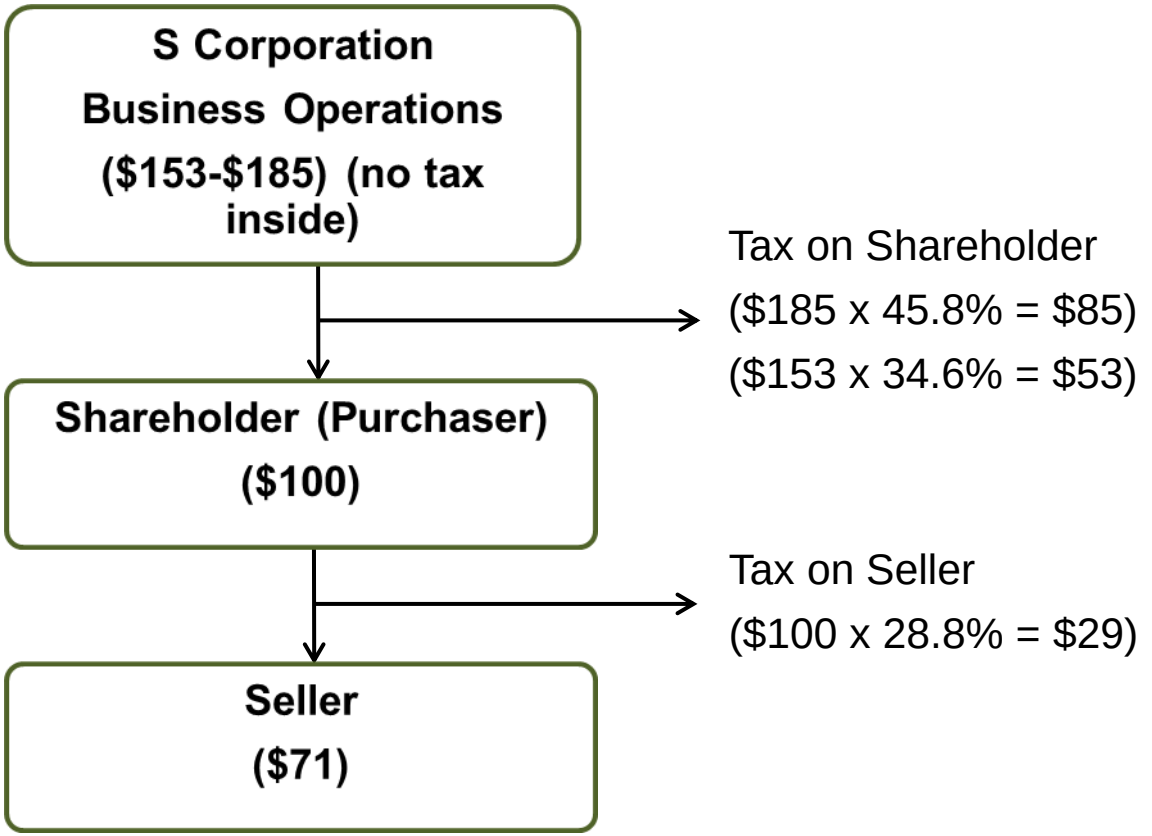


C Corporation Double Taxation with QSBS

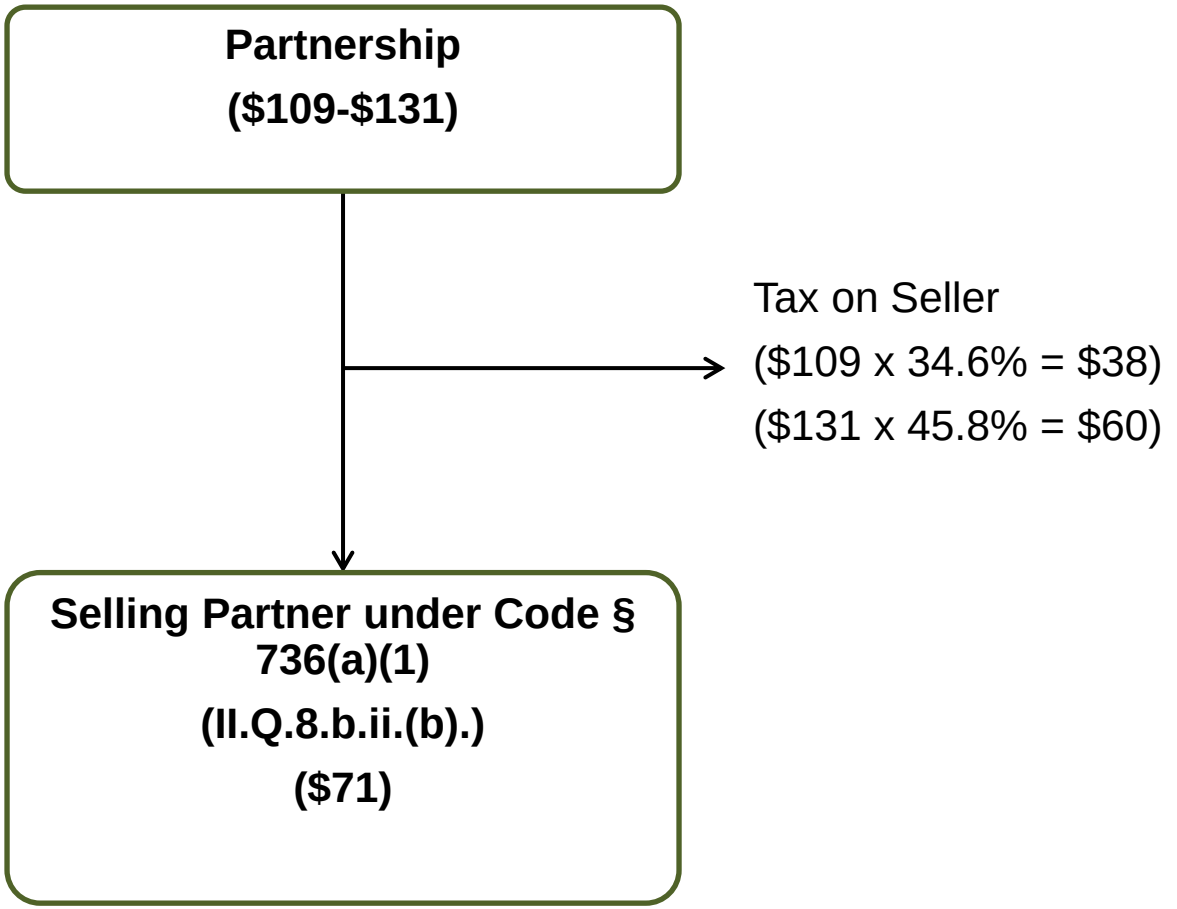
(II.Q.1.a.i.(c).) (moderate state income tax)



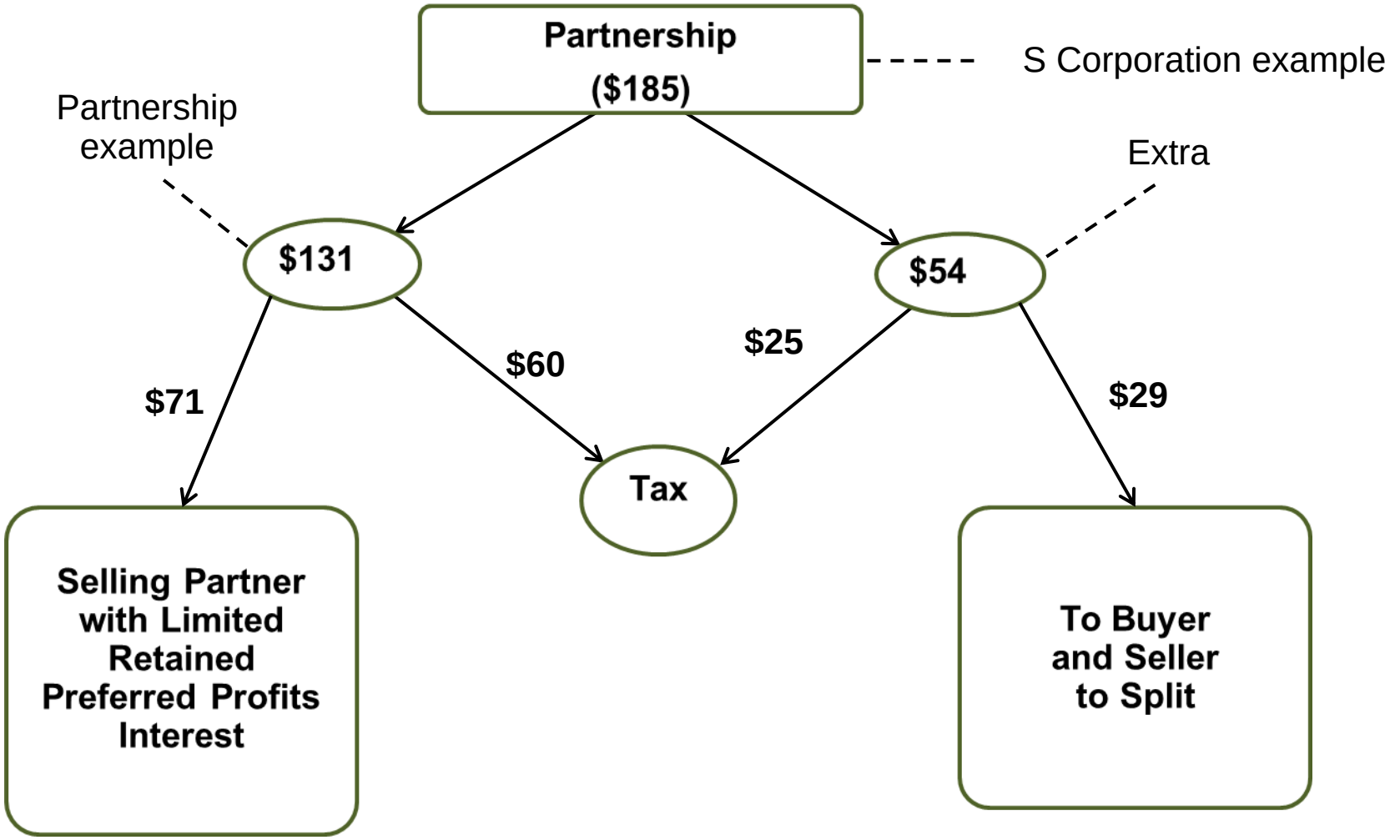
S Corporation Double Taxation (II.Q.1.a.i.(d).) (moderate state income tax)



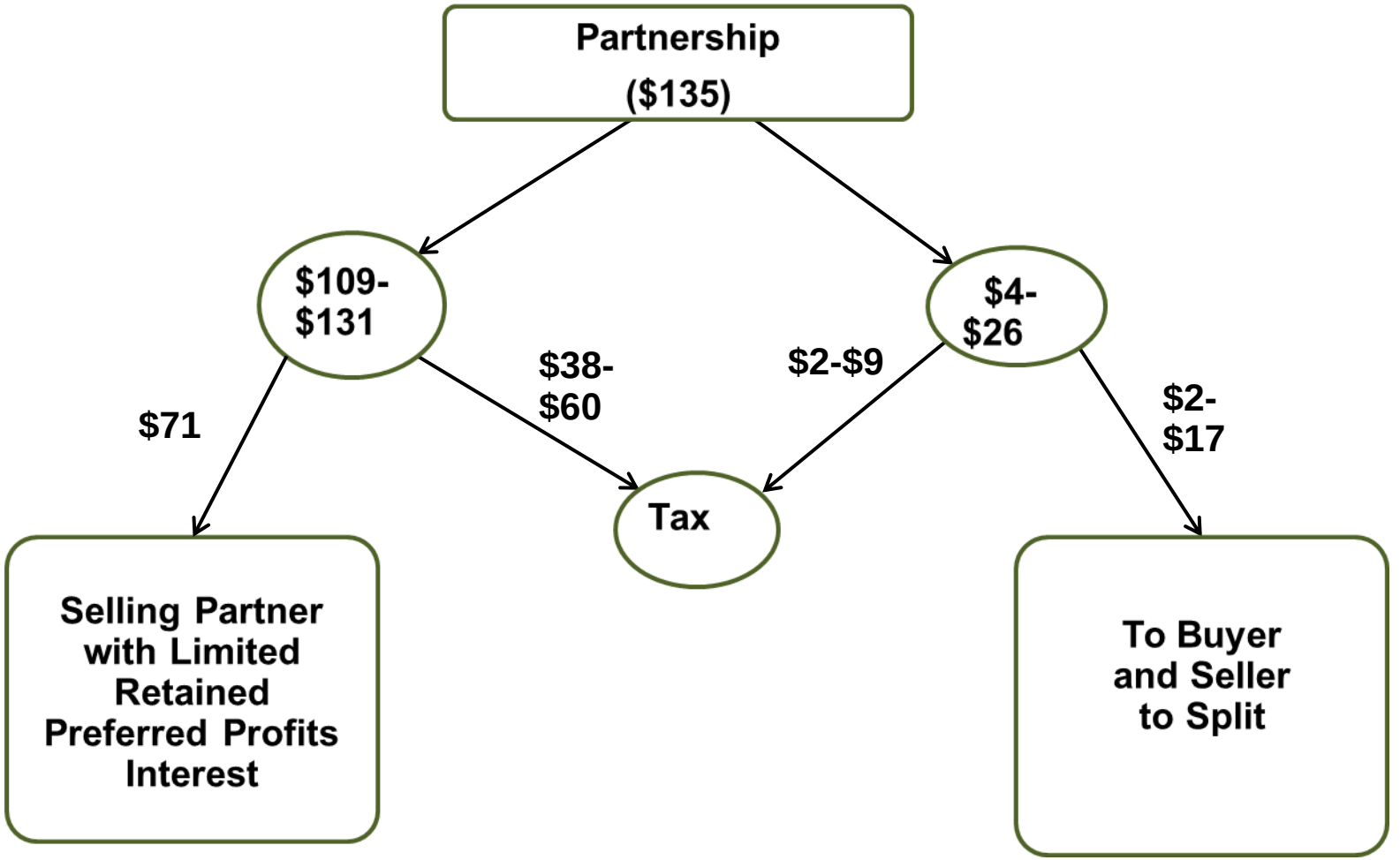
Partnership Single Taxation (II.Q.1.a.i.(e).) (moderate state income tax)



Partnership Use of Same Earnings as S Corporation (II.Q.1.a.i.(f).) (moderate state income tax)



Partnership Use of Same Earnings as C Corporation Assuming Redemption or Exclusion of Gain on the Sale of Certain Stock in a C Corporation (II.Q.1.a.i.(g).) (moderate state income tax)



Deferred Compensation (II.Q.1.d. and II.M.4.d.)

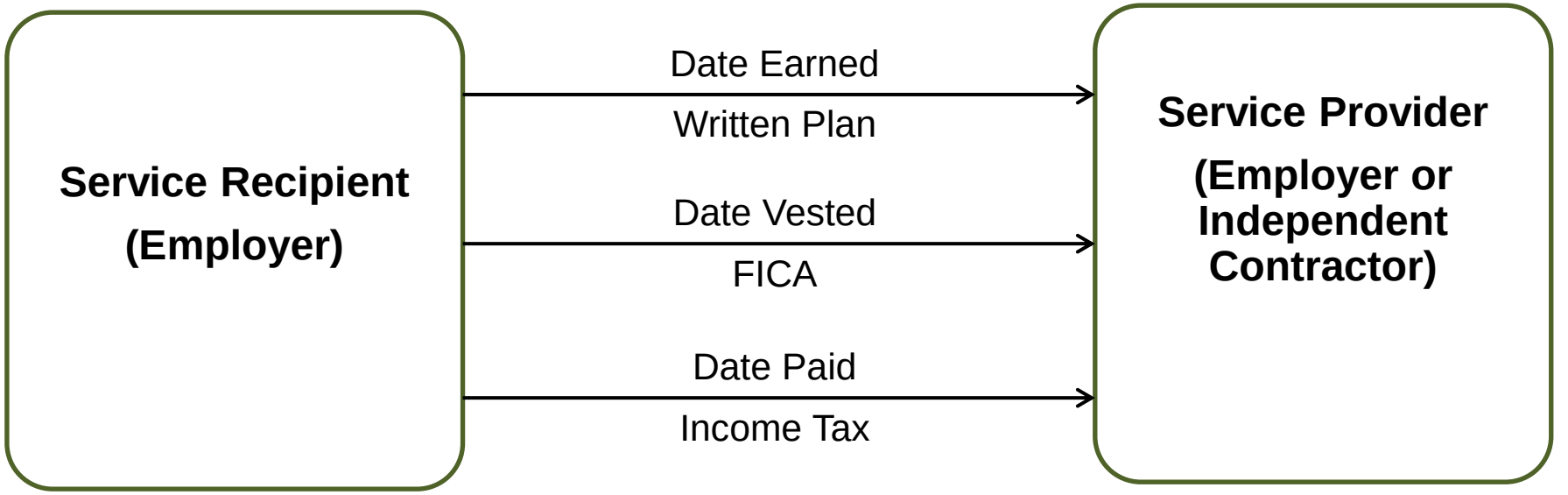
- Using nonqualified deferred compensation to facilitate a sale
- Introduction to Code § 409A nonqualified deferred compensation rules

Deferred Compensation

(II.Q.1.c.i., II.M.4.d.)

- Income tax dynamics are similar to partnership exit strategy, but not as favorable now that the deduction may save less to the service recipient than tax on the income received by the service provider
- Careful in buy-sell agreement not to make it a substitute for purchase price
- Balance sheet effect (II.Q.8.b.ii.(e)). Contrast against profits interests and Code § 736(a)(1) payments)

Timeline for FICA and Income Taxation of Deferred Compensation (II.Q.1.d.iii.)



Deferred Compensation

Code § 409A Violation Incurs (II.M.4.d.)

- Acceleration of income taxation
- 20% penalty
- Interest on previously deferred tax

Deferred Compensation

- Written plan when legally binding
- Reasonable compensation overlay
- § 409A applies with impermissible triggers, acceleration, or re-deferral

Deferred Compensation – Permissible Delay (II.M.4.d.ii.)

- $150,000 per Year Current Compensation
- $100,000 Annual Retirement Payments 2027-2036
- End of 2026, Wants to Push Back Retirement

Deferred Compensation – Permissible Delay (II.M.4.d.ii.)

Agree in 2026

- 2027 work will generate $50,000 compensation paid in 2027 and $100,000 compensation paid in 2037
- 2027 cash paid $150,000
  - ➢$100,000 previously scheduled deferred compensation
  - ➢$50,000 from 2027 work
- 2027-2036 stream of payments stays intact
- 2037 retirement payment added

Other Exit Strategies

- Leasing (II.Q.1.b.)
- Personal Goodwill and Covenants Not to Compete (II.Q.1.c.)
- Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future (II.Q.3.)

Migrating Existing Corporation into Partnership Structure (II.E.7.)

Corporation Forms New LLC

Direct Formation of LLC (1st option)

Advantages

- Corporation Can Keep Nonbusiness Assets
- Corporation Can Keep Business Assets That Would Generate Complications if Transferred to the Limited Partnership Structure and Then Had Income Recognition Event
- New LLC Can Stay as a Disregarded Entity for a While as Transition to New Structure and Get Everyone Used to Working in LLC Structure

Migrating Existing Corporation into Partnership Structure (II.E.7.)

Corporation Forms New LLC

Direct Formation of LLC (1st option)

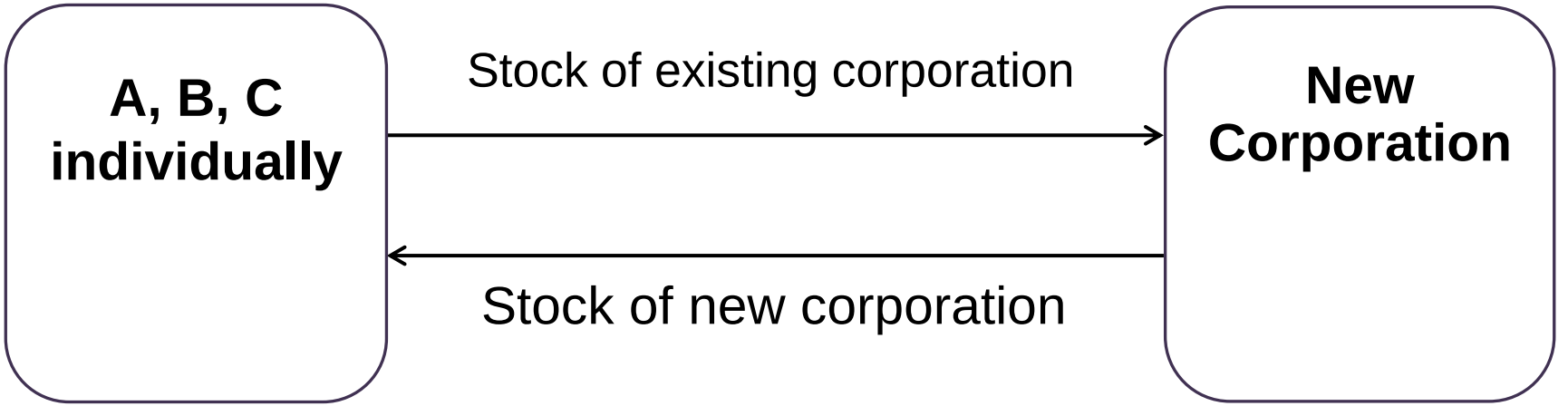
Disadvantages

- Piecemeal Transfer of Assets
- Some Assets Not Readily Transferable

Migrating Existing Corporation into Partnership Structure (II.P.3.h.)

Corporation Forms New LLC

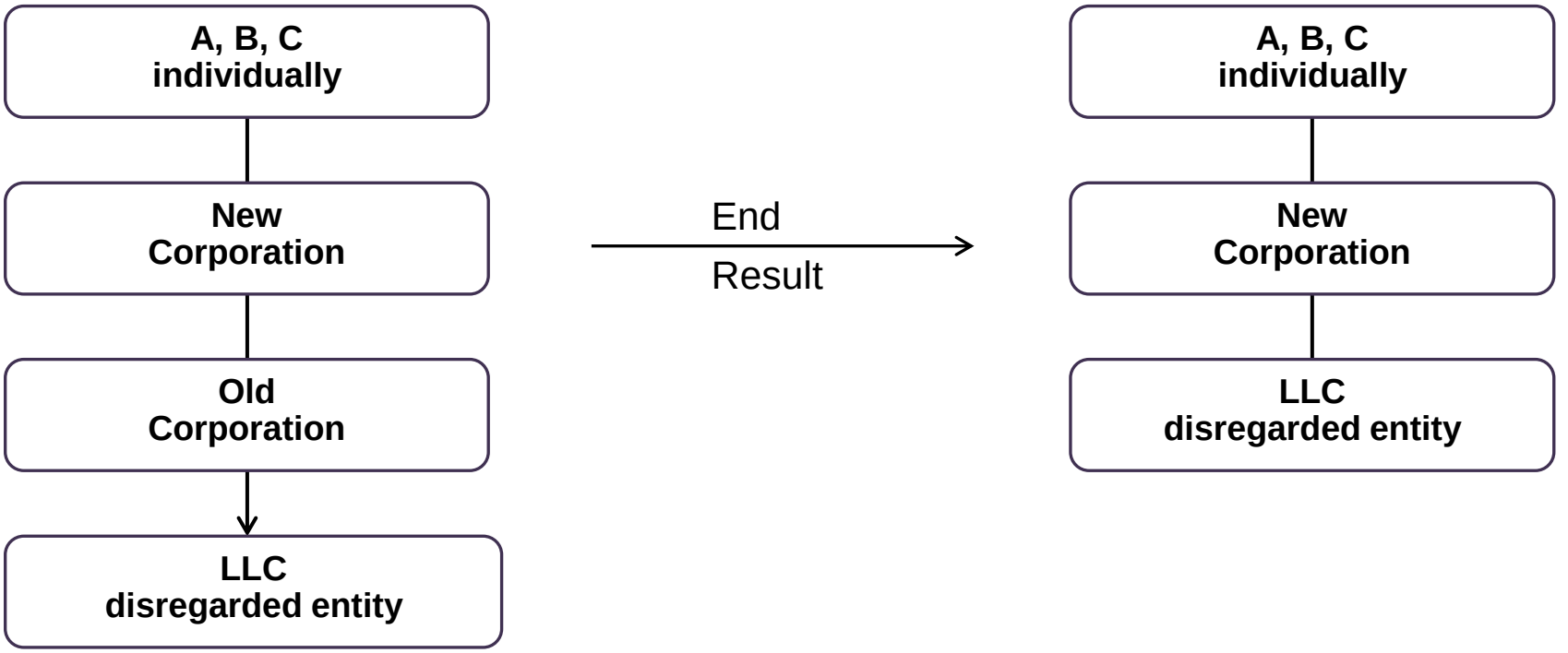
Use F Reorganization to Form LLC (2nd option)



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

Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd option)



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

Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd option)

Advantage

- Moves all assets in one fell swoop

Migrating Existing Corporation into Preferred Structure

Corporation Forms New LLC

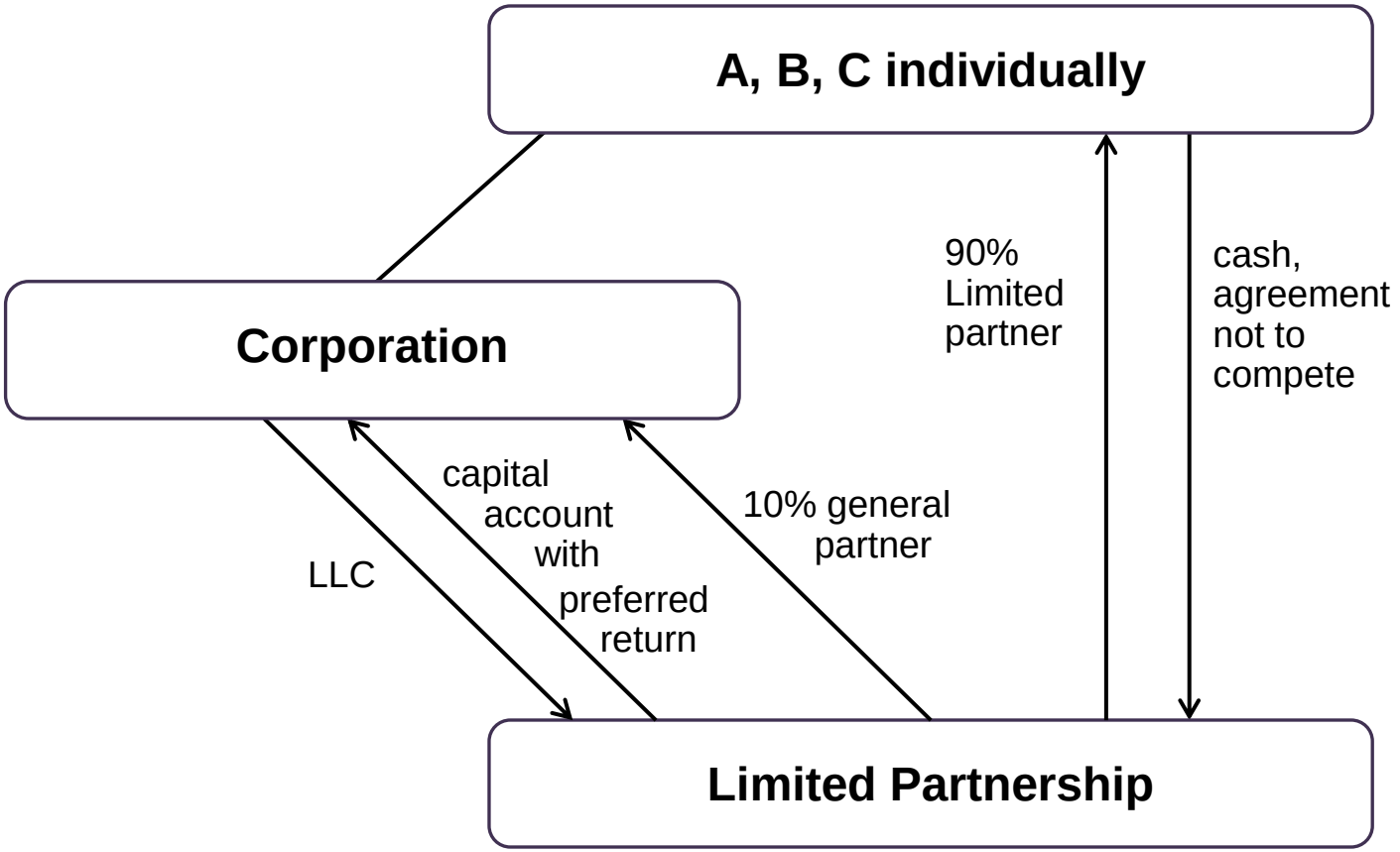
Use F reorganization to form LLC (2nd option)

Disadvantages

- No selectivity of retained assets (but can send back to parent)
- Contribution of stock of old corporation to new corporation and merger or conversion of old corporation into new corporation need to be done at the same time
- If S corporation involved, new corporation does new S election and old corporation does qualified subchapter S subsidiary election

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

Migrating LLC to LP



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Profits Interest (II.M.4.f.)

- No income on issuance of profits interest
- No balance sheet liability
- No Code § 409A concerns

Profits Interest (II.M.4.f.)

- Annual income taxed to partner
- Partnership makes tax distributions
- Balance can be paid whenever makes sense for the business
- Connelly; Profits Interest; Basis Shifting; Non-Compete (7/30/2024) includes discussion of ES NPA Holding, LLC v. Commissioner, T.C. Memo. 2023-55

Profits Interest (II.M.4.f.)

- Revaluation required
- Code § 2701 if controlled by one family (III.B.7.b., III.B.7.c.)
- Under 2017 tax reform, certain sales of compensatory partnership interests recharacterized from long-term to short-term gains (II.M.4.f.ii.(b).)
  - More than 3-year holding period
  - Taxpayer may net the gains and losses unless sale to a related party

When loan is "bona fide" (III.B.1.a.i.(a).)

Dynamo Holdings Ltd. Partnership v. Commissioner, T.C. Memo. 2018-61

- Transferee's unconditional obligation to repay money
- Transferor's unconditional intent to obtain repayment
- Special scrutiny to intrafamily transfers and transactions between entities in same "corporate" family or with shared ownership

When loan is "bona fide" (III.B.1.a.i.(a).)

- Transfers between family members are presumed to be gifts
- Presumption rebutted by affirmative showing of real expectation of repayment and intent to enforce collection
- Multi-factor test articulated slightly differently by different Courts of Appeal (and therefore by Tax Court)

When loan is "bona fide" (III.B.1.a.i.(a).)

- Promissory note or other evidence of indebtedness
- Interest charged
- Security or collateral
- Fixed maturity date
- Demand for repayment was made
- Any actual repayment was made
- Transferee had ability to repay
- Any records maintained by transferor and/or transferee reflected the transaction as loan
- Manner in which transaction was reported for Federal tax is consistent with loan

When loan is "bona fide" (III.B.1.a.i.(a).)

Dynamo Holdings Ltd. Partnership v. Commissioner, T.C. Memo. 2018-61

> Dynamo and Beekman satisfied some but not all of the formal indicia of debt. We agree with the Commissioner that at the time the advances were made there was no contemporaneous promissory note identifying all the terms of the agreement, there was no collateral set aside to ensure repayment, there was no invoice or demand made by Beekman, and there was no fixed maturity date or intent to force Dynamo into bankruptcy if required to ensure repayment. However, there are many meaningful indicia of debt. Dynamo and Beekman maintained records that reflected advances as debt in their general ledgers, and they executed promissory notes.

When loan is "bona fide" (III.B.1.a.i.(a).)

Dynamo Holdings Ltd. Partnership v. Commissioner, T.C. Memo. 2018-61

> We are not troubled by any shortcomings in Dynamo's and Beekman's formal indicia of debt. They must be taken into account in the context of the business realities of the transaction. We would be surprised if Mr. Julien wrote himself an invoice, demanded repayment, or required a credit check or audited financial statements before making an advance. The management of these companies was the same, and they had full knowledge of and access to all financial information. Moreover, we have consistently held that these formal indicia of debt are little more than declarations of intent without accompanying objective economic indicia of debt.

When loan is "bona fide" (III.B.1.a.i.(a).)

Dynamo Holdings Ltd. Partnership v. Commissioner, T.C. Memo. 2018-61

> In ascertaining the economic realities of the transaction, it is helpful to measure the transfer against the economic realities of the marketplace to determine whether a third party lender would have extended the loan. Dynamo and Beekman satisfy all the objective economic indicia of debt. Beekman charged and Dynamo accrued interest on the advances in 2006 and 2007. Beekman reported and paid tax on that interest income. Dynamo reported and deducted that interest expense. Dynamo repaid some of the advances before any examination began. At all times, Dynamo had the ability to repay the loans. Importantly, Dynamo could have received loans on substantially similar terms. And Dynamo did receive sizable loans from third parties.

When loan is "bona fide" (III.B.1.a.i.(a).)

Dynamo Holdings Ltd. Partnership v. Commissioner, T.C. Memo. 2018-61

> After analyzing the facts, we hold that Dynamo and Beekman entered into a bona fide creditor-debtor relationship. At the time the advances were made, Dynamo had an unconditional obligation to repay the loans, and Beekman had an unconditional intent to be repaid. A bona fide loan precludes a constructive distribution. Because we found that the advances were bona fide debt, the advances are not constructive distributions. Likewise, Dynamo is entitled to deduct the interest expenses.

When loan is "bona fide" (III.B.1.a.i.(a).)

Estate of Moore v. Commissioner, T.C. Memo. 2020-40

"A purported loan between family members is always subject to close scrutiny…. The presumption, for tax purposes at least, is that a transfer between family members is a gift...." The presumption may be rebutted upon a showing that the transferor had a real expectation of repayment and an intention to enforce the debt.... A promise to pay money in the future coupled with an implied understanding that the promise will not be enforced does not create a true debtor-creditor relationship.

When loan is "bona fide" (III.B.1.a.i.(a).)

- Name given to instrument underlying transfer of funds
- Presence or absence of fixed maturity date and schedule of payments
- Presence or absence of fixed interest rate and actual interest payments
- Source of repayment
- Adequacy or inadequacy of capitalization
- Identity of interest between creditors and equity holders
- Security for repayments
- Transferee's ability to obtain financing from outside lending institutions
- Extent to which repayment subordinated to claims of outside creditors
- Extent to which transferred funds were used to acquire capital assets
- Presence or absence of sinking fund to provide repayment

When loan is "bona fide" (III.B.1.a.i.(a).)

- Treated loans to children as gifts
- Loan from FLP to decedent's revocable trust not bona fide loan:

  There is no evidence in the record that there was ever a promissory note, that the FLP ever charged interest or the Living Trust ever paid it, or that there was any collateral for the loan. It also appears that there was no maturity date on the loan and that no payments were made. As of the date of trial there has never been a demand for repayment. The estate simply did not meet its burden. We, therefore, find that the estate is not entitled to deduct the $2 million payment as a loan. On the other hand, we do find that Moore spent this money before he died, mostly on income tax that he owed on the sale of the farm. It should not be included in his taxable estate under section 2033.

When loan is "bona fide" (III.B.1.a.i.(a).)

Estate of Mary P. Bolles v. Commissioner, T.C. Memo. 2020-71:

- Same factors as Dynamo Holdings
- Circumstances determined whether bona fide loan from parent to child:

  Peter's creativity as an architect and his ability to attract clients likely impressed Mary. We find she expected him to make a success of the practice as his father had, and she was slow to lose that expectation. However, it is clear she realized he was very unlikely to repay her loans by October 27, 1989, when her trust provided for a specific block of Peter's receipt of assets at the time of her death. Accordingly, in 1990 the "loans" lost that characterization for tax purposes and became advances on Peter's inheritance from Mary. In conclusion, we find the advances to Peter were loans through 1989 but after that were gifts. We have considered whether she forgave any of the prior loans in 1989, but we find that she did not forgive the loans but rather accepted they could not be repaid on the basis of Peter's financial distress.

Loan Guarantees (III.B.1.a.ii.)

Generally, a guarantee (guaranty) is promise to pay another person's debt; borrower is required to repay guarantor any funds guarantor pays on the borrower's behalf:

- Lender loans to borrower
- Guarantor promises that loan will be repaid; guarantee may be for part or all of loan
- At some point, lender may collect from guarantor
- Guarantor steps into lender's shoes with respect to amount lender collects (subrogation right); using subrogation right, guarantor can attempt to collect from borrower
- Guarantor is out-of-pocket only for amounts not collected from borrower (including collection expenses, which loans usually impose on borrower)

Loan Guarantees (III.B.1.a.ii.)

Three common paradigms:

- After borrower defaults, lender must first pursue borrower, then may collect from guarantor
- After borrower defaults, lender may collect from borrower or guarantor
- Guarantor is listed as co-borrower; true borrower is expected to make payments, but lender can require guarantor to pay any time

Loan Guarantees (III.B.1.a.ii.)

- All three paradigms have same tax consequences
- Because co-borrowing on its face makes guarantor legally a co-borrower, additional documentation or course of dealing is required to distinguish a guarantee from a true joint loan
- True joint debtors can change into guarantee if one assumes all obligations

Estate and Gift Tax Consequences of Loan Guarantees (III.B.1.a.ii.(a)., III.B.1.a.ii.(b))

- Guarantor's subrogation right is consideration for guarantee
- Guarantor must prove intent to enforce subrogation right in case future collection from guarantor
- Prove intent objectively analyzing whether could reasonably expect borrower to repay loan

Estate and Gift Tax Consequences of Loan Guarantees (III.B.1.a.ii.(a)., III.B.1.a.ii.(b))

- Code § 7872(e)(1) and (f)(2) refer to the applicable federal rate (AFR) under Code § 1274(d).
- Code § 1274(d)(1)(C) determines the AFR "based on the average market yield … on outstanding marketable obligations of the United States…."

Estate and Gift Tax Consequences of Loan Guarantees (III.B.1.a.ii.(a)., III.B.1.a.ii.(b))

- In appraisal profession, such obligations are benchmark for risk-free rates of return
- Appraisers then add various risk factors to determine an appropriate discount rate or required rate of return
- Therefore, under Code § 7872, loans are deemed to charge adequate interest if they charge interest based on risk-free loan

Estate and Gift Tax Consequences of Loan Guarantees (III.B.1.a.ii.(a)., III.B.1.a.ii.(b))

- Because Code § 7872 applies to borrowers who are not the U.S. government and places no qualifications whatsoever on who may use it, Congress has decreed that credit risk is not taken into account in determining adequacy of interest
- Code §§ 1271-1275, setting the AFR, are read together as one coherent set of rules

Estate and Gift Tax Consequences of Loan Guarantees (III.B.1.a.ii.(a)., III.B.1.a.ii.(b))

- In determining whether to give effect to schedule of stated payments, Reg. § 1.1273-1(c)(1)(ii) ignores "the possibility of nonpayment due to default, insolvency, or similar circumstances" unless "the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions."

Estate and Gift Tax Consequences of Loan Guarantees (III.B.1.a.ii.(a)., III.B.1.a.ii.(b))

- Thus, if one structures a loan with terms (other than interest rate) that reflect arm's length dealing, only remaining issue is whether holder intends to enforce remedies and other terms and conditions
- Pre- and *post-Dickman* authority described above determines this intent

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

- Letter Ruling 9113009 - loan guarantees were "valuable economic benefits" constituting a gift
- Letter Ruling 9409018 withdrew holding
- Letter Ruling 200534014 not appear to be troubled by parent providing creditworthiness to child
- Tax Court has referred to loan guarantees as "unmatured, potential claims"

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

If concerned that loan guarantee is gift:

- Structure loan as a back-to-back loan:
  - Parent borrows from proposed lender and loans money to child
  - Parent can charge AFR to child even though parent pays higher interest to third party lender
- If tax laws allow above, how can guarantee be gift?
- If impractical, consider paying the parent a reasonable guarantee fee

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

Compare loan guarantee to back-to-back loan

- Back-to-back loan: the person whose credit capacity ("credit intermediary") is to be used borrows from a commercial lender, then loans the proceeds to ultimate borrower
- Borrower grants security interest to the credit intermediary, which the credit intermediary then assigns (together with whatever collateral the credit intermediary provides) to lender

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

- Back-to-back mechanism is not just an estate planning tool – rather, it is required for a shareholder in an S corporation to obtain basis against which to deduct the corporation's debt-financed losses (II.G.4.d.ii.(a).)
- Nothing in Code § 7872 looks to the source of lender's funds – how much interest the credit intermediary pays on the loan from the commercial lender that credit facilitator uses to loan to ultimate borrower

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

- Credit intermediary can obtain loan at market interest rates, which take into account risk commercial lender takes in lending to credit intermediary, then turn around and loan that money to ultimate borrower at AFR – risk-free interest rate
- Code § 7872 prevents the arbitrage –excess of interest paid to commercial lender over AFR – from constituting gift
- Furthermore, credit intermediary must pay commercial lender whether or not ultimate borrower is performing on loan

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

- Because interest arbitrage and financial risk credit intermediary incurs exceed cost and risk assumed by a guarantor and such an arrangement does not constitute a gift, I believe that Code § 7872 inherently means that loan guarantee does not constitute gift
- However, objectively guarantor must prove reasonable expectation that borrower would pay loan and guarantee was merely to bridge gap between reduced-risk loan and risks inherent in loaning to that particular borrower

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

- Credit intermediary must deal directly with lender and borrower on a regular (sometimes monthly) basis; with loan guarantee, guarantor has no role regarding loan payment until borrower defaults
- Thus, client may want to be guarantor instead of credit intermediary in back-to-back loan - enforcing loans to family members can disrupt family relationships

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

- Making borrower deal with bank injects formality into process and increases likelihood of payment
- If client asks me about possibly loaning to friend, I first ask whether not getting repaid would ruin friendship (and client's financial position)
- Then I recommend offering to guarantee bank loan to that friend instead
- Those questions usually put kibosh on friend's request
- Thus, relative to back-to-back loan, loan guarantee seems to me to have strong nontax business reason

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

If concerned that loan guarantee by trust is gift, consider:

- Provision in the trust agreement allowing extending credit to other trusts for the benefit of the trust's beneficiaries
- Charging a fair market value guarantee fee would give business purpose to guarantee, or
- Obtaining the beneficiaries' consent (not gift if interest is at least AFR or lender is unrelated third party)

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

If beneficial interests in the trusts are substantially the same:

- Trusts often treated as entities outside of trust law, but trust really not an entity
- Trust is relationship between trustee(s) (the holder(s) of legal title) and beneficiaries (those who receive distributions for their own use) pursuant to wishes of whoever gave property to trust (settlor(s)) [cont'd]

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

If beneficial interests in the trusts are substantially the same:

- Trustees have duty to promote beneficiaries' interests pursuant to this relationship
- Whether trustees further this relationship by holding property in separate accounts or pursuant to different trust instruments with substantially the same terms is of no consequence – either way, all funds promote relationship

Gift Tax Issues Involving Loan Guarantees

(III.B.1.a.ii.(a))

If beneficial interests in the trusts are substantially the same:

- Trustee of identical trusts has fiduciary duty to use one trust to promote other trust when other trust needs that to take advantage of opportunity
- Thus, one trust guaranteeing loan to substantially identical trust would have solid business purpose

Estate Planning Use and Misuse of Loans and Guarantees

- Loan must be bona fide to be recognized as such
- Because consideration for guarantee is expectation of repayment, guarantee cannot cure loan that is not bona fide
- Rather, guarantee supplies economic substance to borrower that already expects to fully repay loan

Estate Planning Use and Misuse of Loans and Guarantees

- Multi-factor test requires court to weigh various factors
- Ultimately, need to convince court that lender intends to enforce loan
- Objective evidence that borrower had solid plan for raising cash to repay loan might be best evidence

Estate Planning Use and Misuse of Loans and Guarantees

- *Galli* court order (not a published opinion)
- Loan at AFR was not gift
  - Consistent with *Frazee* and *Estate of True*
  - Supports position that, once bona fide, credit risk not considered (of course, credit risk might indicate inability to repay loan and undermine bona fides)
- Court denied IRS position hat note must be valued for estate tax purposes without regard to risk of non-payment issues

Conclusion

- Free quarterly newsletter includes most recent version of the PDF and comparison against prior quarter's PDF
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