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MATERIALS AT A GLANCE

The following materials are from the Monday afternoon sessions of the 2024 WICPA Tax Conference held on Monday, Nov. 11 & Tuesday, Nov. 12, including:

- S Corporation Hot Topics
- Designing Buy-Sell Agreements for Closely Held Businesses & Avoiding the New Connelly Trap
- BOI Discussion Panel
- ERC Update: Current Developments in Uncharted Waters
- Hot Tax Practice & Procedure & Ethics Issues

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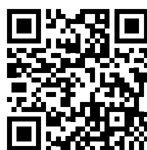

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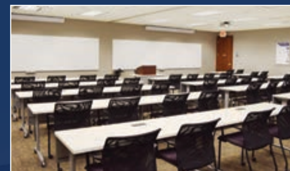
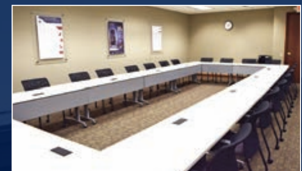

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12:45 – 1:45 p.m.

S Corporation Hot Topics

Jim Brandenburg, CPA, MST, *Director, Taxation, Sikich LLP*

S Corporation Hot Topics

Brookfield, Wisconsin
November 11, 2024

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Outline of Presentation

I. Tax Planning with S Corporations

II. Rev. Proc. 2022-19 and Other Administrative Relief

III. M&A Issues with S Corporations

IV. Recent Cases

Outline of Presentation

I. <u>Tax Planning with S Corporations</u>

II. Rev. Proc. 2022-19 and Other Administrative Relief

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Tax Planning with S Corporations

1. S Corporation Planning – General Comments on Choice of Entity

- **S Corporation has been utilized for many years to avoid double tax on income that applies with a C Corp.**
- Further, even with the drop of the corporate tax rate to 21% with TCJA in 2017, there was the 20% QBI deduction (§199A) that provided some relief to S Corporations and their shareholders.
- **Need to analyze this <u>S Corp *vs.* C Corp</u> next year with the coming sunset of TCJA at end of 2025:**
  - Individual tax rates sunset to 2017 tax rates. Across-the-board tax hikes will result. **Top rate will jump to 39.6% from 37%.**
  - The 20% QBI deduction also scheduled to be eliminated. Thus, top marginal tax rate on pass-through income will jump from **29.6% to 39.6% (an increase of 33.8%).**
  - **"Pease Adjustment"** will return and reduce 3% of itemized deductions. Adds about 1.2% to marginal rate. Thus, top tax rate moves up to **40.8%** [39.6% + 1.2%].
  - **Corporate tax of 21%, however, is <u>not scheduled</u> to change**, but will remain at 21%.
  - Several other TCJA provisions will sunset in 2025.
- **Congress will review these provisions and may extend them, and make other changes, but unsure what may happen.**
- **Consider switching to being taxed as a C Corporation.** If tax rates sunset at end of 2025, C Corporation rates could be lower (or at least the same) as tax rates with S Corporation, even with impact of double tax.

Tax Planning with S Corporations

2. Section 1202 – Qualified Small Business Stock (QSBS)

- **QSBS stock must be held for more than five years to qualify for benefit. The benefit of Section 1202 varies depending on when stock acquired:**
  - Stock acquired on or **after 8/11/1993 and before 2/17/2009** – **50% exclusion on gain**, but gain measured at 28% rate, thus 50% exclusion results in a 14% rate. Compares with a 15% rate at the time produced small tax benefit. There was also a 7% AMT adjustment.
  - Stock acquired on or **after 2/17/2009 and before 9/27/2010** - a **75% gain exclusion applies**. AMT adjustment remains.
  - Stock acquired **on or after September 27, 2010**, a **100% gain exclusion applies, and no AMT adjustment**.

- **Section 1202 Limits**

  Exclusion for any year limited to **greater of**:
  - **$10 million** less any amount excluded with respect to that corporation's stock in prior years; **or**
  - **Ten times aggregate basis of stock** of QSBS sold during year.

Tax Planning with S Corporations

2. Section 1202 – Qualified Small Business Stock (QSBS) *(Continued)*

- **Section 1202 Overview – Qualified Small Business Stock (QSBS). Key requirements:**
  - "Small Business" Requirement
  - "Active Trade or Business Requirement
  - "Original Issuance" Requirement

2. Section 1202 – Qualified Small Business Stock (QSBS) *(Continued)*

- **"Small Business" Requirement:**

  - QSBS stock must be issued by a domestic C Corporation (at date of issuance) with cash and other assets of ≤ $50 million, based on adjusted basis, at all times from August 10, 1993, to date immediately after the stock is issued.

  - Assets amount determined by cash **plus** adjusted tax basis of other assets in corporation. For this test, any contributed property is measured as its fair market value (not its tax basis).

2. Section 1202 – Qualified Small Business Stock (QSBS) *(Continued)*

- **"Active Trade or Business" Requirement**

  - To qualify as QSBS stock, stock must be issued by a C Corporation that meets an active business requirement, with ≥ 80% of value of corporation's assets must be used in a qualified trade or business during substantially all of the taxpayer's holding period for such stock. The corporation must also be an **"eligible corporation."**

  - "Also, for an eligible corporation, the **corporation must NOT** be a:
    - ✓ REIT/RIC;
    - ✓ DISC (IC-DISC);
    - ✓ Cooperative (Co-op):
    - ✓ Corporation which has made a Section 936 election

2. Section 1202 – Qualified Small Business Stock (QSBS) *(Continued)*

“Active Trade or Business” Requirement

- A qualified trade or business **excludes**:
  1. Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, etc.;
  2. banking, insurance, financing, leasing, investing, or similar business;
  3. farming (including the business of raising or harvesting trees);
  4. production or extraction of products subject to percentage depletion; and
  5. a hotel, motel, restaurant, or similar business.

- **Note** – these exclusions for Section 1202 active trade or business are similar to the Section 199A excluded businesses; “Specialized Service Trade or Business” (SSTB).

2. Section 1202 – Qualified Small Business Stock (QSBS) *(Continued)*

“Original Issuance” Requirement

- **Shareholder must acquire the QSBS stock in original issue in exchange for:**
  1. money;
  2. property; **or**
  3. compensation.

  Shareholder acquiring QSBS stock by buying it from an existing shareholder will not hold QSBS stock.
- **Shareholder must acquire the Section 1202 stock in an original issue in exchange for: money, or other property, or as compensation. Thus, a shareholder who acquires stock in a corporation via the purchase from an existing shareholder's shares will not be treated as holding QSBS stock.**

Tax Planning with S Corporations

2. Section 1202 – Qualified Small Business Stock (QSBS) *(Continued)*

Section 1202 Planning

- **Assuming business is type of business eligible for Section 1202, but is operated as an S Corporation or Partnership, what can the business do to take advantage of Section 1202?**
  - **If an S Corporation,** consider dropping the business into a Subsidiary Corporation. Should be non-taxable under Section 351. Let business operate as a C Corporation (not as a QSub).
  - **If a Partnership,** also consider dropping business into a Corporation. Should be non-taxable under Section 351. Business will operate as a C Corporation.
- **Section 1202 relief passes through to owners of S Corporation/Partnership. See Section 1202(g).**
- **Need to value business at time of dropping it into Corporation. Only appreciation after dropping into Corporation is entitled to Section 1202 tax benefit. Also, five year holding period begins once stock issued.**

Tax Planning with S Corporations

3. S Corporations and ESOPs

Possible Advantages with an ESOP

- **Tax advantages to Seller and then post-transaction benefits as an ESOP.**
- Productivity and profitability can improve with ESOP-owned companies. They now own part of the Company.
- Gives employees another retirement plan, and some “skin in the game.”
- **ESOP creates a market for stockholder’s investment that may otherwise be limited or not available at all.**
- Shares the wealth built up in the Company, and keeps the business local.

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

Possible Disadvantages with an ESOP

- Complexity, regulation, and risk – ESOPs require specialists who can address complexities of accounting issues, legal, and ERISA issues. Class-action lawsuits are possible where companies under-perform and ESOP participants are harmed.
- **"Repurchase Obligation"** results in a continuous funding requirement.
- Perception of lower price for an **ESOP *vs.* a 3rd Party Sale.**
- **Annual appraisal required.** True arms-length valuation needed. Risk if value is too high, or if it is too low.
- Ongoing costs to maintain ESOP.
- ESOP is not always a "magic bullet" to create a culture or to solve leadership shortfalls.

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

Other ESOP Considerations

- Stockholder gives up ownership as a Seller and may now be a banker and continue to have similar, if not more, risk.
- Tax laws for ESOPs are likely safe for now – generally a popular strategy politically (bi-partisan support).
- **Upon retirement/termination, ESOP participant typically has ESOP stock redeemed and pays ordinary income tax on proceeds – not capital gains.**
- If ESOP permits employee to receive stock, then could have some capital gains by participants. "NUA" – "Net Unrealized Appreciation" needs to be determined by ESOP for the retiring participant.
- Outside investors sometimes back off in doing deals with Companies owned by ESOPs.

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

S Corporation with ESOP as Shareholder.

- Sale of stock will generate taxable gain to Seller.
- As S Corporation Shareholder/Seller should have accumulated some basis to reduce gain from stock sale.
- **ESOP will be allocated proportionate share of profits of S Corporation, but not be taxed on this income.** It is a non-profit S Corporation shareholder. Special exception for ESOPs. No UBTI.
- Distributions paid will be allocated pro-rata to owners of S Corporation, including the ESOP. ESOP can use distributed funds to pay off any debt, or to allocate to participants.

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

- **S Corporation differ from C Corporation with ESOPs**
- **ESOPs and Section 1042 Rollover for C Corporations:**
  - ➢ Advantageous to Seller – can reinvest sale proceeds in "Qualified Replacement Securities" under Section 1042. No current tax on gain. Possible indefinite deferral.
  - ➢ **ESOP must own ≥ 30% of Company stock immediately after sale transaction** to qualify for rollover under §1042.
  - ➢ Seller must have held stock for 3 years minimum for §1042 eligibility.
  - ➢ C Corporation owned by ESOP (fully or partially) continues to pay income tax as before.
  - ➢ **C Corporation dividends** are deductible under **§404(k)** if paid to ESOP as shareholder, and then used by ESOP: **(1)** to pay down ESOP loan; **or (2)** to pay out to ESOP employee/participants.

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

Section 1042 Changes with S Corporations and ESOPs.

- Changes made in **SECURE 2.0** in December 2022.
- Deferral of tax for certain sales of employer stock to employee stock ownership plan (ESOP) sponsored by S Corporation. *(Act §114 of SECURE 2.0).*
- New law expands Section 1042 gain deferral provisions with a **10% limit on the deferral** to sales of employer stock to S Corporation ESOPs.
- Effective for **sales made after December 31, 2027.**

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

Possible ESOP Strategy.

- **Strategy to consider is to form the ESOP when operating as a C Corporation so shareholders can take advantage of Section 1042 (again with at least 30% ESOP ownership in Corporation), and then perhaps later elect to convert to S Corporation status:**
  - ➢ Owner/Seller gets the benefit of selling the stock and deferring/avoiding capital gains tax (under Section 1042).
  - ➢ S Corporation allows for some or all profits from the Company to avoid tax to the extent of ESOP ownership. No tax on income generated by the Company. **S Corporation pays no tax, and then ESOP pays no tax on its allocated share of income from S Corporation.**
  - ➢ Importance of modeling out certain ESOP scenarios.

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

ESOP Triggering Section 267 Application. *Petersen Case.*

- *Petersen* involved an S Corporation on the accrual basis and had an employee stock ownership plan (ESOP) whose covered employees were on the cash basis.
- **The court held that non-owner employees were related parties under Section 267(c) through the trust beneficiary rules, even though they had no direct ownership. The result was a postponed entity deduction of $1 million in salary, as well as $500,000 in vacation pay and bonus.**
- It was appealed to the Tenth Circuit, which affirmed the Tax Court's decision.
- *Petersen v. Commissioner, 148 T.C. 463 (2017), aff'g No. 17-9003 (10th Cir. 2019).*

Tax Planning with S Corporations

3. S Corporations and ESOPs *(Continued)*

ESOP and Section 1042 and Installment Sale. *Berman Case.*

- ESOP Sale under Section 1042 and Installment Sale Applies to Recapture Gain on Stock Sale.
- *Edward L. Berman, et al vs. Commissioner Case; No. 202-13; No. 388-13; 163 T.C. No. 1.*
- *Berman's case* decided by Tax Court on July 15, 2024.
- Tax Court held two cousins made valid elections under Section 1042 (ESOP Rollover) to defer the gain recognized on their sale of stock to an ESOPS.
- **But the sale of "qualified replacement property" the following year triggered recapture of the gain, which the Tax Court held should be determined under the Installment Method (§453).**

Outline of Presentation

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II. <u>Rev. Proc. 2022-19 and Other Administrative Relief</u>

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Rev. Proc. 2022-19, 2022-41 I.R.B. 282

1. Purpose

- To allow for the resolution of frequently encountered issues without needing a PLR.
- Applicable to issues "the IRS historically has identified as not affecting the validity or continuation of a corporation's election" – either an S election or a QSub election – or for which the IRS has historically granted termination relief.

Rev. Proc. 2022-19 (cont'd)

2. Six areas for which issues are resolvable without a PLR:

- One class of stock requirement and governing provisions, including "principal purpose conditions"
- Disproportionate distributions
- Certain inadvertent errors or omissions on Form 2553 or Form 8869
- Missing administrative acceptance letter for S election or QSub election
- A federal income tax return filing inconsistent with an S election or a QSub election
- Non-identical governing provisions

Rev. Proc. 2022-19, Secs. 2.03(1), 3.01 – One class of stock requirement and governing provisions, including "principal purpose conditions"

1. Background

- A corporation with more than one class of stock is not a "small business corporation."
- A corporation is treated as having just one class of stock "if all *outstanding* shares of stock confer identical rights to distribution and liquidation proceeds." Treas. Reg. s. 1.1361-1(l)(1); *see* PLR 9530026 (multiple classes of stock authorized, but not outstanding, did not prevent corporation from being a "small business corporation").
- Whether all outstanding shares "confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions)."

Rev. Proc. 2022-19, Secs. 2.03(1), 3.01 – One class of stock requirement and governing provisions, including “principal purpose conditions” (cont’d)

2. **Various arrangements are not considered to create a second class of stock unless a principal purpose of the arrangement was to circumvent the single class of stock requirement**
   - Commercial contractual agreements, e.g., lease, employment agreement, loan agreement, etc. (Treas. Reg. s. 1.1361-1(l)(2)(i))
   - Buy-sell agreements, redemption agreements and stock transfer restriction agreements (Treas. Reg. s. 1.1361-1(l)(2)(iii)(A))
   - Certain instruments, obligations, or arrangements treated as equity under general principles of federal tax law (Treas. Reg. s. 1.1361-1(l)(4)(ii)(A))
   - Short-term unwritten advances not within straight-debt safe harbor (Treas. Reg. s. 1.1361-1(l)(4)(ii)(B)(1))
   - Obligations of the same class that are considered equity (Treas. Reg. s. 1.1361-1(l)(4)(ii)(B)(2))
3. **Corrective procedure**
   - IRS will not treat the arrangements above as violating the single class of stock requirement unless a principal purpose of the arrangement was to circumvent the single class of stock requirement.
   - The IRS will not rule as to whether there was a principal purpose to circumvent the single class of stock requirement since such a determination is inherently factual in nature.

Rev. Proc. 2022-19, Secs. 2.03(2), 3.02 – Disproportionate Distributions

1. **Disproportionate distributions**
   - Again, no second class of stock so long as the governing provisions provide for identical rights to distribution and liquidation proceeds.
   - A “disproportionate distribution” is “any distribution (including an actual distribution, a constructive distribution, or a deemed distribution) of property by a corporation with respect to shares of its stock that differs in timing or amount from the distribution with respect to any other shares of its stock.” Rev. Proc. 2022-19, Sec. 2.03(2); Treas. Reg. s. 1.1361-1(l)(1)-(2).
   - Any disproportionate distributions “are to be given appropriate tax effect in accordance with the facts and circumstances.” Treas. Reg. s. 1.1361-1(l)(2)(i).
2. **Corrective procedure**
   - “[T]he IRS will not treat any disproportionate distributions made by a corporation as violating the one class of stock requirement . . . so long as the governing provisions of the corporation provide for identical distribution and liquidation rights.”
   - Taxpayers do not need to seek relief from the IRS, and the IRS will not grant relief if a PLR request is made for these situations.

Rev. Proc. 2022-19, Secs. 2.03(3), 3.03 – Certain inadvertent errors or omissions on Form 2553 or Form 8869

1. Inadvertent errors or omissions

- "An inadvertent error or omission on Form 2553 or Form 8869 does not invalidate an S election or a QSub election, ***unless the error or omission is with respect to a shareholder consent, a selection of a permitted year . . . , or an officer's signature***." Rev. Proc. 2022-19, Sec. 2.03(3) (citing IRC s. 1362(a)(2), Treas. Reg. s. 1.1378-1, and Treas. Reg. s. 1.1361-3(a)(2)).
- How far can this be taken? What if missing corporation's name, TIN, address, or other information required to be included in the S election?

Rev. Proc. 2022-19, Secs. 2.03(3), 3.03 – Certain inadvertent errors or omissions on Form 2553 or Form 8869 (cont'd)

2. Corrective procedures for missing shareholder consents discussed later

- Rev. Proc. 2013-30 – Late-filed return relief (3 years and 75 days from requested eff. date)
- Rev. Proc. 2004-35 – Missing spousal consents w/r/t community property interest in stock
- Treas. Reg. s. 1.1362-6(b)(3)(iii) – Extended period of time to file missing shareholder consent
- PLR if above methods are unavailable

3. Corrective procedures for error with regard to a permitted year

- If a Form 2553 contains an inadvertent error with regard to a permitted year, then
  - Rev. Proc. 2013-30 – Late-filed return relief (3 years and 75 days from requested eff. date)
  - PLR if above method is unavailable

4. Corrective procedures for missing officer's signature

- If a Form 2553 or Form 8869 is missing the signature of an authorized officer of the S corporation that affects the validity of the S election or QSub election, then
  - Rev. Proc. 2013-30 – Late-filed return relief (3 years and 75 days from requested eff. date)
  - PLR if above method is unavailable

Rev. Proc. 2022-19, Secs. 2.03(3), 3.03 – Certain inadvertent errors or omissions on Form 2553 or Form 8869 (cont'd)

5. Corrective procedure for other inadvertent errors or omissions

- Any errors or omissions on Form 2553 or Form 8869 (other than those described in (2)-(4) above) can be corrected "by explaining in writing the error(s) or omission(s) and the necessary correction(s) and submitting the written explanation to one of the following addresses (depending on the Internal Revenue Submission Processing Center with which the S corporation files its Form 1120-S) or any successor address the IRS may provide":
  - Internal Revenue Service, MS 6055, 333 W. Pershing Rd., Kansas City, MO 64108
  - Internal Revenue Service, MS 6273, 1973 N. Rulon White Blvd., Ogden, UT 84404

Rev. Proc. 2022-19, Secs. 2.03(4), 3.04 – Missing administrative acceptance letter for S Election or QSub Election

1. IRS correspondence in response to an S election or QSub election

- Following filing of Form 2553, IRS mails a CP261 Notice as an acknowledgment that the S election was accepted.
- Following filing of Form 8869, IRS mails a CP279 Notice to the parent corporation and a CP279A Notice to the subsidiary.
- "[S]uch notices are merely administrative acknowledgments of an effective election that can be reproduced upon the taxpayer's request."

2. Corrective procedure

- Replacement letters may be requested (i) by S corporation or S corporation shareholder, via the Business and Specialty Tax line at 800-829-4933 or (ii) by practitioners, via the IRS Practitioner Priority Service line at 866-860-4259.
- Since a missing administrative acceptance letter does not impact an S election or QSub election, the IRS will not issue a PLR with regard to a missing acceptance letter.
- ABA Tax Section has recently provided comments to the IRS asking the Commissioner to also provide S corporations, shareholders, and practitioners with the ability to ask for administrative acceptance letters for QSST or ESBT elections similar to the above.

Rev. Proc. 2022-19, Secs. 2.03(5), 3.05 – Procedures for addressing a federal income tax return filing inconsistent with an S election or a QSub election

1. **Filing inconsistent returns**
   - S corporation files a Form 1065
   - QSub files a Form 1120
   - "Although an inconsistent Federal income tax return filing can create several complications for the filer, nothing in the Code or Income Tax Regulations thereunder provides that such a filing affects the validity of a corporation's S election or QSub election."
2. **Corrective procedure**
   - An S corporation that filed inconsistent returns must "file a Federal income tax return for open taxable years consistent with its status, as appropriate (a) to reflect the status of the corporation as an S corporation or parent of a QSub; or (b) to reflect the status of the subsidiary as a QSub."
   - Distributions and other transactions will be treated consistently with status as S corporation or Qsub.
   - IRS will not rule with regard to an inconsistent filing since it does not impact the validity of the S election or QSub election.

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions

1. **Non-identical governing provisions**
   - An S corporation must have a single class of stock, which is determined by reference the rights to distributions and liquidation proceeds inherent in the outstanding shares of stock, assuming no instrument or obligation or other arrangement is treated as a second class of stock.
   - Whether all outstanding shares "confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions)." Treas. Reg. s. 1.1361-1(l)(2)(i).
   - An S corporation in compliance with these rules is viewed as having "identical governing provisions." Rev. Proc. 2022-19, Sec. 2.03(6)(a). A "non-identical governing provision" means a governing provision that results in the S corporation being treated as having more than one class of stock. *Id.*
   - Generally, if the S corporation had a non-identical governing provision at the time it filed its S election, the entity did not meet the requirements to be an S corporation and the attempted election is invalid. If the non-identical governing provision arises after a valid S election is made, then the entity's S election automatically terminates on the day the disqualifying event occurs.

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

2. Corrective procedure

- If the corporation completes a "Corporate Governing Provision Statement" and a "Shareholder Statement" as described below, an "S election that is invalid or terminated *solely as the result of one or more non-identical governing provisions* will be treated . . . as continuing from the date on which the first non-identical governing provision that invalidated or terminated the corporation's S election was adopted."

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

3. Eligibility for Corrective Relief

- Corporation has or had one or more non-identical governing provisions
- The corporation has not made (or been deemed to have made) a disproportionate distribution to an applicable shareholder
- The corporation *timely* filed S corporation tax returns during the period it had a non-identical governing provision AND
- Corrective procedure complied with prior to discovery of the non-identical governing provision by the IRS.

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

3. Eligibility for Corrective Relief (cont'd)

- Situation #1 (Disproportionate Distributions) → LLC previously taxed as partnership makes an S election effective 1/1/2024. The operating agreement of the LLC is not amended to update the "boilerplate" partnership tax provisions such that the LLC is considered to have non-identical governing provisions and a second class of stock. Around April of 2024, the LLC pays out a disproportionate distribution to enable the LLC's members to pay taxes on their distributive share of partnership income for 2023 taxes.
- Situation #2 (Late-filed Return) → LLC previously taxed as partnership makes an S election effective 1/1/2022. The operating agreement of the LLC is not amended to update the "boilerplate" partnership tax provisions such that the LLC is considered to have non-identical governing provisions and a second class of stock. The LLC files its Form 1120-S for its 2022 tax year on January 1, 2024.
- ABA Tax Section recently provided comments suggesting that an S corporation should still be eligible for relief in Situation #1 so long as the disproportionate distributions were not made pursuant to the non-identical governing provisions and should still be eligible for relief in Situation #2 so long as the entity has consistently filed as an S corporation, regardless of whether the returns were timely filed.

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

4. Corporate Governing Provision Statement [Sample in Appendix A to Rev. Proc.]

- Must state at the top "CORPORATE GOVERNING PROVISION STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(ii)"
- Must include the following information:
  - (A) Date of the Corporate Governing Provision Statement and the corporation's name, EIN, address, date of formation or incorporation, and state of formation or incorporation;
  - (B) The actual or intended effective date of the Corporation's S election that is the subject of the request for corrective relief;
  - (C) The name, address, and SSN or TIN of each applicable shareholder (i.e., any current or former shareholder who owns or owned stock during the period the non-identical governing provision(s) were in effect);
  - (D) To establish an inadvertent termination or invalidation of the S election, "a description of all relevant facts regarding why each non-identical governing provision was adopted, how each non-identical governing provision was discovered, and each action taken to correct or remove each non-identical governing provision before any non-identical governing provision is discovered by the IRS. The description must include each action taken by the corporation and each applicable shareholder to establish that the corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery to demonstrate reasonable cause for relief."

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

4. Corporate Governing Provision Statement (cont'd)

- Must provide the following representations:
  - (1) The corporation's S election was inadvertently invalid or terminated *solely* because of the adoption of one or more non-identical governing provisions.
  - (2) The "corporation and each applicable shareholder satisfy all of the requirements set forth in section 3.06 of Rev. Proc. 2022-19."
  - (3) The corporation must represent that it responds in the negative to the statements listed in Section 7.01(4)-(5) of Rev. Proc. 2022-1 (or a successor Revenue Procedure), e.g., "whether the same or a similar issue was previously ruled on or whether a request involving the same or a similar issue was submitted or is currently pending." If the corporation cannot respond in the negative to any requested statement, then it must provide an explanation for each such non-negative response as "part of the description of all relevant facts required" in (D) on the previous slide.
  - (4) The corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery.

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

4. Corporate Governing Provision Statement (cont'd)

- Must provide the following statements:
  - (A) "The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is limited solely to each non-identical governing provision described in this Corporate Governing Provision Statement."; NOTE: The onus is on the taxpayer to describe each non-identical governing provision.
  - (B) "The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is based solely on the information, representations, and other statements provided by the corporation pursuant to section 3.06 of Rev. Proc. 2022-19, each of which is subject to verification during IRS examination."; and
  - (C) "During the period between the date on which the non-identical governing [provision] became effective and the date on which all of the procedures described in section 3.06 of Rev. Proc. 2022-19 are completed, each applicable shareholder has reported their income on all affected returns consistent with the S corporation election for the taxable year the non-identical governing provision became effective and for all subsequent years for which each applicable shareholder owned shares of the corporation."
- Signature
  - Must be signed under penalties of perjury by a person authorized to sign the corporation's Federal income tax return under section 6062 of the Code.
  - "Under penalties of perjury, I declare that I have examined this Corporate Governing Provision Statement for corrective relief for one or more non-identical governing provisions, as provided by Rev. Proc. 2022-19, section 3.06, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts, and such facts are true, correct, and complete."

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

5. Shareholder Statement [Sample in Appendix A to Rev. Proc.]

- Must state at the top "SHAREHOLDER STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(iii)"
- Must include the following information:
  - (A) The date of the Shareholder Statement and the corporation's name, EIN, address, date of formation or incorporation, and State of formation or incorporation;
  - (B) The name and address of each applicable shareholder;
  - (C) The SSN or TIN of each applicable shareholder;
  - (D) The number of shares of stock or, in the case of an LLC, percentage of ownership each applicable shareholder owns or owned and the date(s) the stock was acquired and, if applicable, transferred; and
  - (E) The date that each applicable shareholder provided their signature to the Shareholder Statement.

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

5. Shareholder Statement (cont'd)

- Statement of Consent
  - Under penalties of perjury, I declare that I consent to the election of (insert the Corporation's name), referred to herein as "the Corporation," located at (insert the Corporation's address), whose employment identification number (EIN) is (insert the Corporation's EIN), to be an S corporation under § 1362(a)(1). I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the request for corrective relief contains all the relevant facts, and such facts are true, correct, and complete. I understand that my consent is binding and may not be withdrawn after the Corporation receives relief pursuant to Rev. Proc. 2022-19, section 3.06. I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the Corporation's election to be an S corporation for the taxable year for which the election would have been in effect but for the non-identical governing provision(s) described in the Corporate Governing Provision Statement for corrective relief and for all subsequent years I have owned shares of the Corporation."
- Signature (under penalties of perjury)

Rev. Proc. 2022-19, Secs. 2.03(6), 3.06 – Non-identical governing provisions (cont'd)

6. Record Retention

- Corporation is required to retain the Corporate Governing Provision Statement, the Shareholder Statement(s), and the revised governing provisions for so long as the contents thereof may become material in the administration of any provision of the Code or the Treasury Regulations.

7. Alternative Relief – PLR

- If the corporation or any applicable shareholder does not qualify for the foregoing relief, then you can still submit a PLR.
- Must include an explanation regarding each reason why the requirements for corrective relief under Rev. Proc. 2022-19 could not be satisfied.

IRS No-Rule Areas

1. No principal purpose determinations

2. No comfort rulings

- Disproportionate distributions if the governing provisions confer identical rights to distribution and liquidation proceeds
- Missing administrative S election or QSub election acceptance letters
- Inconsistent return filings

3. No rulings where administrative relief provided for late elections or correction of non-identical governing provisions

4. The IRS will not issue a PLR with respect to whether an inadvertent error or omission, or a missing required consent or signature on Form 2553 or Form 8869 affects the validity of the S election or QSub election, EXCEPT

- (1) With regard to an inadvertent error relating to a "permitted year" under 1378(b) OR
- (2) For a missing shareholder consent or officer signature for which no other authority grants relief.

1362(f) Relief for Inadvertent Ineffective Elections or Terminations

1. **Requirements for 1362(f) Relief for Ineffective Elections or Terminations**
   - The Secretary determines that the circumstances causing the ineffective election or termination were inadvertent;
   - After discovery, steps were taken within a reasonable period of time to correct the circumstances; and
   - The corporation and each person who was a shareholder at any time during the relevant period agree to make such adjustments as may be required by the Secretary with respect to such period.
2. **How to Request Relief**
   - Submit a request for a PLR [Treas. Reg. s. 1.1362-4(c)]

Rev. Proc. 2013-30, 2013-36 I.R.B 173

1. **Overview**
   - Provides the "exclusive simplified methods" for taxpayers to make late S elections, ESBT elections, QSST elections, and QSub elections.
     - If an entity classification election was intended to take effect at the same time as the S election, this Revenue Procedure also grants relief for the late entity classification election.
     - Consolidated prior Revenue Procedures into one, modifying and superseding prior guidance, e.g. Rev. Proc. 97-48, 1997-2 C.B. 521; Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2004-49, 2004-2 C.B. 210; and Rev. Proc. 2007-62, 2007-2 C.B. 786.
   - Used in lieu of filing for relief via a PLR, so no user fee is applicable.

Rev. Proc. 2013-30 (cont'd)

2. General Requirements for Relief

- The entity intended to be classified as an S corporation, intended the trust to be an ESBT, intended the trust to be a QSST, or intended a subsidiary corporation to be a QSub as of the intended effective date.
- The entity requests relief within 3 years and 75 days after the intended effective date.
- The failure to qualify as an S corporation, ESBT, QSST, or QSub as of the intended effective date was solely because the relevant election was not timely filed.
- With respect to a late S election or QSub election, there was reasonable cause for the corporation's failure to timely make the election, and the corporation has acted diligently to correct the mistake upon its discovery.
- With respect to a late ESBT or QSST election, the failure was inadvertent and the person seeking relief acted diligently to correct the mistake upon its discovery.

Rev. Proc. 2013-30 (cont'd)

3. Additional Procedural Requirements for Relief

- Generally, just file the properly completed election form and attach supporting documentation with the IRS within 3 years and 75 days after the intended effective date.
- Supporting documentation must include reasonable cause / inadvertent error statement together with description of diligent actions taken to correct the mistake, which must be signed under penalties of perjury.
- Must state "FILED PURSUANT TO REV. PROC. 2013-30" at the top.

4. Late S election – Corrective Procedure

- Make sure 2553 filled out with respect to reasonable cause section (Part I, Line I).
- If also making a permitted late entity classification election, make sure pages 3-4 are included since Part IV contains required representations with respect to such late election.
- Must be signed by all persons who were shareholders at any time on and after the intended effective date through the date of filing of the election.

Rev. Proc. 2013-30 (cont'd)

5. ESBT or QSST Elections – Corrective Procedure

- Appropriate election must be filed and include:
  - A statement from ESBT trustee or QSST beneficiary containing information required under regulations.
  - For a QSST, a statement from the trustee that the trust satisfies all QSST requirements and that the income distribution requirements have been and will continue to be met.
  - For an ESBT, a statement from the trustee that all potential current beneficiaries are eligible S shareholders and that the trust is otherwise eligible to be an ESBT.
  - Statements from all shareholders that they reported income consistent with the S election on all affected returns.

6. Late QSub Election – Corrective Procedure

- Make sure 8869 includes as an attachment a reasonable cause statement signed by corporate officer under penalties of perjury.
- Must also include statement that the subsidiary corporation satisfied the requirements to be a QSub and was treated as a QSub on all affected tax returns.

Rev. Proc. 2004-35, 2004-23 I.R.B 1029

1. Grants automatic relief to otherwise invalid S election where spousal consent missing in community property state.

2. Eligibility

- S election is invalid "solely" because the 2553 failed to include the signature of a community property spouse who was a shareholder solely pursuant to state community property law; and
- Both spouses have reported all items consistent with the S election on all affected returns.

3. Corrective Procedure

- File a statement with the IRS at the service center where the corporation files its tax return.
- Must provide that statement is being furnished pursuant to Rev. Proc. 2004-35 for a late filing of shareholder consents for community property spouses of S corporation shareholders in community property states.
- Statement must include information with respect to the corporation (name, EIN, address, date/state of incorporation, intended effective date) and with respect to the spouses (names, SSNs, tax year end, # of shares owned at the date of the intended election).
- Statement must also provide that the spouses reported all items consistent with the S election.
- Signed under penalties of perjury by each community property spouse.

Treas. Reg. s. 1.1362-6(b)(3)(iii)

1. Extension of time for filing missing shareholder consents to an S election

- An election that is timely filed and would be valid but for missing shareholder consent(s) is not invalid if it is shown to the satisfaction of the IRS that (1) there was reasonable cause for the failure to file the consent, (2) the request for the extension of time to file a consent is made within a reasonable time under the circumstances, and (3) the interest of the Government will not be jeopardized by treating the election as valid.
- Consents must be filed within the extended time granted by all persons who were shareholders on the date of the election through the date the extension is granted and who had not previously consented.

2. Corrective Procedure

- No specified form or format for the request.
- See RIA Checkpoint Catalyst, Sec. 252:187, *Late and Inadvertently-Invalid S Elections*, for a document assembly link that will prepare a draft letter for the request.
- Letter should be mailed to the IRS Service Center with which the S corporation files its tax returns.

Treas. Reg. s. 1.1362-6(b)(3)(iii) (cont'd)

3. Benefits

- Can fix some issues without needing to fully comply with Rev. Proc. 2013-30. So, if there are problem shareholders who would not readily consent again, then this might be useful to prevent you from having to get everyone's signature again.
  - *See* Rev. Rul. 92-82, 1992-2 C.B. 238 (ruling that executor appointed on April 1 could consent on behalf of shareholder who died on March 1 where S election timely filed on March 15, provided that an extension of time request was made).
  - PLR 201714018 (suggesting that certain defective consents could be perfected by following the procedure outlined in Treas. Reg. s. 1.1362-(b)(3)(iii)).
- No user fee is required.

Outline of Presentation

I. Tax Planning with S Corporations

II. Rev. Proc. 2022-19 and Other Administrative Relief

III. <u>M&A Issues with S Corporations</u>

IV. Recent Cases

M&A Issues with S Corporations

1. "F Reorganization" Structure with Sale of an S Corporation

- Common format now for structuring the sale of an S Corporation. Seller generally receives capital gains treatment on sale; and buyer obtains a step-up in basis to purchase price.
- **Treated as an asset sale, not a stock sale.**
- F Reorganization route is often the preferred structure by private equity firms in their acquisition of an S Corporation.
  1. Allows for sellers to "rollover" or transfer some of their equity into the acquiring company (buyer).
  2. Protects the acquiring company if the seller has experienced issues or trouble with its S Corporation election in the past. Any S Corp election issues of the seller present problems if attempting to carry out a §338(h)(10) election or a §336(e) election.

“F Reorganization” Structure with Sale of an S Corporation *(Continued).*

- **Steps in Transaction:**
  1. **Sellers of S Corporation Target form a Holding Company (Holding Co) by contributing shares of S Corporation Target to Holding Co. Non-taxable transfer (Section 351).**
  2. **Target** makes a **“Qualified Subsidiary” (“Q-Sub”) election** immediately after transfer. Form 8869.
  3. The Q-Sub election by the Target extends the S Corporation status of Target to Holding Co. See also ***Rev Rul 2008-18*** and ***Rev Rul 64-250.***
  4. **Holding Co does not need to make an S Corporation election** on Form 2553. See IRS Instructions for **Form 8869, Line 14.**

     Line 14 (IRS Instructions). This box should be checked “Yes” if this election is being made pursuant to a reorganization under Section 368(a)(1)(F) and Rev. Rul. 2008-18. This occurs when a newly formed parent holding company holds the stock of the subsidiary that was an S Corporation immediately before the transaction and the transaction otherwise qualifies as a reorganization under Section 368(a)(1)(F). No Form 2553, Election by a Small Business Corporation, is required to be filed by the parent. See Rev. Rul. 2008-18 for details.

“F Reorganization” Structure with Sale of an S Corporation *(Continued).*

- **Steps in Transaction:**
  5. Q-Sub (Target) is a disregarded entity (DRE) upon the Q-Sub election. **The Target often then executes a state law conversion from a corporation (a QSUB) to an LLC. This is a non-taxable event.** For tax purposes, the Target is a disregarded entity before and after the conversion to a single member LLC.
  6. **Buyer then acquires LLC units from Holding Co.** This purchase could be 100%, or a lesser amount if the seller rolls over some equity (this is the actual sale transaction step in the process). Seller generally receives capital gain from the sale, and buyer obtains a step-up in basis to the amounts paid.

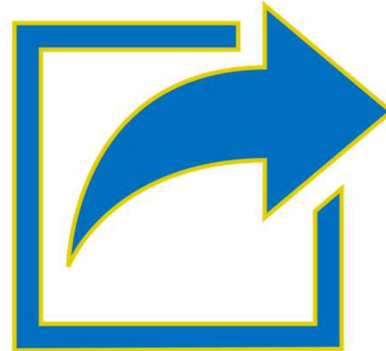
- **Compare F Reorganization structure for sale of an S Corporation to a Section 338(h)(10) election and a Section 336(e) election.**

M&A Issues with S Corporations

2. Section 338(h)(10) Election vs. Section 336(e) Election

- **Target must be a corporation.** With a Section 338(h)(10) election, the corporation is limited to three types of corporations:
  1. A subsidiary of the affiliated group filing a consolidated tax return with ≥ 80% ownership;
  2. A subsidiary owned ≥ 80% but has not made an election to be part of on affiliated group; **and**
  3. **An S Corporation.**

- **A Target with a Section 336(e) election must also be a corporation.** In this case, it would be an S Corporation or a subsidiary corporation.



2. Section 338(h)(10) Election *vs.* Section 336(e) Election *(Continued)*

- **Section 338(h)(10) Election -** involves a **"qualified stock purchase" ("QSP"). This QSP requires that in a transaction - or a series of transactions that occur during a 12-month period, P must acquire 80% of the voting power and value of all classes of T stock.** These stock transactions must be taxable transactions.

- **A §338(h)(10) election involves a stock sale that is treated as an asset sale for tax purposes.** It is considered generally if: **(1)** S Corporation owns certain contracts, licenses, permits, or other legal titles that are unable to be transferred (or would be very difficult legally to transfer); **(2)** there are strict debt covenants that limit such sales; and/or **(3)** an actual asset sale would result in burdensome retitling of property or other state and local transfer taxes/fees.

- **Acquirer (Buying Company) must be a Corporation** for Section 338(h)(10) election.

2. Section 338(h)(10) Election *vs.* Section 336(e) Election *(Continued)*

- **Section 338(h)(10) Election**

- Ability to use Section 338(h)(10) election with the sale of an S Corporation is allowed in the regulations under Section 338(h)(10); it is not spelled out specifically in the statute.
- If election is made, the sale of stock is disregarded for tax purposes. What is recognized is - the sale of assets and the deemed taxable liquidation of the corporation. Tax consequences of §338(h)(10) election is the same as if the S Corporation had sold all its assets and then liquidated.
- BIG Tax under §1374 could apply with a §338(h)(10) election. Be careful.
- **All S Corporation shareholders must consent to the Section 338(h)(10) election even if they do not sell their stock. Acquirer (purchasing corporation) also consents.**
- **File Form 8023.**

2. Section 338(h)(10) Election *vs.* Section 336(e) Election *(Continued)*

- Determination to make a Section 336(e) election is similar to making a Section 338(h)(10) election. Similar tax results. **Buyer, however, does not need to be a corporation under §336(e).**

- **Section 336(e) Election -** involves a **"qualified stock disposition."** A Section 336(e) election can be made if one or more shareholders of an S Corporation dispose of at least 80 percent of the stock of the S Corporation in one or more fully taxable transactions within a 12-month period; the identities of the acquirer (or acquirers) are irrelevant in determining if the election can be made.

- **Focus is on the disposition of stock.** Thus, if sellers meet 80% threshold, they could perhaps seek a higher price from acquirer from sale, as acquirer would be entitled to a FMV step-up if seller makes the Section 336(e) election.

- **See format for making Section 336(e) election in regulations. No particular IRS form for making a Section 336(d) election. Only Selling shareholders of S Corporation need to sign, but should make buyer aware of the election.**

- **If a transaction qualifies as both a Section 338(h)(10) election and a Section 336(e) election, it is treated as a Section 338(h)(10) election.** Consider a "protective Section 336(e) election" in these situations.

M&A Issues with S Corporations

3. Section 1374 Built-in Gains (BIG) Tax Issues

- **BIG tax applies for any net recognized built-in gains generated in the five-year period beginning with first day S Corporation election is effective. §1374(d)(2) and §1374(d)(7).**
- **Section 1374(d)(3) provides: "recognized built-in gain" means any gain recognized during the recognition period on the disposition of any asset except to the extent that the S Corporation establishes that—**
  - **A. such asset was not held** by the S Corporation as of the beginning of the 1st taxable year for which it was an S Corporation, **or**
  - **B. such gain exceeds the excess** (if any) of—
    - **i. the fair market value** of such asset as of the beginning of such 1st taxable year, over
    - **ii. the adjusted basis** of the asset as of such time.

M&A Issues with S Corporations

3. Section 1374 Built-in Gains (BIG) Tax Issues *(continued)*

- **Section 1374(d)(4) provides: "recognized built-in loss"** means any loss recognized during the recognition period on the disposition of any asset **to the extent that the S Corporation establishes that**—
  - **A. such asset** was held by the S Corporation as of the beginning of the 1st taxable year referred to in paragraph (3), **and**
  - **B. such loss does not exceed** the excess of—
    - **i. the adjusted basis** of such asset as of the beginning of such 1st taxable year, over
    - **ii. the fair market value** of such asset as of such time.
- Both definitions for recognized built-in gains and losses impose burden on taxpayer to document assets held (or not held) and value/basis of these assets as of date of S Corporation election.
- Not always certain what assets may be disposed over during five year-period after S Corporation election made (and ten-year BIG tax recognition period for Wisconsin and other states). Thus, critical for company to document the values, amounts, tax basis at the time of its S Corporation election. **Recommend obtaining an appraisal of S Corporation assets on date S Corporation election is first effective.**

M&A Issues with S Corporations

3. Section 1374 Built-in Gains (BIG) Tax Issues *(Continued)*

- **Accounts Receivables (A/R)** for a cash basis taxpayer can trigger a recognized built-in gain as these are collected in the first S Corporation year.
- See Section 1374(d)(5) for built-in items for BIG tax purposes, which covers built-in items of **income [§1374(d)(5)(A)]** and **deduction [§1374(d)(5)(B)]**.
- A cash basis taxpayer making an S Corporation election should look to offset or reduce it recognized built-in gain by paying out accrued compensation in its first S Corp year. Several factors to address in determining whether there is a built-in deduction with compensation payments.
- This Section 1374 addressed in **PLR 200925005** released by the IRS on June 19, 2009. Compensation needs to be fixed; reasonably determined, and economic performance (payment) made in a timely manner. Look closely at ***Reg. §1.1374-(4)(c)(1).***

M&A Issues with S Corporations

3. Section 1374 Built-in Gains (BIG) Tax Issues *(Continued)*

- **Reg. § 1.1374-4(c)(1)** provides that any payment to a related party properly deducted in the recognition period under **Section 267(a)(2)** will be deductible as recognized built-in loss only if:
  - **i.** **all events have occurred** that establish the fact of the liability to pay the amount, and the exact amount of **the liability can be determined**, as of the beginning of the recognition period; **and**
  - **ii.** **the amount is paid: (A) within the first two and one-half months** of the recognition period; or **(B)** to a related party owning **less than five percent**, by voting power and value, of the corporation's stock, **both as of the beginning of the recognition period and when the amount is paid.**
- **Reg. § 1.1374-4(c)(2)** provides that any amount properly deducted in the recognition period under **Section 404(a)(5)** will be deductible as recognized built-in loss to the extent:
  - **i.** **all events** have occurred that establish the fact of the liability to pay the amount, and the exact amount of **the liability can be determined**, as of the beginning of the recognition period; **and**
  - ii. the amount is not paid to a related party to which Section 267(a)(2) applies.

Thus, if accrued amount owed to employee that is not a related party under §267, then built-in loss available when payment is made, but not required to be paid within 2½ months.

M&A Issues with S Corporations

3. Section 1374 Built-in Gains (BIG) Tax Issues *(Continued)*

- Final item with Section 1374 relates to fixed assets.
- If the seller has significant level of fixed assets, some with built-in gains tax exposure and some acquired once S Corporation election effective, then important to:
  1. Keep track of fixed assets with built-in gains tax exposure. Does company still have them? What was the amount of built-in gain at time of S Corp election? Can the built-in gain be supported?
  2. If the business is sold within the BIG tax recognition period, important to analyze purchase price allocation to fixed assets. Document amounts allocated between fixed assets subject to BIG tax, and fixed assets acquired after S Corp election filed. To the extent possible and supportable, allocate more towards fixed assets acquired after S Corp election effective and less to fixed assets with BIG tax exposure. Should not impact buyer, but could impact BIG tax incurred by the seller from sale of business.

M&A Issues with S Corporations

4. S Corporations with Installment Notes in Liquidation - §453B(h)

- **Section 453B(h) is a special provision only available to S Corporations.**
- It provides that if an S Corporation:
  1. **Adopts a plan of liquidation before the sale of its assets; and**
  2. **Completes the liquidating distributions within 12 months of the date the plan is adopted.**
- Then the distribution of the installment note is not treated as the S Corporation's disposition of the obligation.
- **Instead, the shareholder's receipt of payments on the installment obligation (but not the receipt of the installment obligation in liquidation) is treated as the receipt of payment for the stock.**
- **Adopt plan of liquidation before sale of assets.**
- Allocation of stock basis to distributed assets. Complicated provisions, so review regulations closely. Possible trap. Consider short-term note and not cash in liquidation.

M&A Issues with S Corporations

5. Liquidation Issue for Shareholders with a Corporation

- Review the tax treatment to the shareholder when a loss is recognized on the liquidation of a corporation. (Section 331).
- See ***IRS Revenue Ruling 68-368*** - and *Tax Adviser* article dated September 1, 2012, titled "Determining Tax Consequences of Corporate Liquidation to the Shareholders").
- It indicates that generally, the loss with excess basis is reported in the tax year when the final distributions occurs.
- **However, the Tax Adviser article and *Rev Rul 68-368* mention that if the final distribution is known, this can be accrued and reported in the year before the final distribution occurs.** Thus, since the corporation sold all of its assets and property in, say 2023, paid any related expenses, and distributed almost all of the cash in the corporation in 2023, then they might fall under this exception.
- The amount of the final modest distribution was known at 12/31/2023, and there were no asset or property sales to carry out in 2024. Corporation would accrue additional distribution and treat it distributed in 2023. This would permit the loss in liquidation to be reported in 2023, not 2024.
- **Could have significant tax benefit if an S Corporation involved and sold its assets at a large gain in Year 1, and then was facing a capital loss in liquidation in Year 2.**

Outline of Presentation

I. Tax Planning with S Corporations

II. Rev. Proc. 2022-19 and Other Administrative Relief

III. M&A Issues with S Corporations

IV. <u>Recent Cases</u>

Estate of Thomas H. Fry v. Comm'r, T.C. Memo. 2024-8 (Debt v. Equity)

1. Factual Background

- Taxpayer was the sole shareholder of two S corporations, Crown and CR Maintenance.
- CR Maintenance ceased being profitable around 2010 and lost $5-$7m per year thereafter.
- Beginning in 2010, Crown began providing financial support to CR Maintenance to permit it to continue operations. These transfers were bank-to-bank transfers directly to CR Maintenance from Crown and were not, in form, a distribution of cash followed by a contribution to CR Maintenance. Crown also made payments directly to CR Maintenance's vendors for certain expenses.
- These transfers totaled $36,255,141.

Estate of Thomas H. Fry v. Comm'r, T.C. Memo. 2024-8 (Debt v. Equity)

1. Factual Background (cont'd)

- CR Maintenance accounted for each of the transfers from Crown as a "loan payable."
- Crown accounted for the amounts it paid as a "due from" CR Maintenance.
- With respect to these transfers, there were no promissory notes put in place, there was no written due date for a return of the money, no security interest was requested by Crown or granted by CR Maintenance, and CR Maintenance did not make, or promise to make, interest payments related to the transfers. No interest deductions were taken or interest income included with respect to the transfers.
- The taxpayer claimed a loss deduction of $4.7M from CR Maintenance on his 2013 Form 1040.
- The IRS disallowed $3.5M of this loss asserting the taxpayer had insufficient stock basis to permit the loss.

Estate of Thomas H. Fry v. Comm'r, T.C. Memo. 2024-8 (Debt v. Equity)

2. Parties' Positions

- Taxpayer: took the position that under relevant caselaw, the transfers from Crown to CR Maintenance were not bona fide debt but were instead constructive equity distributions and contributions. If the transfers had been characterized as distributions/contributions, the taxpayer argued that he would have had sufficient stock basis to deduct the additional $3.5M of disallowed loss.
- IRS: argued that (i) 385(c) should require the taxpayer to treat the instrument as debt since CR Maintenance, the issuer, treated it as debt and (ii) other, nonstatutory doctrines should apply so that the taxpayer is held to the form chosen.

Estate of Thomas H. Fry v. Comm'r, T.C. Memo. 2024-8 (Debt v. Equity)

3. Resolution – 385(c)

- The Court held 385(c) to be inapplicable since there was no actual issuance of an instrument pertaining to these transfers, so there was no "issuer" with respect to the indebtedness and CR Maintenance was not held to the form selected on that basis.
- The Court also noted that this wasn't a situation where the policy underlying 385(c) was implicated. The policy underpinning 385(c), it said, was to prevent an issuer and a holder from taking contrary positions as to the characterization of an instrument as debt v. equity to prevent the issuer from taking an interest deduction (treating as debt) while the holder takes a dividends received deduction (treating as equity).
- In addition, the Court noted, in dicta, that 385(c) seemingly doesn't apply to S corporations in any event.

Estate of Thomas H. Fry v. Comm'r, T.C. Memo. 2024-8 (Debt v. Equity)

3. Resolution – Debt v. Equity Caselaw

- The Tax Court undertook a debt-vs-equity inquiry under relevant caselaw and determined that the transfers were not debt for tax purposes.
- In doing so, it looked at the 11 factors in *Hardman v. U.S.*, 827 F.2d 1409 (9th Cir. 1987), including the following: (i) the names given to the certificates evidencing the debt [held: neutral – no instrument], (ii) the presence or absence of a fixed maturity date [held: favors equity – no fixed date], (iii) the source of the payments [held: favors equity – repayment only on future profitability], (iv) the right to enforce payments of principal and interest [held: favors equity – no security interest or other steps taken to enforce], (v) whether the advances increase participation in management [held: neutral], (vi) whether the "lender" has a status equal or inferior to that of regular creditors [held: favors equity – viewed as subordinate to other creditors], (vii) objective indicators of the parties' interest [held: favors indebtedness – how accounted for, tax returns, K-1s supported view that loan was intended], (viii) whether the capital structure of the "borrower" is thin or adequate [held: neutral – suggestive that capitalization was thin, but no financial statements, so impossible to determine debt-to-equity ratio]; (ix) the extent to which the funds advanced are proportional to the shareholder's capital interest [held: favors equity – taxpayer owned both companies 100%, so interests were "significantly intertwined"]; (x) the extent to which interest payments come from "dividend" money [held: favors equity]; and (xi) the ability of the "borrower" to obtain loans from outside lending institutions [held: neutral – seemingly no other lender would have loaned money based on amount of losses, but insufficient evidence].

Estate of Thomas H. Fry v. Comm'r, T.C. Memo. 2024-8 (Debt v. Equity)

3. Resolution – Debt v. Equity Caselaw (cont'd)

- After applying these factors, the Court held that the transfers did not constitute true indebtedness and also held that the transfers should be treated as constructive distributions from Crown to the taxpayer and constructive contributions from the taxpayer to CR Maintenance.
- However, the Court had insufficient information to recalculate the taxpayer's bases in both CR Maintenance and Crown since the distributions would now reduce the taxpayer's basis in Crown, while increasing his basis in CR Maintenance.

Estate of Thomas H. Fry v. Comm'r, T.C. Memo. 2024-8 (Debt v. Equity)

4. Takeaways

- 385(c)(1) did not apply because (i) no "instrument" was issued and (ii) 385(c) had never been applied to S corporations. Decision at odds with IRS guidance that would apply 385(c)(1) even where a note is not formally issued.
- Even undocumented advances have to be analyzed under general debt-vs.-equity principles.
- Interesting how little weight the Court gave to the intent of the parties to treat as debt.
- Memorandum opinions generally involve application of settled legal principles, are "unpublished," and are not viewed as having as much weight as a reviewed opinion.

Maggard v. Comm'r, T.C. Memo. 2024-77 (Disproportionate Distributions)

1. Factual Background

- Taxpayer founded an engineering firm 50/50 with another co-founder. After his original co-founder left, he took on two friends as equityholders and transferred 40% to one of them and 20% to the other.
- The Company elected S status throughout the relevant years at issue.
- The Company's articles of incorporation and bylaws clearly indicated that only one class of stock was issued and outstanding, and, under California law, each share would be entitled to its pro rata share of distributions.

Maggard v. Comm'r, T.C. Memo. 2024-77 (Disproportionate Distributions)

1. Factual Background (cont'd)

- Shortly after taking shares in the Company, the new owners began looting the Company.
  - One of the 2 new owners started inflating reimbursements for his expense accounts.
  - The 2 new owners also began disproportionately distributing the earnings of the entity to themselves at the expense of the taxpayer.
  - The new owner who was put in charge of the entity's finances ceased filing tax returns and sending K-1s.
  - Eventually, the taxpayer accused the new owners of embezzling over $1m from the Company.
- After being accused of embezzlement (in 2012), the new owners froze the taxpayer out of the Company by cutting him off from the Company's books and leaving him out of meetings.
- The taxpayer submitted a whistleblower form to the Commissioner alleging that the Company had claimed false deductions, underreported income, failed to pay tax, and provided kickbacks to LL and WJ. He was told that these actions might have terminated the Company's S election such that it should have been treated as a C corporation during the years at issue.

Maggard v. Comm'r, T.C. Memo. 2024-77 (Disproportionate Distributions)

2. Parties' Positions

- Taxpayer: Because of the systematic, ongoing disproportionate distributions being made, the Company's S election should have terminated on account of having more than one class of stock, and the Company should have been classified as a C corporation during the years at issue. In that event, any income that would otherwise have passed through to the taxpayer should have been taxable at the entity level.
- IRS: The disproportionate distributions do not impact the Company's S status because the regulations focus on shareholder "rights" under the corporation's governing documents, not what the shareholders actually do.

Maggard v. Comm'r, T.C. Memo. 2024-77 (Disproportionate Distributions)

3. Resolution

- The Court applied the regulations finding that a corporation is treated as having only one class of stock so long as all "outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds." Treas. Reg. s. 1.1361-1(l)(1).
- Whether shares confer such identical rights depends on the terms in the corporation's "governing provisions," e.g., corporate charter, articles of incorporation, bylaws, etc.
- In this case, despite the unfortunate situation befalling the taxpayer, the shareholders' rights to distributions were identical, and the fact that distributions were not made pro rata in accordance with share ownership does not change the shareholders' entitlement to pro rata distributions.
- The facts did not show that there was any formal amendment to the Company's articles of incorporation or other governing provisions.

Maggard v. Comm'r, T.C. Memo. 2024-77 (Disproportionate Distributions)

4. Takeaways

- Disproportionate distributions do not, by themselves, terminate S status.
- Rather, some change is required to an entity's governing provisions, e.g., issuance of second class of stock, binding agreement as to distribution or liquidation proceeds, etc.

In re Vital Pharmaceutical, 655 B.R. 374 (S.D. Fl. 2023) (Ability to Revoke)

1. Factual Background

- The Company, classified as an S corporation for tax purposes, was a debtor in a chapter 11 bankruptcy case.
- After filing for bankruptcy, the Company's board was reconstituted to include a majority of directors independent from the sold shareholder and the shareholder was removed as an officer and director.
- In January 2023, the Company was sold for $370M, of which $362M was cash. After paying secured debt, there was only $11.6M to payoff unsecured creditors and no amount remaining for the sole shareholder.

In re Vital Pharmaceutical, 655 B.R. 374 (S.D. Fl. 2023) (Ability to Revoke)

2. Parties' Position

- Sole shareholder: sought a determination that the Company's S election was not property of the bankruptcy estate and that he could take action to terminate the Company's S election, which would shift income from him on account of the asset sale to the Company, which would be a C corporation if its S election terminated.
- Committee of Unsecured Creditors: Objected to sole shareholder's motion claiming that the S election was the property of the bankruptcy estate.
- Experts testified that if the S election was revoked, the Company would have two short tax years, one a short S year and the other a short C year. The default rule would be that income for the year would be divvied up based on the number of days covering the short S year as opposed to the short C year. If the S election were terminated, the sole shareholder would have a $3.4M tax liability, while if it were not, then the sole shareholder would have no tax liability while the Company would have a $27.5M tax liability.

In re Vital Pharmaceutical, 655 B.R. 374 (S.D. Fl. 2023) (Ability to Revoke)

3. Resolution

- The Court held that the S election was the property of the bankruptcy estate and that the sole shareholder could not violate an automatic stay and take steps to revoke the Company's S election.
- The Court also pointed out that the sole shareholder did not have the ability, in any event, to unilaterally terminate the Company's S election. In order to revoke an S election, the "corporation files a statement that the corporation revokes the election." Treas. Reg. s. 1.1362-6. This revocation then must be consented to by shareholders who, at the time of the revocation, hold more than one-half of the number of issued and outstanding shares of the corporation.
- Given this, the Company would be the one with the ability to revoke the S election, not the sole shareholder.

In re Vital Pharmaceutical, 655 B.R. 374 (S.D. Fl. 2023) (Ability to Revoke)

4. Takeaways

- Shareholders of financially distressed S corporations should understand that the S election is the property of the bankruptcy estate and that post-petition income/gains flow through to them.
- Some consideration should be made prior to filing a bankruptcy petition as to whether the S election should be terminated, but consider whether having the corporation revoke its S election would implicate fraudulent transfer laws. To avoid that issue, it may make sense to have the shareholder transfer stock to an ineligible shareholder since that would not, assuming no shareholders agreement prevents such transfer, require formal action on the part of the corporation.

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Designing Buy-Sell Agreements for Closely Held Businesses & Avoiding the New Connelly Trap

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Designing Buy-Sell Agreements for Closely Held Businesses and Avoiding the New *Connelly* Trap

WICPA 2024 Tax Conference

November 11, 2024

Randy S. Nelson

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JD, CPA

Randy is an attorney focusing his practice on estate planning, advising family businesses, tax planning, trust administration and probate. He is a Certified Public Accountant and was an Adjunct Professor at Marquette University Law School where he taught estate planning for over 30 years. He is a frequent speaker at continuing education courses for lawyers and CPAs on the subjects of estate planning and tax planning. He is the original author of the chapter "Estate Planning for Owners of Closely Held Businesses" in *Eckhardt's Workbook for Wisconsin Estate Planners* published by the State Bar of Wisconsin.

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Nature of Buy-Sell Agreements

Nature of Buy-Sell Agreements

- Agreement for the sale by one party and purchase by another of a business interest (stock, LLC membership interest, or partnership interest) upon the happening of a triggering event, such as death, disability or termination of employment

Nature of Buy-Sell Agreements

- Two basic types
  1. Stock redemption or entity purchase agreement – the corporation, LLC, or partnership is the buyer
  2. Cross purchase agreement – the other shareholder, LLC member, or partner is the buyer

Methods for Determining the Purchase Price

- Fair market value per outside appraisal
- Multiple of earnings formula (formula determined now)
- Fair market value balance sheet
  - Substitute FMV of each asset and liability for book value
  - Missing goodwill, if any
- Net book value with adjustments – e.g. real estate and equipment at appraised value
  - Missing goodwill, if any

Methods for Determining the Purchase Price

- Net book value (i.e., assets minus liabilities per balance sheet)
  - Lots of problems
- Specifically stated value, revised annually
  - **Problem** – parties often do not revise the value annually or are unable to agree on a revised value
  - **Solution** – provide a fail-safe so that if the value is not revised, there is an automatic adjustment (e.g. adjust for a multiple of earnings formula or appraised value)

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Methods for Determining the Purchase Price

- Solomon's choice
  - Where there is a deadlock between two co-owners
  - One co-owner sets the price and the other co-owner has a specified period in which to decide whether to be the buyer or the seller

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Methods for Determining the Purchase Price

- Option to liquidate
  - Gives the buyer option to liquidate the business rather than proceed with the purchase
  - Used where owners are concerned that the method selected for determining price could result in an artificially high amount
  - Use cautiously – could have very detrimental impact on the seller

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Common Payment Terms

- Certified or cashier's check at closing
- Purchase price fully funded with life insurance and/or disability buy-out insurance
- Purchase price partially funded with life insurance and/or disability buy-out insurance and balance payable by negotiable promissory note

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Common Payment Terms

- Negotiable promissory note at closing (possibly with a down payment)
  - Interest at minimum rate necessary to avoid imputed interest under the Internal Revenue Code (i.e., the applicable federal rate)
  - Interest at prime rate or prime plus a specified number of points
  - Fixed interest rate
  - Floating interest rate

Common Payment Terms

- Negotiable promissory note at closing (cont'd)
  - Amortization of interest and principal payments over a fixed period
  - Periodic payments of interest, with balloon payment of principal at end of term
  - Personal guaranty by remaining owners (guaranty may be in proportion to remaining ownership interests or may be joint and several)
  - Secured by collateral, such as the business interest purchased or other assets

Benefits of Buy-Sell Agreements

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Benefits of Buy-Sell Agreements

- Provide for orderly disposition of a closely held business interest upon occurrence of triggering event
    - Creates a ready market for the business interest and avoids a forced sale price
    - Sets the method for determining price and payment terms now vs. having to negotiate them after the triggering event occurs, for example, with surviving spouse of a deceased owner, with a disabled owner, or with a retiring owner
    - Assures continuity of management of the business by remaining business owners

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Benefits of Buy-Sell Agreements

- May fix the value of the closely held business interest for federal estate tax purposes if certain requirements are met
  - If accomplished, avoids delay and expense of a dispute with the IRS over the value of a hard to value asset
  - If accomplished, achieves consistency between amount the estate receives and amount which is subject to estate tax
  - But if IRC § 2703 applies and its requirements are not met, then the buy-sell agreement will be disregarded in valuing the closely held business interest for federal estate tax purposes

Fixing the Federal Estate Tax Value of the Closely Held Business Interest

Fixing the Federal Estate Tax Value

- Buy-sell agreement will fix federal estate tax value of the closely held business interest if all of the following requirements are met:
  - Ascertainable value – price must be determinable from agreement
  - Restrictions at death – estate of the business owner must be required to sell; buyer may be obligated to buy or have an option to buy
  - Lifetime restrictions – obligation to sell at the contract price must be binding during lifetime as well as upon death

Fixing the Federal Estate Tax Value

- Bona fide business arrangement –
  - Required before and by IRC § 2703
- "[N]ot a device to pass decedent's [interest] to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth" [Reg. § 20.2031-2(h)]
  - Required before and by IRC § 2703

Fixing the Federal Estate Tax Value

- Not a device and bona fide business arrangement requirements should be satisfied in a family business if:
  - There is a valid business purpose for the agreement (e.g. continuity of management where a child is in the business)
  - Contract price was reasonable when the agreement was signed
  - Agreement provides for a periodic review if a fixed price is used
  - Parties abide by the agreement

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Fixing the Federal Estate Tax Value

- Comparable to similar arrangements entered into at arm's length
  - Requirement added by IRC § 2703
  - If not satisfied, IRC § 2703 provides that buy-sell agreement is disregarded in valuing the business interest
  - Perhaps may only be satisfied by expert testimony
  - Likely to create great uncertainty as to whether a buy-sell agreement fixes the federal estate tax value of the business interest

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Fixing the Federal Estate Tax Value

- Important exceptions
  - IRC § 2703 does not apply to buy-sell agreements entered into before October 9, 1990, unless substantially modified after that date
    - Be careful in amending pre-October 9, 1990 buy-sell agreements
    - See Reg. § 25.2703-1(c) for examples of what is and is not a substantial modification

Fixing the Federal Estate Tax Value

- IRC § 2703 requirements are considered met if more than 50% by value of the business interests subject to buy-sell agreement are owned directly or indirectly by individuals who are not family members of the transferor's family (spouse, ancestor of transferor or transferor's spouse, spouse of any such ancestor, lineal descendants of parents of transferor or transferor's spouse, or the natural objects of transferor's bounty) [Reg. §§ 25.2701-2(b)(5)(i) and 25.2703-1(b)(3)]

Fixing the Federal Estate Tax Value

- The Tax Court in *Estate of Blount*, T.C. Memo 2004-116, the 11th Circuit in *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005), and the 8th Circuit in *Connelly*, 70 F.4th 412 (8th Cir. 2023) reaffirmed the need for the buy-sell agreement to meet the requirements of pre-IRC § 2703 law to fix the federal estate tax value even when IRC § 2703 applies and must also be met

Impact of Marital Property Act on Buy-Sell Agreements

Impact of Marital Property Act

- Determine the marital property classification of the business interest subject to buy-sell agreement to determine ownership as compared to title holding of the business interest
  - If the business interest is and remains non-marital, the Marital Property Act should have no impact
    - All business interests owned before the determination date are non-marital

Impact of Marital Property Act

- **CAUTION**: watch out for mixing marital property with the business interest which occurs:
  - If subsequent capital contributions are made with marital property
  - If the business interest substantially appreciates as a result of the undercompensated substantial efforts of the titled spouse [Wis. Stat. § 766.63(2)]
  - If debt relating to purchase of the business interest is paid with marital property
- If business interest is acquired after determination date with marital property, it is marital property

Impact of Marital Property Act

- Buy-sell agreements entered into by the titled spouse having the right to management and control of the corporate stock, LLC interest, or partnership interest are binding on the non-titled spouse, even if the business interest is or becomes marital property and the non-titled spouse does not sign the agreement [Wis. Stat. § 766.51(9)]
  - Statute applies whether agreement was entered into before or after the determination date
  - If the triggering event occurs (e.g. death of the titled spouse) the buy-sell agreement will operate to purchase the entire business interest, including any marital property component of the non-titled spouse

Impact of Marital Property Act

- **Problem** – if the business interest is marital property and the non-titled spouse dies first, the buy-sell agreement may not be triggered because the terms of the agreement historically did not include the death of the non-titled spouse as a triggering event
  - Non-titled spouse could will their 1/2 of the marital property business interest to someone other than the titled spouse, either intentionally or inadvertently
  - **Solutions**
    - Amend the buy-sell agreement so it is triggered by the non-titled spouse's death (consent of the non-titled spouse is not needed – This is usually not satisfactory since the titled spouse will have a reduced interest in the business

Impact of Marital Property Act

- **Solutions**
  - By marital agreement
    - Classify the business interest as the titled spouse's individual property or terminable interest marital property; or
    - Have the non-titled spouse agree to will the marital property business interest to the titled spouse
    - Many practical difficulties in getting marital agreements, especially for all titled spouses and that is harder the more of them you have

Impact of Marital Property Act

- Amend the buy-sell agreement so that on a non-titled spouse's death, if the marital property business interest is not left to the titled spouse, then the titled spouse has a 1st option to purchase the business interest from the non-titled spouse's estate and the business entity or other owner(s) has a 2nd option to purchase

Impact of Marital Property Act

- **Solutions**
  - Exercise the statutory option to purchase under Wis. Stat. §§ 857.015 and 861.015
    - Applies only to corporate stock not publicly traded, an LLC interest, and a partnership interest in which the partner is a general partner
    - Election must be in writing, signed by the titled spouse, and notarized

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Impact of Marital Property Act

- Election must be executed within 90 days after the non-titled spouse's death
- Payment must be made in full within one year after the non-titled spouse's death
- Purchase price is the "clear market value" at the non-titled spouse's death plus the business income [under Wis. Stat. § 701.20(5)(b)l] from the date of death to the date of payment

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Impact of Marital Property Act

- Should the non-titled spouse sign the buy-sell agreement?
  - Arguments for "No"
    - Not necessary because the titled spouse has the right to management and control [Wis. Stat. § 766.51(9)]
    - Avoids having to explain the buy-sell agreement to the non-titled spouse
    - Avoids practical difficulties of getting signatures of all of the nontitled spouses

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Impact of Marital Property Act

- **CAUTION**: titled spouse must act in good faith when exercising management and control rights over the marital property business interest [Wis. Stat. § 766.15(l)]
  - Price for non-titled spouse's interest should be determined in same manner as price for titled spouse's interest
  - Payment terms and conditions for non-titled spouse's interest should be same as those for titled spouse's interest

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Impact of Marital Property Act

- Argument for "Yes"
  - Makes it harder for non-titled spouse or their estate to later argue breach of the good faith duty by titled spouse
    - But if non-titled spouse is not represented by independent counsel, how meaningful is their signature?
    - But if non-titled spouse believes the attorney is representing both spouses, how much exposure does the attorney have to a later malpractice claim by the non-titled spouse or their estate if they become unhappy with the buy-sell agreement?

Some Income Tax Considerations That Benefit a Cross Purchase Agreement

Income Tax Considerations

- After purchase under a cross purchase agreement, remaining business owners will have additional income tax basis in the business equal to the purchase price, but after purchase under a stock redemption agreement they will not
- For C corporation, cross purchase agreement avoids the attribution of ownership rules which may cause a corporate redemption under a stock redemption agreement to be treated as a dividend rather than a sale
- But for C corporations when life insurance is used to fund the purchase obligation on death see below for some income tax benefits of a redemption agreement

Special Considerations When the Buy-Sell Agreement Is Funded with Life Insurance

Funding the Purchase Obligation

- Life insurance is often a cost-effective way to have the funds to pay for all or part of the business interest which is required to be purchased on the titled spouse's death

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Marital Property Considerations

- Stock redemption or entity purchase agreement
  - The corporation is the owner, beneficiary, and premium payer of the insurance policy on the shareholder's life
  - Since no premiums are paid with marital property, there is no marital property component to the policy
  - The same reasoning should apply to LLC and partnership entity purchase agreements funded with life insurance owned by the LLC/partnership on the member's/partner's life

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Marital Property Considerations

- Cross purchase agreement
  - Each shareholder is the owner, beneficiary, and premium payer of the insurance policy on each other shareholder's life
  - If the other shareholder pays a premium with marital property, the policy has a marital property component belonging to the other shareholder and their spouse
  - **Problem 1** – if a shareholder's spouse dies first, the spouse could will their 1/2 of the marital property component of the policy to someone other than the shareholder, either intentionally or inadvertently

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Marital Property Considerations

- **Solutions to Problem 1:**
  - Have each shareholder's spouse sign § 766.61(3)(e) written consent relinquishing their ownership interest in the policy if they die before both the policyholder and the insured, may be difficult to get from all spouses
  - By marital agreement
    - Classify the policy as the shareholder's individual property or as terminable interest marital property, or
    - Have the spouse agree to will the marital property component of the policy to the shareholder
    - Many practical difficulties in getting marital agreements, especially for all shareholders and that is harder the more of them you have

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Marital Property Considerations

- **Problem 2** – on death of the insured shareholder, 1/2 of the marital property component of the policy belongs to the surviving shareholder's spouse and may not be available to fund the cross purchase agreement without the spouse's consent.

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Marital Property Considerations

- **Solutions to Problem 2:**
  - Provide in the cross purchase agreement that the policy proceeds must be used to purchase (may trigger Wis. Stat. § 766.61(4) and give creditor's rights in the policy proceeds to the seller which override the spouse's marital property rights)
  - Have each shareholder's spouse sign a declaration of gift or § 766.61(3)(e) written consent reclassifying the policy and proceeds as the individual property of the shareholder, may be difficult to get from all of the spouses
  - Have each shareholder and spouse sign a marital agreement agreeing to use the policy proceeds to satisfy the obligation under the cross purchase agreement, may be difficult to get from all of the spouses
  - Same reasoning should apply to members' and partners' cross purchase agreements funded with life insurance

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Income Tax Considerations

- For a C corporation that is in a lower income tax bracket than its shareholders, the payment of the nondeductible premium by the C corporation costs less with a stock redemption or entity purchase agreement than the payment of those nondeductible premiums by the shareholders with a cross purchase agreement
- For a C corporation, the cross purchase agreement avoids a corporate alternative minimum tax which may be generated with a stock redemption agreement by the inclusion of the corporate owned life insurance proceeds in excess of the cash surrender value in the corporation's adjusted current earnings

Life Insurance Considerations

- Number of life insurance policies needed
  - Stock redemption or entity purchase agreement – the entity will own one policy on each titled owner's life
  - Cross purchase agreement – each titled owner will own a policy on each other titled owner's life which becomes more complicated as the number of owners increase above 2; for example, with 3 owners there will be 6 policies, with 4 owners there will be 12 policies, etc.; unless a Life Insurance LLC is used

Estate Tax Considerations
The New *Connelly* Trap

- Prior to June 2, 2023, with a properly drafted stock redemption agreement or entity purchase agreement we were comfortable that pursuant to the 11th Circuit Court of Appeal's opinion in *Estate of Blount* that any life insurance funding the purchase at death was offset by the liability for purchasing the stock so that it did not increase the value of the entity and the shares included in the deceased owner's gross estate for federal estate tax purposes
- On June 2, 2023, the 8th Circuit Court of Appeals issued its decision in the *Connelly* case in which they held that the life insurance proceeds payable to the corporation to be used to fund the stock redemption by the corporation increased the value of the corporation with no offset for the liability for purchasing the stock and therefore increased the value of the deceased owner's shares included in the deceased owner's gross estate for federal estate tax purposes

Estate Tax Considerations
The New *Connelly* Trap

- On June 6, 2024, the United States Supreme Court issued its decision in the *Connelly* case (*Connelly v. United States*, 602 U.S. ___ (2024)) unanimously affirming the 8th Circuit Court of Appeals
- All of the filings with the Supreme Court in this case are at https://www.supremecourt.gov/docket/docketfiles/html/public/23-146.html; this includes all of the briefs which are interesting to read
- We have to consider *Connelly* to be a trap for the unwary and we should be encouraging our clients who have stock redemption agreements or entity purchase agreements funded with life insurance to have them reviewed and analyzed to determine the impact of *Connelly* and whether there is a better alternative arrangement
- The primary alternative may be a cross purchase agreement with or without a Life Insurance LLC

The Life Insurance LLC

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The Life Insurance LLC

- The Life Insurance LLC is a concept that started to be considered more widely when PLR 200747002 was released on November 23, 2007

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Summary of Key Provisions

- Business owners enter into a cross purchase agreement covering their ownership interests in the operating company
- Business owners form a limited liability company in which they are members in the same proportion that they own the operating company
- Business purpose of the LLC is to hold and manage life insurance policies on the owners of the operating entity and to make sure insurance proceeds are used to satisfy the purchase obligations under the cross purchase agreement on the death of an owner of the operating entity

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Summary of Key Provisions

- LLC is the owner and beneficiary of the life insurance policies on the owners of the operating company and only one policy will be needed on each owner
- Cross purchase agreement and LLC operating agreement include references to each other and how one works with the other
- LLC is taxed as a partnership, useful in avoiding the transfer for value rules

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Summary of Key Provisions

- LLC will maintain a separate capital account for each member in a manner that complies with Treas. Reg. § 1.704-1(b)(2)(iv)
- LLC is managed by a manager who is not a related or subordinate party to any member under IRC § 672(e)
- No member whose life is insured by a policy owned by LLC may vote on LLC's exercise of incidents of ownership with respect to any life insurance policy owned by the LLC
- Written notice to the insured and written consent of the insured to comply with IRC § 101(j) is required and given

Summary of Key Provisions

- Specify how life insurance premiums will be paid and allocated, for example by the operating company as compensation to the members who are employees of the operating company or as distributions/dividends from the operating company, or by the members who are not the insured of that specific policy
- LLC manager required to use life insurance proceeds for purchase as required by the buy-sell agreement by either paying decedent's estate directly or distributing proceeds to surviving members who then pay decedent's estate

The Life Insurance LLC

- For a detailed discussion of the Life Insurance LLC and sample documents, *see The Special Purpose Buy-Sell Insurance LLC* (2019, Leimberg Information Services, Inc.)

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2 – 3 p.m.

BOI Discussion Panel

Moderator: Joseph W. Boucher, CPA, MBA, JD, *Founding Shareholder, Neider & Boucher, S.C.*

Jeff Kowieski, CPA, JD, *Risk Management Partner & General Counsel, Wipfli LLP*

Christopher Olson, CPA, MST, *Shareholder, KerberRose*

Peter J. Soukenik, JD, *Associate Attorney, Reinhart Boerner Van Deuren s.c.*

Matt Whalen, CPA, *Vice President & Director of Taxation, Northland CPAs*

Beneficial Ownership Interests

Discussion Panel

WICPA ANNUAL TAX CONFERENCE
NOVEMBER 11-12, 2024

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BOI Panel

Moderator:

- Attorney Joseph W. Boucher, JD, CPA, MBA co-founder Neider & Boucher, S.C

Panelists:

- Jeff Kowieski, CPA, JD, Risk Management Partner & General Counsel of Wipfli, LLP
- Christopher Olson, CPA, MST Shareholder KerberRose
- Peter J. Soukenik, JD, Associate Attorney, Reinhart Boerner Van Deuren, S.C.
- Matt Whalen, CPA, Vice President & Director of Taxation, Northland CPAs

BOI Panel

Special thank you to Attorneys Kent Schlienger, Craig Miller and Julijana Englander of Neider & Boucher, S. C. who assisted in the preparation of these materials.

What is the CTA?

The Corporate Transparency Act (CTA) was enacted on Jan. 1, 2021, to reduce terrorist financing, money laundering, and other illicit activities by increasing transparency and creating additional reporting requirements for businesses.

The CTA went into effect on Jan. 1, 2024.

As a result of the CTA, millions of small businesses, or Reporting Companies, will be required to disclose information to the U.S. Department of Treasury's Financial Crimes Enforcement Network (FinCEN) about:

1. The company itself
2. Its Beneficial Owners
3. Its Company Applicants

QUESTION: Any guesses how many Reporting Companies are affected by the CTA and required to report to FinCEN?

Who is a Beneficial Owner?

- **Beneficial Owners** are individuals who directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise:
  - **Substantial Control.** (i) Exercise substantial control over the entity, or
  - **Ownership Interest.** (ii) Own or control not less than 25% of the ownership interests of the entity.
- **Exceptions.** Individuals who may otherwise be considered a Beneficial Owner are *exempt if they are*:
  - Minors;
  - Creditors;
  - Individuals acting as a nominee, intermediary, custodian, or agent on behalf of another individual;
  - Individuals acting solely as an employee and whose control over or economic benefits from such entity is derived solely from the employment status of the person; or,
  - Individual whose only interest is through a right of inheritance.

CPAs' Role in Compliance with the CTA

Q1 What role can CPAs play in Corporate Transparency Act (CTA) compliance and in Beneficial Ownership Information (BOI) reporting?

How does this relate to the unauthorized practice of law?

CPAs' Role in Compliance with the CTA

A1

- In the most recent FAQs for BOI (www.fincen.gov/boi-faqs), B9 specifically notes that non-lawyer third-parties (e.g., CPAs) can help entities in the filing or preparation of filing for the CTA, if authorized by the entity to do so.
- B.9 also notes that whether this is the unauthorized practice of law is determined by state law and therefore may vary.
- In **Wisconsin**, the authorized practice of law is in part governed by the WI Supreme Court Rules.
- The following slides include *abbreviated* versions of the rules that define **who may practice law** in Wisconsin and some (*but not all*) defined **exceptions** when a license and membership in the WI State Bar is not required for someone to engage in specific activities, regardless of whether these activities constitute the practice of law.

CPAs' Role in Compliance with the CTA

SCR 23.02 License required to practice law; use of titles.*

(1) RIGHT OF A PERSON TO PRACTICE LAW IN WI. A person who is duly licensed to practice law in this state by the WI Supreme Court and who is an active member of the WI State Bar may practice law in WI. No person may engage in the practice of law in WI, or attempt to do so, or make a representation that he or she is authorized to do so, unless the person is currently licensed to practice law in WI by the WI Supreme Court and is an active member of the WI State Bar.

In other words:

- Licensed by the WI Supreme Court
- Active Member of the WI State Bar

**abbreviated/edited*

CPAs' Role in Compliance with the CTA

SCR 23.02 License required to practice law; use of titles.*

(2) EXCEPTIONS AND EXCLUSIONS. A license to practice law and active membership in the WI State Bar are NOT required for a person engaged in any of the following activities in WI, regardless of whether these activities constitute the practice of law:

(a) Practicing law per SCR 10.03(4) by a non-resident counsel or registered **in-house counsel**.

(c) Appearing in a representative capacity before an **administrative tribunal** or agency if permitted by such tribunal or agency.

Comment: A nonlawyer who is an employee, member, or officer of an entity may represent such entity or any corporate affiliate before an administrative tribunal or agency of the State.

(d) Serving in a **neutral capacity as a mediator**, arbitrator, conciliator, or facilitator.

**abbreviated/edited*

CPAs' Role in Compliance with the CTA

SCR 23.02 License required to practice law; use of titles.*

(2) EXCEPTIONS AND EXCLUSIONS. *[continued]*

(i) Selection/completion of a legal document, including administrative agency documents…where the document may contain various blanks… and selection/completion requires only **common or transaction-specific knowledge** of the required information and general knowledge of the legal consequences.

(s) Professional activities performed by a **certified public accountant** or by a person working under the direction of a certified public accountant.

- This exception allows CPAs to help with tax returns, financial reports, etc.
- Under this exception, CPAs can *guide clients* on BOI reporting requirements and collect information to complete or submit BOI forms based on client-provided data.
- However, CPAs may need to (and should) consult with a lawyer for any analysis, questions or complex scenarios.

**abbreviated/edited*

Possible Fact Patterns

There are several possible common entity ownerships. All of the scenarios on the following slides are Wisconsin based examples.

Unless stated otherwise, assume:

1. All of the entities are Wisconsin formed.
2. No marital property agreements, unless stated otherwise.
3. These entities are not exempt.
4. There are no unusual management arrangements.
5. LLCs are member managed, unless stated otherwise.
6. All entities were formed before January 1, 2024.

Possible Fact Patterns – Q2

Q2 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity. The husband owns 100%.

Possible Fact Patterns - A2

Q2 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity. The husband owns 100%.

A2 *Answer:*

Under Wisconsin marital property law, each spouse is the equitable owner of 50% of the LLC interest, even though the husband has titled ownership.

Both spouses should be reported under the CTA as a beneficial owner.

Possible Fact Patterns - Q3

Q3 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity. The husband owns 100%. Here, the husband and wife have a marital property agreement which classifies the LLC interest as individual property of the titled spouse.

Possible Fact Patterns - A3

Q3 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity. The husband owns 100%. Here, the husband and wife have a marital property agreement which classifies the LLC interest as individual property of the titled spouse.

A3 *Answer:*

Here, whoever has **legal title** is the 100% owner and the holder of all of the **management control** over the LLC interest, and that person must be reported under the CTA as the beneficial owner.

Possible Fact Patterns - Q4

Q4 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity. The husband and wife are each the titled holder of 50% of the LLCs interests.

Possible Fact Patterns – A4

Q4 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity. The husband and wife are each the titled holder of 50% of the LLCs interests.

A4 *Answer:*

Here, **both** the husband and wife must be reported under the CTA as beneficial owners.

Possible Fact Patterns - Q5

Q5 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity.

The husband and wife have a revocable trust in their estate plan which owns all of the LLC interests. (The husband and wife are the grantors and initial co-trustees.)

Possible Fact Patterns - A5

Q5 *Scenario*:

A husband and wife form a single member LLC which is a disregarded entity. The husband and wife have a revocable trust in their estate plan which owns all of the LLC interests. (The husband and wife are the grantors and initial co-trustees.)

A5 *Answer:*

- When trusts are the holder of an interest in an entity, **each trustee** is [almost] always a beneficial owner under the CTA.
- A **beneficiary** of the trust is a beneficial owner only if the beneficiary is solely entitled to all distributions of principal and income from the trust or can demand a withdrawal or distribution of the trust assets.
- Also , **a grantor** of a trust **who can revoke the trust** or withdraw all of its assets is the **beneficial owner** with respect to the interest held by the trust.
- **Here**, both husband and wife should be reported as beneficial owners under the CTA because they are the trustees and the grantors of the revocable trust.

Possible Fact Patterns - Q6

Q6 *Scenario*:

A husband and wife along with the wife's sister and brother-in-law form a cabin LLC to own their Door County property.

Each couple holds 50% of the LLC interests, which is split equally between the husband and wife in each couple.

Possible Fact Patterns - A6

Q6 *Scenario*:

A husband and wife along with the wife's sister and brother-in-law form a cabin LLC to own their Door County property. Each couple holds 50% of the LLC interests, which is split equally between the husband and wife in each couple.

A6 *Answer:*

All 4 individuals must be reported as a beneficial owners under the CTA, since each person is a 25% owner.

Possible Fact Patterns - Q7

Q7 *Scenario*:

Now, instead of 2 families, there are 3 families, with 3 married couples, forming the Cabin LLC with each family owning 33.33%.

The LLC interests of each couple are held jointly as marital property.

Possible Fact Patterns - A7

Q7 *Scenario*:

Now, instead of 2 families, there are 3 families, with 3 married couples, forming the Cabin LLC with each family owning 33.33%. The LLC interests of each couple are held jointly as marital property.

A7 *Answer:*

Joint owners of an interest each have management control over the entire interest, so each spouse has control of a 33% interest in the LLC.

All 6 people must be reported under the CTA as a beneficial owner, even though each of the 6 people individually "own" less than 25% of the LLC interests.

Possible Fact Patterns - Q8

Q8 *Scenario*:

Mary and Susan form an LLC to operate their engineering consulting firm. Mary owns 67% while Susan owns 33%.

Possible Fact Patterns - A8

Q8 *Scenario*:

Mary and Susan form an LLC to operate their engineering consulting firm. Mary owns 67% while Susan owns 33%.

A8 *Answer:*

Both Mary and Susan must be reported under the CTA as beneficial owners, since both have an ownership interest of 25% or more.

Possible Fact Patterns - Q9

Q9 *Scenario*:

Mary and Susan form an LLC to operate their engineering consulting firm. Mary owns 67% while Susan owns 33%.

Here, Mary and Susan's LLC is a manager-managed LLC. Nancy, who is not an owner, is the manager.

Possible Fact Patterns - A9

Q9 *Scenario*:

Mary and Susan form an LLC to operate their engineering consulting firm. Mary owns 67% while Susan owns 33%. Here, Mary and Susan's LLC is a manager-managed LLC. Nancy, who is not an owner, is the manager.

A9 *Answer:*

Mary and Susan must be reported under the CTA as beneficial owners by virtue of their ownership of the LLC interests.

Any of the senior officers of an entity must also be reported under the CTA as beneficial owners, *even if they have no ownership interest*. A **SENIOR OFFICER** is any person who acts in the traditional role of president, CEO, CFO, general counsel, or COO, or any person who performs a similar function regardless of title. An **LLC manager** has the kind of authority that qualifies as a senior officer; here, Nancy must also be reported under the CTA as a beneficial owner.

So, **Mary**, **Susan** and **Nancy** must be reported as beneficial owners.

Possible Fact Patterns - Q10

Q10 *Scenario*:

10 friends are going into business together to invest in real estate properties.

They will create separate LLCs for each real estate property with varying ownership percentages based on which person invests in the specific LLC. For example, 22 Badger St, LLC and 98 State Rd, LLC.

The friends also create Management, LLC to control, manage, and oversee the real estate LLCs (e.g., 22 Badger St, LLC). Management, LLC is manager-managed; and the friends have equal ownership and control in Management, LLC.

Possible Fact Patterns – A10

A10 *Answer:*

- For **22 Badger Street, LLC**: Any person who owns 25% or more of that entity is a beneficial owner under the CTA.
- Although Management LLC would qualify as a "senior officer"(see A.9), entities cannot be reported as beneficial owners; instead, the entity must be "looked through" to the individuals who own or control them.
- Since no person owns 25% or more of Management, LLC, then the individual or individuals who have "substantial control" over Management LLC are the beneficial owners to be reported under the CTA.
- Ultimately, each company must have at **least one individual** that is reported under the CTA as the beneficial owner, which in some cases where no person has 25% or more ownership and control is determined by a majority vote of multiple people, the beneficial owner might be the person or persons who act as the entity's agent to exercise that control (for example, a designated managing member).

Company Applicants and Deadlines for Initial Reporting

Scenario Considering Company Applicants and Deadlines for Initial Reporting

For entities formed after 2023, the reporting must include the **Company Applicant(s)** – the individual or individuals (up to two) that were involved in the process of filing of the incorporation or organization documents that created, organized or registered the entity. For example, the person that filed the Articles of Organization with Wisconsin's DFI to create an LLC.

Who is a Company Applicant?

- A "**Company Applicant**" is the individual who directly files the document that creates the reporting company or registers the reporting company to do business in the US, and the individual who is primarily responsible for directing or controlling the CTA filing.
- The CTA filing limits the number of Company Applicants to two names.
- For entities formed before Jan. 1, 2024, no Company Applicant is required.

What are the deadlines for initial reporting?

Companies Formed **Before** Jan. 1, 2024

- For initial reports, required info must be reported to FinCEN between **Jan. 1, 2024** - **Jan. 1, 2025**.
  - However, reporting information about Company Applicants is not required.

Companies Formed **Between** Jan. 1, 2024 – Dec. 31, 2024

- For initial reports, required info must be reported within **90 days** of the acceptance of the company's state registration filing.

Companies Formed **After** Dec. 31, 2024

- For initial reports, required info must be reported within **30 days** of the acceptance of the company's state registration filing.

Possible Fact Patterns – Q11

Q11

Companies Formed **Before** Jan. 1, 2024

- Formed Jan. 1, 2022 → when is the initial report due? Company Applicant required in report?

Companies Formed **Between** Jan. 1, 2024 – Dec. 31, 2024

- Formed Jan. 1, 2024 → when is the initial report due? Company Applicant required in report?
- Formed Nov. 1, 2024 → when is the initial report due? Company Applicant required in report?

Companies Formed **After** Dec. 31, 2024

- Formed Jan 1, 2025 → when is the initial report due? Company Applicant required in report?

Possible Fact Patterns – A11

A11

Companies Formed **Before** Jan. 1, 2024

- Formed Jan. 1, 2022 → *Initial report?* Dec. 31, 2024. *Company Applicant?* No.

Companies Formed **Between** Jan. 1, 2024 – Dec. 31, 2024

- Formed Jan. 1, 2024 → *Initial report?* Mar. 31, 2024. *Company Applicant?* Yes.
- Formed Nov. 1, 2024 → *Initial report?* Jan. 30, 2025. *Company Applicant?* Yes.

Companies Formed **After** Dec. 31, 2024

- Formed Jan 1, 2025 → *Initial report?* Jan. 31, 2025. *Company Applicant?* Yes.

How often is reporting required?

- **Initial Report.** The CTA creates an initial reporting requirement and an ongoing obligation for Reporting Companies to update their reports after changes occur.
  - After the initial report, no annual or quarterly reports are required.
- **Ongoing Obligation to Update Reports.** Reporting Companies must file an amendment or update within 30 days after any change to their reported information.
  - Even seemingly minor changes require reporting a chance – such as an address change for a Beneficial Owner.

Examples

- New Beneficial Owner? → File updated Report within 30 days of such change
- New Company address? → File updated Report within 30 days of such change
- Different address for existing Beneficial Owner? → File updated Report within 30 days of such change

Possible Fact Patterns – Q12

Q12 *Scenario*:

There is a manager-managed, LLC with 3 equal members who hold title to the LLC's interests in their individual capacity.

The LLC has hired a Kate as a Manager to run the company, and Kate is not a member.

Possible Fact Patterns – A12

Q12 *Scenario*:

There is a manager-managed, LLC with 3 equal members who hold title to the LLC's interests in their individual capacity. The LLC has hired a Kate as a Manager to run the company, and Kate is not a member.

A12 *Answer:*

All 3 members and the **Manager** (i.e., Kate) must be reported as beneficial owners under the CTA.

Possible Fact Patterns - Q13

Q13 *Scenario*:

There is a manager-managed, LLC with 3 equal members who hold title to the LLC's interests in their individual capacity. Now, all 3 of the equal members are married (to non-members) and do not have marital property agreements.

The LLC has hired a Kate as a Manager to run the company, and Kate is not a member (and not married to a member).

Possible Fact Patterns - A13

Q13 *Scenario*:

There is a manager-managed, LLC with 3 equal members who hold title to the LLC's interests in their individual capacity. Now, all 3 of the equal members are married (to non-members) and do not have marital property agreements. The LLC has hired a Kate as a Manager to run the company, and Kate is not a member (and not married to a member).

A13 *Answer:*

This is the same as A12. **All 3 members** and the **Manager** (i.e., Kate) must be reported as beneficial owners under the CTA.

The members do not have marital property agreements, so the ownership is marital property. However, each of the untitled spouse's equitable interest doesn't meet the 25% threshold.

Therefore, **only the 3 titled members** (+ **the Manager**) are beneficial owners for the purpose of the CTA.

Possible Fact Patterns - Q14

Q14 *Scenario*:

A manager managed LLC has 4 equal members who hold title to their interests.

One of the members is married without a marital property agreement.

One of the unmarried members is the Manager.

Possible Fact Patterns - A14

Q14 *Scenario*:

A manager managed LLC has 4 equal members who hold title to their interests.
One of the members is married without a marital property agreement.
One of the unmarried members is the Manager.

A14 *Answer:*

All **4 members** must be reported as beneficial owners under the CTA.

Possible Fact Patterns - Q15

Q15 *Scenario*:

There is a Wisconsin corporation with 2 Officers (who have positions that qualify as 'senior officers' under the CTA – see A.9), 2 Directors, and 5 equal shareholders. The Directors and Officers are not shareholders.

Put another way…

Wisconsin Corporation:

- 2 Officers ('senior officers') who are not shareholders
- 2 Directors who are not shareholders
- 5 equal Shareholders

Possible Fact Patterns - A15

A15 *Scenario/Answer*:

- 2 Officers ('senior officers') who are not shareholders → YES beneficial owners under the CTA
- 2 Directors who are not shareholders → YES beneficial owners under the CTA
- 5 equal Shareholders → NO, not beneficial owners under the CTA

Individuals with the power to direct, determine or have **substantial influence** over the reporting company's, including its business, finances or structure, **are beneficial owners** for purposes of the CTA, *even if they have no ownership interest.*

Directors do not necessarily have the power to "control" the corporation individually, since the Board acts by majority vote. Thus, being a director, by itself, does not make an individual a beneficial owner under the CTA.

If, however, the Board has only one or two Directors, each Director in those circumstances does have control, since the sole Director on a one-person board **can unilaterally control**, and since each Director's vote on a two-person Board is a controlling vote.

Therefore, **here**, the **two Directors** should also be reported as beneficial owners under the CTA.

Possible Fact Patterns - Q16

Q16 *Scenario*:

There is a Wisconsin corporation with 2 Officers (who qualify as 'senior officers' under the CTA), 3 Directors on the Board, and 5 Shareholders. Their ownership interests and positions are as follows:

- Alex: 40% owner, Officer, and Director
- Becca: 15% owner, Officer
- Charlie: 15% owner, Director
- Dana: 15% owner, Director
- Eddie: 15% owner

Possible Fact Patterns - A16

A16 *Scenario/Answer:*

- Alex: 40% owner, Officer, and Director → **YES**, beneficial owner under the CTA
- Becca: 15% owner, Officer → **YES**, beneficial owner under the CTA
- Charlie: 15% owner, Director → **NO**, not a beneficial owner under the CTA
- Dana: 15% owner, Director → **NO**, not a beneficial owner under the CTA
- Eddie: 15% owner → **NO**, not a beneficial owner under the CTA

On a three-person board, no Director has a controlling vote, so none of the Directors are beneficial owners by virtue of being a Director.

Possible Fact Patterns - Q17

Q17 *Scenario*:

ABC, LLC is owned and managed as follows:

- *Ownership* – Three Owners
  - Fred: 20%
  - Gerry: 20%
  - Hill Family, LLC*: 60%
- *Management:*
  - Manager Mike, not an owner

***Hill Family, LLC:**

- Jack Hill: 50%
- Jill Hill: 50%

Possible Fact Patterns - A17

Q17 *Scenario*:

ABC, LLC is owned and managed as follows:

- *Ownership:*
  - Fred: 20%
  - Gerry: 20%
  - Hill Family, LLC: 60%
    - Jack and Jill each own 50% of Hill Family, LLC
- *Management:*
  - Mike, not an owner

A17 *Answer:*

Jack and Jill are each beneficial owners of **ABC, LLC** because they each indirectly own a 30% interest in ABC, LLC by virtue of their ownership in Hill Family, LLC Mike is a beneficial owner of ABC, LLC as a manager.

3:10 – 4 p.m.

ERC Update: Current Developments in Uncharted Waters

Joseph R. Rekrut, JD, *Attorney, Reinhart Boerner Van Deuren s.c.*

ERC Update:
Current Developments in Uncharted Waters

WICPA Tax Conference
Brookfield Conference Center
Nov. 11, 2024

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Agenda

- The ERC Program – Brief Background
- Widespread Abuse of the ERC and Recent Events
- IRS Scrutiny
- ERC Audits – What to Expect & Best Practices
- ERC Litigation
- ERC Best Practices for M&A

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The ERC Program – Brief Background

ERC Basics

- Employee Retention Credit ("ERC") was created by the CARES Act in March of 2020, and provides eligible employers with a refundable tax credit. Expanded by the Consolidated Appropriations Act.
- Can generally be claimed for Q2-Q4 of 2020 and Q1-Q3 of 2021.
  - Focus will typically be on 2021 quarters because the 2021 ERC offers a larger credit for each quarter, and vastly expands the number of employers that can qualify for the credit for all wages paid to employees.
- If a company claims the ERC, they are required to amend their income tax return to reduce their payroll tax deduction attributable to the ERC period.

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Who is Eligible for the ERC?

Two tests – satisfaction of either gives rise to eligibility (discussion of RSBs excluded).

1. **Decline in Gross Receipts Test**
   - Black and white test, generally based purely on receipts for the tested quarter compared to the receipts for the same quarter in 2019.
   - Certain exceptions (alternative quarter election), and be wary of misinformation (projected receipts)

2. **Partial Suspension Due to Governmental Order Test**
   - Much more grey test, more room for gameplaying. Generally requires that the operations of the business were partially or fully suspended due to an appropriate governmental order.
   - Be wary of supply chain/port closure arguments, misunderstandings about remote work and mask mandates, etc.

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Calculating the ERC Refund – Qualifying Wages

- First hurdle – large vs. small employers
  - Importantly, certain wages (productive time) are excluded for "large" employers.
  - For the 2020 ERC, a "large" employer has an average of more than 100 full-time employees (based on 2019 figures). For the 2021 ERC, this figure was raised to 500.
- Generally, qualifying wages are defined as "wages" under Code section 3121(a) and "compensation" as defined in Code section 3231(e) paid by an eligible employer during a covered calendar quarter.
  - Certain healthcare costs borne by the employer can be included.
- Also, note that PPP double dipping is not permitted. Wages paid with forgiven PPP funds are not ERC-eligible.

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How the ERC is Claimed

- 2020 SoL closed, 2021 claims may still be filed (until April 15, 2025).
- Credit is claimed by amendment of the business's Forms 941 (i.e., via a Form 941-X).
  - Must be paper filed.
- IRS used to publish the number of unprocessed Forms 941 and 941-X.
  - They have stopped this practice, and now exclude ERC claims from the count.
- On October 10, 2024, IRS announced they were processing about 400,000 claims (~$10 billion in claims).
  - Reports of 1.4 million unprocessed claims as of June 17, 2024.

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Widespread Abuse of the ERC and Recent Events

Widespread Attention – Some Legit, Others Not

Inside a Sales Army Turning a Tax Break Into a Modern-Day Gold Rush

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Justice.gov > U.S. Attorneys > Western District of Missouri > Press Releases > Independence Man Pleads Guilty To $1.4 Million COVID Fraud Scheme

PRESS RELEASE

Independence Man Pleads Guilty to $1.4 Million COVID Fraud Scheme

Wednesday, October 30, 2024

For Immediate Release

PRESS RELEASE

New Jersey Tax Preparer Arrested for Fraudulently Seeking Over $124 Million in COVID-19 Employment Tax Credits

Monday, July 31, 2023

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For Immediate Release
Office of Public Affairs

PRESS RELEASE

Operation Fraud Street Mafia Results Announced: Nine Arrested for Drug Trafficking and Committing More Than $550 Million in Attempted Tax Fraud

Friday, February 23, 2024

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U.S. Attorney's Office, Eastern District of California

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IRS Scrutiny

IRS Dirty Dozen (2023 and 2024)

Home / News / News Releases / IRS opens 2023 Dirty Dozen with warning about Employee Retention Credit claims; increased scrutiny follows aggressive promoters making offers too good to be true

IRS opens 2023 Dirty Dozen with warning about Employee Retention Credit claims; increased scrutiny follows aggressive promoters making offers too good to be true

English | Español | 中文 (简体)

Topics in the News
- News Releases
  - News Releases for Frequently Asked Questions
- Multimedia Center
- Tax Relief in Disaster Situations
- Inflation Reduction Act
- Tax Reform
- Taxpayer First Act

IR-2023-49, March 20, 2023

WASHINGTON — In a further warning to people and businesses, the Internal Revenue Service added widely circulating promoter claims involving Employee Retention Credits as a new entry in the annual Dirty Dozen list of tax scams.

For the start of the annual Dirty Dozen list of tax scams, the IRS spotlighted Employee Retention Credits following blatant attempts by promoters to con ineligible people to claim the credit. Renewing several earlier alerts, the IRS highlighted schemes from promoters who have been blasting ads on radio and the internet touting refunds involving Employee Retention Credits, also known as ERCs. These promotions can be based on inaccurate information related to eligibility for and computation of the credit.

"The aggressive marketing of these credits is deeply troubling and a major concern for the IRS," said IRS Commissioner Danny Werfel. "Businesses need to think twice before filing a claim for these credits. While the credit has provided a financial lifeline to millions of businesses, there are promoters misleading people and businesses into thinking they can claim these credits. There are very specific guidelines around these pandemic-era credits; they are not available to just anyone. People should remember the IRS is actively auditing and conducting criminal investigations related to these false claims. We urge honest taxpayers not to be caught up in these schemes."

Home / News / News releases / Dirty Dozen: Beware of aggressive promoters who dupe taxpayers into making questionable Employee Retention Credit claims; risks continue for small businesses, special withdrawal program remains available

Dirty Dozen: Beware of aggressive promoters who dupe taxpayers into making questionable Employee Retention Credit claims; risks continue for small businesses, special withdrawal program remains available

English | Español | 中文 (简体) | 中文 (繁體) | 한국어 | Русский | Tiếng Việt | Kreyòl ayisyen

Topics in the news

IR-2024-85, March 29, 2024

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IRS Shares "Warning Signs" of Incorrect Claims (August 26, 2024)

- Essential businesses during the pandemic that could fully operate and didn't have a decline in gross receipts
- Businesses using wages already used for Paycheck Protection Program loan forgiveness
- Too many quarters being claimed
- Too many employees and wrong calculations
- Businesses citing supply chain issues
- Businesses didn't pay wages or didn't exist during eligibility period
- Businesses unable to support how a government order fully or partially suspended business operations
- Businesses reporting family members' wages as qualified wages
- Large employers claiming wages for employees who provided services
- Government orders that don't qualify
- Businesses claiming ERC for too much of a tax period
- Promoter says there's nothing to lose

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Available Options for Forfeiting or Amending Claims

- First Round Voluntary Disclosure Program (Closed)
  - IRS received more than 2,600 applications involving more than $1.09 billion
- Second Round Voluntary Disclosure Program (Open until Nov. 22, 2024)
  - Available if ERC refund has been paid/credited and you are willing to return 100% of the refund
  - Only 2021 quarters permitted
  - Requires repayment of 85% of refund amount (*i.e.*, 15% windfall)
  - No penalties or interest (absent fraud)
- Withdrawal of Entire Claim
  - Available only if refund not paid/cashed
  - Must withdraw the **entire amount** of the ERC claim
  - No penalties or interest (absent fraud)
- Amended Forms 941-X
  - Useful if claim is partially valid

* Note also the consolidated claim process for third-party payers promulgated in Sept.

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ERC Audits – What is Happening and What to Expect

IRS ERC Enforcement Activity

- Various avenues, including the following:
  - 105C Recapture Letters
  - Field Audits
  - Criminal Promoter Prosecution
  - Whistleblowers (Promoters, Circ. 230, etc.)
    - Report a promoter or advisor outside of the VDP application with Form 14242, Report Suspected Abusive Tax Promotions or Preparers PDF

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105C Letters – Generally

- IR-24-169
  - Issuance began in July 2024
- Various reasons for disallowance, including:
  - No record of prior employment tax deposits
  - No signs of operating a trade or business
  - Failure to qualify for credit (under either test)
- Significance
  - Opportunity to protest to the IRS Independent Office of Appeals
    - Typically 30 days, but IRS has indicated that they won't enforce this for these ERC 105C letters
    - Check with IRS if waiting for 86-C (referring you to Appeals) letter for extended period of time
  - Formal disallowance that starts the 2-year refund suit timeline

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105C Letters – Another IRS Mistake

- Many 105C letters have contained incorrect information, or omitted language regarding taxpayer rights
  - "The IRS learned that some of the recent early mailings have inadvertently omitted a paragraph highlighting the process for filing an appeal to the IRS or district court, and the agency is taking steps to ensure this language is mailed to all relevant taxpayers."
- IRS says more than 90% were "validly issued"
  - 10% sent in error…
  - National Taxpayer Advocate: "This doesn't mean they didn't contain errors – rather, it only means the IRS believes the errors did not invalidate the notices. Thus, I suspect it's possible – if not likely – that many of the notices, even if valid, contained errors."

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ERC Audits, Generally

- "Thousands" have been initiated and are underway, per the IRS

- Wide scope of issues
  - Eligibility, particularly under the partial suspension test
    - Focus on supply chain arguments (*see* GLAM 2023-005)
  - FTE Counts
  - Qualified wage calculation (owner wages, PPP double dipping, etc.)
  - Aggregation

- Statute of Limitations
  - Note the special 5-year SoL for Q3 and Q4 of 2021 (IRC § 3134(l))
  - No SoL in the case of fraud

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ERC Audits – The Stakes

- Penalties
  - Underpayment (IRC §§ 6662 and 6663)
  - Accuracy
    - Reasonable cause?
  - IRC § 6676 misinformation

- Interest

- Criminal Exposure
  - Fraudulent/willful misconduct

Type of interest or penalty	Code section that provides authority to assess	Interest or penalty rate
Interest	IRC 6601	Varies quarterly. 1st quarter 2024 rate is 8%-10%
Failure-to-pay penalties	IRC 6651(a)(2) IRC 6651(a)(3)	.5-25% Or 1/4% or 1%
Failure-to-file penalties	IRC 6651(a)(1)	5-25%
Failure-to-deposit penalties	IRC 6656(a)	2-15%
Accuracy-related penalties	IRC 6662(a)	20%
Civil fraud penalties	IRC 6663	75%
Fraudulent failure-to-file penalties combined with the failure-to-file penalties	IRC 6651(f)	15-75%
Trust fund recovery penalties	IRC 6672	Equal to total amount of the tax evaded, or not collected, or not accounted for and paid over.

Criminal charges related to taxes can include, but are not limited to, tax evasion (IRC 7201), filing a false return (IRC 7206(1)), false claims (18 USC 287) and false statements (18 USC 1001). A person convicted of tax evasion is subject to a prison term of up to five years and a fine of up to $250,000. Filing a false return subjects a person to a prison term of up to three years and a fine of up to $250,000.

https://www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit-voluntary-disclosure-program

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How to Prepare for Audits/Lessons from the Front

- Re-examine eligibility and recalculate wages yourself

- Looks for common pressure points
  - Aggregation
  - Owner wages
  - FTE count
  - Be wary of M&A activity

- Bolster the record
  - Reach out to past advisors
  - Create documentation where necessary

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Documenting ERC Claims to Protect Against Penalties/Interest

- At a bare minimum, any business that claimed the ERC should have an audit file consisting of:

  - Detailed memo/email chain specifically identifying the quarters for which the company is eligible and identifying the method of qualification with specificity.
    - If based on partial suspension, be sure to detail governmental orders, document more than nominal interruption, etc.

  - Excel spreadsheet showing payroll and other "wage" expenses for each eligible quarter and backing out any PPP-funded payroll.

  - List of advisors used when claiming the credit and what advice came from each.
    - Retain all correspondence (*i.e.,* emails), consultant presentation materials, etc.

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IRS Criminal Investigations

- According to the IRS, 460 criminal cases have been initiated (as of July 1, 2024)
  - Potentially fraudulent claims worth nearly $7 billion
  - As of August 8, 37 investigations had resulted in federal charges, with 17 investigations resulting in convictions and nine sentencings with an average sentence of 20 months
- Your clients may be asked to help (interviews, etc.)
  - Think this through
  - We have seen clients who participate in the VDP be asked to assist with this process

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Loper Bright Implications?

- Beyond the scope of this presentation, but there is an informal rule since the decision that every presentation must mention the case.
- Per Loper Bright, courts are required to exercise their own independent judgment when engaging in statutory interpretation and reviewing IRS interpretation of statutes
- IRC § 3134 (the codification of the ERC) leaves room for interpretation on various issues
  - Some commenters have focused in on the “more than nominal” suspension standard

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ERC Litigation

ERC Litigation, Generally

- Can be filed in federal district court (where business is located) or in the Court of Federal Claims in Washington, D.C.
  - Either way, US DoJ will represent the IRS
- In many cases, not going to be advisable, but that calculus is slowly shifting.
  - Cost can be a factor, especially if the business is in desperate need of the refund (contingent or alternative fees?)
  - Consider alternate sources of funding
- If filing suit makes sense:
  - Be cognizant of the 6-month waiting period after filing of refund claim – not usually an issue
  - Heavily scrutinize the claim (and give preference to decline in gross receipts)

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ERC Litigation – Recent Examples

- The Job Center LLC (S.D. Ohio, No 1:24-cv-00510 – filed 9.17.24)
  - Ohio industrial staffing company
  - $5.1M in ERC
  - Based on partial suspension test
  - Claim filed in June 2023
- MTH Industries (N.D. Ill., No 1:24-cv-09729 – filed 10.8.24)
  - Glass & architectural metal business
  - $1.3M in ERC
  - Based on gross receipts test

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Best Practices for M&A

If ERC Claim Has Not Been Filed – Who is Entitled to the ERC?

- Targets are often in the process of claiming or reconsidering the ERC when the terms of the deal are being worked out.

- Who does the ERC belong to?
  - Generally, there is a good argument that the target should enjoy the benefit of the ERC since it relates to 2020/2021 quarters.
  - If the risk associated with the ERC is large, equity buyers may argue that a portion of the credit should stay with them
    - Many possible factors depending on deal structure – increased income/employment tax audit risk, use of EIN, handling of refund check, possible penalties and interest, etc.

- Be wary of long timelines with respect to ERC refund issuance and review

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If ERC Claim Has Been Filed – Diligence and Impact on Financials

- If it is determined that a target has taken the ERC, a number of questions should be asked:
  - Request a description of (i) the target company's rationale for qualifying for the credit, and (ii) the calculation of the qualified wage amounts being claimed.
  - Confirm that the target has not received a PPP loan, or that such loan was accounted for in the ERC calculation.

- Be wary of companies booking receipt of the ERC as "income" or an increase in revenue if this impacts valuation.

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If ERC Claim Has Been Filed – Reps and Warranties

- Amended Returns
  - Who controls the amendment of income tax and payroll tax returns?
  - The filing of amended payroll or income tax returns could be required for a variety of ERC-related reasons (even in some cases, to take the credit after the deal is done).
- Possible Escrow of ERC Funds
  - For ERC claims not under the decline in gross receipts test, we should contemplate requesting an escrow of the full ERC amount (including contingent fees, etc.)
- R&W Insurance
  - The ERC is often excluded, and tax insurance typically isn't palatable
  - Depending on the size of the deal, this may be necessary, but I have seen deals die due to questionable ERC claims

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If ERC Claim Has Been Filed – Mitigating Audit Risk

- Tax Contests
  - Who will answer questions/substantiation requests from the IRS?
  - Who will control in the event of an ERC audit?
    - NOTE: Recall the extended audit period for Q3/Q4 of 2021… 5 years!
- Voluntary Disclosure Program
  - Forced participation is becoming common
  - If the claim is suspect, the buyer should contemplate including language permitting voluntary disclosure of the ERC claim (similar to common sales tax voluntary disclosure language).

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Questions?

THANK YOU!

This presentation provides information of a general nature. None of the information contained herein is intended as legal advice or opinion relative to specific matters, facts, situations or issues. Additional facts and information or future developments may affect the subjects addressed in this presentation. You should consult with a lawyer about your particular circumstances before acting on any of this information because it may not be applicable to you or your situation.

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4:10 – 5 p.m.

Hot Tax Practice & Procedure & Ethics Issues

Michael Goller, JD, *Shareholder, Reinhart Boerner Van Deuren s.c.*

HOT TAX PRACTICE AND PROCEDURE ISSUES

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Contents

- IRS Update
- Loper Bright – What do IRS Regulations mean?
- Other Issues
  - High "Net Worth" Audits
    - Airplane Cases
    - Family Office - Planning
  - Real Estate Professional Status
  - Research Credit Audits
  - Interest Free Adjustments in Form 941 Cases
  - Valuation Issues
  - Tax Ethics Update

IRS – Chief Counsel Update

- Effective October 6, 2024 IRS Counsel Attorneys in LB&I SB/SE merged into – Division Counsel Litigation and Advisory (L&A).

- 14 Attorneys are in the group headed in Milwaukee (not all in Milwaukee)

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Loper Bright – How important is an IRS regulation?

- Loper Bright Enterprises et al. v. Raimondo et al. and Relentless, Inc. v. Dept. of Commerce, 603 U.S. ___, 144 S.Ct. 2244 (2024)
- Corner Post v. Board of Governers of the Federal Reserve System, 603 U.S. __, 144 S.Ct. 2440 (2024)

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Background

- Loper overruled Chevron U.S.A. v. NAT. Resources Defense Counsel, Inc. 467 U.S. 837 (1984)

- Administrative Procedures Act
- Section 706 – Courts will decide "all relevant questions of law."
- Section 553 – Contains a detailed notice and comment period for government regulations.

Background (cont.)

- Section 533(b) – APA Section 553 procedures apply to "legislative" regulations. Do not apply to "interpretive" regulations.
- Malbury v. Madison 5 U.S. 137 (1803)
- I.R.C. §§ 7805(a) ". . . the Secretary shall prescribe all needful rules and regulations for enforcement of this title [26 of the U.S.C.], . . ."

Background (cont.)

- Loper
- The Administrative Procedures Act (5 U.S.C. §§ 551 et seq.) requires courts to exercise independent judgment when deciding whether an Agency has acted within its statutory authority; courts may not defer to the Agency interpretation of the law simply because the statute is ambiguous.
- Corner Post
- Statute of limitations to challenge regulations starts when there is a harm suffered by virtue of the Reg.

Background (cont.)

- Relevant Cases
- Skidmore v. Swift Co., 323 U.S. 134 (1944) Skidmore Deference - courts will defer to an agency depending on the thoroughness of its consideration, validity of its reasoning, consistency with other pronouncements and all those factors which give it a power to persuage.
- The doctrine survives after Loper. Courts may defer to the agency if the agency's interpretation has the "power to persuade." The "best read of a statute is that the agency may well be authorized to exercise a degree of discretion." Loper, Slip. Op. at 17

Background (cont.)

- Chevron USA Inc. v. National Reserve Defense Counsel, 467 U.S. 837 (1984) – two famous factors used to make a Reg. legally binding
  - Regulation must be consistent with the plain meaning of the statute
  - Regulation is not an unreasonable interpretation of the statute.

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Background (cont.)

- *Stare Decisis* - Loper
- Mayo Foundation for Medical Education and Research v. U.S., 562 U.S. 44 (2011) FICA Reg. upheld under Section 7805(a)
- Varian Medical Systems v. Comm'r, 163 T.C. No. 4 (Aug. 26, 2024)
  - Section 254A v. Section 78 effective dates
  - Treas. Reg. 1.78-1 clarifies dates. Reg. was issued under Sections 245A and 7805. The court noted a "change in unambiguous provisions of the statute" is not allowed. Id.

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Background (cont.)

- There is a basic difference between filling a gap left by Congress and rewriting rules Congress enacted. Id. (Citing Loper at 2263).
- When, however, Congress has delegated authority to an agency, the court's role is to fix the boundaries of that delegated authority. Id.

A Walk-through – Regulations That May Be At Issue

- Facts
- Section 6501(a) and a Section 481 adjustment
- § 446(a) – "Taxable income is computed under the method of accounting on the basis of which the taxpayer regularly computes his income . . ."
- § 446(c) – Lists permissible methods - cash, accrual, any other method permitted by Chapter 1 of the Code and "any combination of the foregoing methods permitted under regulations prescribed by the Secretary."
- A change in accounting method occurs when, under the lifetime income test, income changes. Does the change result in more or less income over the taxpayer's lifetime? If so, it is not a CIAM. Hyatt Hotels Corp & Subidiaries, 2023-122 (2023) (citing Peoples Band & Tire Co. v. Comm'r, 412 F.2d. 1341, 1344 (7th Cir. 1969)).

A Walk-through – Regulations That May Be At Issue

- Treas. Reg. 1.446-1(e)(ii)(d)(2)(i) – A change in the "depreciation or amortization period of recovery, or convention of a depreciable or amortizable asset" is a CIAM. (Reg. was issued under 7805)
- IRS view is that the statute and this reg. cover a change from depreciable to non depreciable classification (i.e., depreciable property to land).
- The argument will be that an allocation to land increases basis. Basis reduces gain and thus Gross Income and (after deductions) Taxable Income. Depreciation does not reduce Gross Income but is deducted from Gross Income to arrive at Taxable Income. So, assuming the property is sold, life time Taxable Income is the same.
  - Comment: What about 1031 exchanges and step-up-at-death? Or, what if land is sold and the increased basis will reduce the Section 1231 gain, and possibly reduce future 199A deductions, which is a new deduction for years 2018, forward. Some of the properties at issue were depreciated pre 2018. So the change results in less life than Taxable Income than if no change occurred??

Qualified Appraisal and Form 8283 Issues
Appraisal Issues for In Kind Donations

- Facts
- Section 170(f)(11)(A)(i) provides that no charitable contribution deduction is allowed unless the taxpayer meets certain requirements.
- (B) requires the taxpayer to "include with the return . . . a description of such property and such other information as the Secretary may require . . ."
- (C) requires that for donations over $500,000 the taxpayer must "attached to the return a qualified appraisal of [the donated] . . . property."
- Section 170(f)(11)(H) – IRS can issue regulations
- Reg. 1.170A-13(c)(2)(A) must attach a qualified appraisal to the return; and (2)(B) must attach the appraisal summary.
- Reg. 1.170A-13(c)(4)(iv)(H) – Reasonable Cause

Qualified Appraisal and Form 8283 Issues
Appraisal Issues for In Kind Donations (cont.)

- Arguments
  - Qualified Appraisal
  - Taxpayer must provide sufficient information to permit the IRS to evaluate the reported contributions, as intended by Congress. See Mohamed v. Comm'r T.C. Memo 2012-152, quoting the Estate of Clause v. Comm'r 122 T.C. 115, 122 (2009). The qualified appraisal and Form 8283 that was attached to the 1040 meet this test.
  - Form 8283
  - Note: RERI Holding I, LLC et al v. Comm'r, 149 T.C. No. 1 No. 17-1266 (5/24/19) Aff'd USCA DC (2019) case disallowed a $33 Million charitable contribution deduction because basis was missing on the Form 8283. Does not indicate if the taxpayer attempted to "fix" the Form 8283.

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Qualified Appraisal and Form 8283 Issues
Appraisal Issues for In Kind Donations (cont.)

- Strategy
- "While the Service has never requested that the defects on the Form 8283 alleged in the Revised Lead Sheets at issue be corrected, a new Form 8283 is being faxed to you. The Taxpayer is providing the IRS with a new Form 8283 that is signed by the appraiser and donee. Also, the basis of the donation at issue is included on this form.

  As noted in the instructions to Form 8283, failure to attach a correct Form 8283 to a tax return will not result in a contribution deduction being disallowed if the failure is due to reasonable cause and not willful neglect. See instructions to Form 8283 at 8 (Rev. December 2021).

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Qualified Appraisal and Form 8283 Issues
Appraisal Issues for In Kind Donations (cont.)

Further, Treasury Regulation Section 1.170A-13(c)(4) and (c)(4)(iv)(H) note that a taxpayer is allowed to explain if he or she has reasonable cause for an inadequate Form 8283. The same regulation allows the IRS to request that a taxpayer provide a correct Form 8283 within 90 days. If this request is complied with the charitable deduction will not be disallowed as long as the taxpayer's error was in good faith. See Treas. Reg. § 170A-13(c)(4)(iv)(H).

In the instant case the Service has not requested that the alleged defects noted in the Revised Lead Sheets on the Form 8283 be corrected."

Case To Watch

- Tribune Media Co. v. Comm'r, T.C. Memo. 2021-122 Appeal Pending Dkts. 23-1135, 23-1136, 23, 1243 (7th Cir.)
  - At issue is the partnership anti abuse rule under §1.701-2(a)(1). Is this a Reg. authorized under 7805(a) and the mere summary of anti abuse law traceable to Gregory v. Helvering or, should the Reg. be afforded nothing more than Skidmore deference.

Accuracy Related Penalty

- Section 6662(a) & (b)(1)
  - Statute that imposes a 20% penalty for disregard of the rules and regulations
  - Now that a regulation is entitled to for less deference, does this do to the statute? Especially with a Section 6664 Reasonable Cause Defense.

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Disregard of Rules or Regulations

- Is defined as any "careless, reckless, or intentional disregard"
  - Section 6662(c)

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Reasonable Cause

- Defined as Ordinary Business Care and Prudence
- Section 6662 Penalty can be avoided by showing reasonable cause (in most-cases)
- Proof of Reasonable Cause, when arguing reliance on a professional – 3 part test
  - Advisor was competent and had significant expertise to justify reliance
  - Taxpayer gave advisor adequate and necessary information
  - Taxpayer relied in good faith upon the advisor

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Raising Reasonable Cause Can Waive a Privilege

- CAUTION:
- Raising the assertion of reliance on professional advice constitutes reasonable cause probably waives the attorney/client privilege and the Section 7525 privilege.

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Raising Reasonable Cause Can Waive a Privilege (cont.)

- IRM 20.1.5.6.4 (January 24, 2013)
  (If the taxpayer claims a tax memorandum or advice is privileged, the IRS will not abate the penalty)
- Comment: Would the IRS assert a penalty to force a privilege waiver?

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SALT Ramifications

- WI – Tetra Tech EC, Inc. v. W. WDOR, 382 Wis.2d 496 (2018)
  - Not bound by agency but will give “due weight” to the agencies experience, technical competence, and specialized knowledge under Section 227.57(10), Wis. Stats.
  - Very disjointed opinion.
- IL – Hartney Fuel Oil v. Hamer, 998 N.E. 2d 1227 (Ill. 2013)
  - Illinois Department of Revenue regulations are entitled to substantial weight and deference. Regulations enjoy a presumption of validity
- FL – Amendment 6 to Florida’s Constitution now requires courts to interpret statues de novo. FLA. CONT. art. V §21(11/6/2018)

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Other "Hot Issues"

- High Net Worth Audits
- Real Estate Professional Status
- Airplane Cases
- Family Office Planning
- The Research Credit – IRS & WDOR
- Interest in Form 941 Cases

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- IRS Announces New Pass-Through Unit to Scrutinize Wealthy
- By David van den Berg

- Law360 (September 20, 2023, 6:33 PM EDT) – The Internal Revenue Service will launch a new group focused on scrutinizing pass-through organizations as part of its broader plan for beefing up enforcement work against the wealthy, according to an agency statement. . . [A] new unit scrutinizing pass-through organizations is part of a previously announced plan. . . to ramp up enforcement work against high-income earners, corporations and partnerships.

- The agency said the initiative will drill down on large or complex pass-throughs. . . to ramp up enforcement work against high-income earners, corporations and partnerships. . .

- The pass-through group will be housed in the IRS' Large Business & International Division, according to the agency. The pass-through entity's workforce will eventually also include current employees in both Large Business & International and the Small-Business & Self-Employed divisions, the agency said. The IRS' statement also said the pass-through group will include the more than 3,700 revenue agents it plans to hire for expanded enforcement work geared toward large corporations and complex partnerships. . .

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IRS Announces New Pass-Through Unit to Scrutinize Wealthy (cont.)

- The IRS' strategic plan for the funding increase provided by the Inflation Reduction Act called for expanded enforcement work against large partnerships and said the agency would hire specialized compliance workers and train others to help ensure pass-through entities comply with the law. . .
- Greater resources are needed to evaluate the compliance of pass-through entities, especially large and complex ones, and pass-through audit rates dropped because of funding cuts, the agency said. . . [its] the strategic plan. The agency audited 4.4% of pass-throughs in 2010, and the rate dropped to 0.1% in 2017, the most recent year with nearly all audits closed, according to the plan, which was released in April.

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High Net Worth Issues

- Responding to Information Document Requests can be very burdensome, with a number of practical and ethical concerns
- IRS Counsel is often involved through the audit
- Often if information is not produced by the IDR deadline the IRS will issue a pre-summons letter and then an IRS summons

High Net Worth Issues

- Some examples of the broad scope of high net worth audits include
  - Estate and Gift Tax Issues
  - **Valuation Issues**
  - Executive Compensation
  - C corporation and S corporation Issues
  - **Noncash Charitable Contributions**
  - **Partnership and LLC Issues**
  - Passive Activity Loss
  - Foreign Trusts
  - Foreign Bank Account Reporting
  - Basis and At-Risk Issues
  - Transfer Pricing Issues
  - **Private Airplane Issues**

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Airplane Cases

- Use a Partnership or Corporate structure
- SIFL or §274-10(e)
- Personal Entertainment v. Non-Personal Entertainment
- SIFL is much more favorable than §274-10(e)
- Avoid Schedule C Structure – CCA 202117012 (4/30/21)
  - IRS: Can not pay a fringe benefit to a sole proprietor so income is not SIFL income. Simply disallow all personal expenses. Unclear how to measure expenses.

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Airplane Cases (cont.)

- Section 280F
  - Leasing Trap
  - Here's a new one – a single member LLC is not a single member LLC

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Airplane Cases (cont.)

- Depreciation and the Section 280F trap
- Need 51% business use to take accelerated depreciation. The first 25% of business use cannot be a rental to a related party.
- Entertainment Facility trap
  - No deduction is allowed for an entertainment facility. §274(a)(1)(B). Transportation entertainment facilities are deductible if the facility is used in pursuit of a trade or business. §1.274-2(b)(1)(iii)(1); TAM9608004. If a partnership or corporation use SIFL or §274-10(e). If a Schedule C, see CCA 202117012. Need to document the business purpose for the airplane.

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Airplane Cases (cont.)

- Section 183 – Hobby Loss
  - Business Plan
  - Factors §1.183-2(b)

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Airplane Cases (cont.)

- IRS Activity
  - IRS Notice – IR – 2024-46 (2/21/24)
  - LB&I "Campaign" Issue

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Passive Losses and the Real Estate Professional

- Section 469
- Rental Real Estate
- Real Estate Professional
- Proving Material Participation
- Make a Grouping Election – watch limited partnership trap

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Passive Losses and the Real Estate Professional

- My Worst Nightmare
  - 280F – Airplane Leasing Trap and/or
  - 469 – Passive Loss Argument
- Rental is Per Se Passive
  - Need a “Dry Lease” for FAA reasons

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Passive Loss Rules

- Limit a taxpayer from deducting losses and excess credits from a passive activity against income from nonpassive activities. I.R.C. § 469(a).
- A passive activity is one that:
  - Involves the conduct of a trade or business in which the taxpayer does not materially participate. I.R.C. § 469(c)(1).
  - Is a rental activity. I.R.C. § 469(c)(2).

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Passive Loss Rules (cont.)

- Establishing Material Participation.
  - A taxpayer materially participates in an activity if, and only if, the taxpayer meets one of the following seven tests:
    - Work done in a taxpayer's capacity as an investor does not count toward the 500 Hour test, unless the taxpayer is directly involved in the day-to-day management or operations of the activity. Treas. Reg. § 1.469-5T(f)(2)(ii).
    - Investor activities include studying and reviewing financial statements or reports on an activity, preparing studies or analyses of the activity's finances or operations for the taxpayer's own use, and monitoring the activity's finances or operations in a nonmanagerial capacity

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Passive Loss Rules (cont.)

- Facts and circumstances. Treas. Reg. § 1.469-5T(a)(7).
  - Taxpayer can establish material participation by regular, continuous and substantial involvement in an activity based on all the facts and circumstances
  - Must participate in activity for more than 100 hours. Treas. Reg. § 1.469-5T(b)(2)(iii).
  - Caution! Services performed in the management of an activity are disregarded unless:
    - No other individual is compensated for performing management services in connection with such activity; and
    - No other individual performs management services that exceed the hours spent by the taxpayer. Treas. Reg. § 1.469-5T(b)(2)(ii).

Passive Loss Rules (cont.)

- A taxpayer must establish hours of participation under the seven tests.
  - Any reasonable means of proof is sufficient to establish hours of participation. Treas. Reg. § 1.469-5T(f)(4).
  - Courts and the IRS are skeptical when a taxpayer makes extravagant claims on the number of hours of participation.
  - Courts generally do not accept "post-event ballpark guesstimate" of hours unless supported by credible testimony and other objective evidence
  - Taxpayers are recommended to keep careful records of participation
  - Practice Tip
    - Use an affidavit
    - A client interview

Passive Loss Rules (cont.)

- Special Rules for Real Estate Rental Activities.
  - Taxpayers who qualify as "real estate operators" may treat their real estate rental activities as nonpassive upon a showing of material participation. I.R.C. § 469(c)(7).
  - To qualify as a "real estate operator":
    - For CHCs:
      - More than 50% of the corporation's gross receipts for the year must be derived from real property trades or businesses in which the corporation materially participates. I.R.C. § 469(c)(7)(D)(i).

Passive Loss Rules (cont.)

- For individuals:
  - The taxpayer must satisfy the two following requirements:
    - More than one half of all personal services performed in trades or businesses must be performed in the real property trades or businesses; and
    - More than 750 hours of services must be performed in real property trades or businesses in which the taxpayer materially participates. I.R.C. § 469(c)(7)(B).
  - Personal services include any work performed by the individual in the connection with a trade or business, except for:
    - Worked performed by an individual in the individual's capacity as an investor. Treas. Reg. § 1.469-9(d)(4).

Passive Loss Rules (cont.)

- Services performed as an employee, unless the employee is a 5% owner of the employer. I.R.C. § 469(c)(7)(D)(ii).
  - Practice Tip: When looking to purchase Real Estate (e.g., Apartment Buildings), document that the activity is not investment activity
- Services of the taxpayer's spouse cannot be combined to satisfy either of the two requirements. Treas. Reg. § 1.469-9(c)(4).
- Caution! Rental activities held through a passthrough entity constitute a single interest if the entity grouped its real estate as a single activity. Treas. Reg. § 1.469-9(h). However, if a taxpayer owns directly or indirectly a 50% or greater interest in the passthrough entity, each interest in rental real estate is treated as a separate interest unless the taxpayer makes his or her own election to treat all interests in real estate as a single activity.

Family Office Planning

- Lender Mgmt LLC V. Comm'r, T.C. Memo 2017-25
- Family office takes a profits interests in investments and is treated as a trade or business.
- Has to be a real trade or business

The Taxpayer Has Two Business Argument

- Example – Real Estate
- - 1.469 – 9(e)(3)(i) – Trap
  - May net group rental real estate with any other activity (i.e., group rental real estate with development to determine material participation in the rental real estate.
  - Comment: Are they really separate activities or is development and rental "one activity."

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Section 41 Research Credit

- Four Tests
- Funded Research

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Interest Free Adjustments in Form 941 Cases

- Employee v. I.C. Issue
- ERC Audits

Interest-Free Adjustments

- Generally, for employment tax (i.e., Form 941 obligations), if the adjustment to the Form 941 (i.e., the tax deficiency) is
  - paid on or before the due date of the 941 for the period in which the error is "ascertained,"
  - the amount of the underpayment shall be paid without interest being charged.
- An error is ascertained when resolved at examination or with appeals.

Interest-Free Adjustments (cont.)

- If, however, the case is not resolved at Appeals and the taxpayer receives a notice and demand for payment from the IRS, the adjustment will not be interest free.
- In addition, the taxpayer will not be allowed an interest free adjustment where a prior audit found that additional tax was due with respect to the same issue.

Valuation Checklist

- The Cover Letter – Summary
- Who is the retaining party and other intended users?
- Use the Correct Definition of Fair Market Value ("FMV"), FMV for a gift, Treas. Reg. Section 25.2512-1 defines fair market value as
  - [T]he price at which property would change hands between a willing buyer and a willing seller, Neither being under any compulsion to buy or sell and both having reasonable knowledge of the Relevant facts

Valuation Checklist (cont.)

- The "as of" or date
- Purpose of the valuation and intended use (e.g. estate and gift tax purposes)
- Type of asset and interest being valued (i.e. a minority interest . . .)
- Control Rights - in any
- Access to Liquidity
- The Scope of Work
- Information Considered
- Methodologies Utilized
- Fair Market Value Conclusion

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Valuation Checklist (cont.)

- The Report- Body
- Standard of value – Define FMV again
- Purpose of the valuation
- What is being valued?
- Prior transactions if any
- Rights, preferences, and privileges of interest being valued
- Economic overview / market conditions
- Company specific information
- Methodologies used to determine FMV (Holding Company v. Active Business).

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Valuation Checklist (cont.)

- Discounts. Do not rely only on case law. Berg Estate v. Comm'r, T.C. Memo 1991-279
- Explain the weight given to each methodology used. Otherwise if one methodology is rejected, the whole report any fail. True Estate v. Comm'r T.C.Memo 2001-167 aff'd., 390 F.3d 1210 (10th Cir 2004)
- Tax Affecting Earnings if an S Corp. or Partnership. Calculation both ways. Recent Cases, Kress, Estate of Jones. If do not tax affect, can the marketability discount be increased.
- Do I need a good Form 8283?

Valuation Checklist (cont.)

- Justify the discount rate being used in the calculation
- Statement of qualifications that meets Tax Court Rule 143
- Exhibits showing calculations
- What is the FMV of the interest being valued?
- Signed certification

Ethics Hypothetical

- We are preparing a tax return for a new client's parents. The parents are planning on donating land, which has been previously used a quarry, to the local municipality and taking a deduction for the donation. There is an easement on the land that mirrors local law.
- We select the appraiser, who we have used in the past to value a service business (i.e., an insurance agency). The appraisal comes back, after numerous revisions and drafts from our out of state appraisal firm. The firm values the property at much higher than the client expected. We rely on the appraisal. The number seems great! We send an e mail to the family saying that we like the appraised value for deduction purposes. Ultimately, with our help, the parents long time CPA prepares and signs the parent tax return.
- Do you prepare the tax return, claiming the charitable deduction for the amount of the appraised value. What are the ethical issues?
- If there is a tax audit a few years later, what are the additional ethical issues? Note, the audit could go very well, the IRS does not have the budget approval to obtain an appraisal.

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Michael Goller Thoughts

- Who is my client. Define. Is there a conflict?
- Circular 230 Section 10.29 (and AICPA -Conflict of Interest ("COI")
- Scope of services in the engagement letter
- Circular 230 Section 10.22 – Diligence
- AICPA – Code of Prof Conduct Art. V - Due Care
- Circular 230 Section 10.35 Competence
- Circular 230 Section 10.34 – Talk about disclosure (see chart om slide 78)
- Who is the return preparer – AICPA rules make it clear

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Michael Goller Thoughts (cont.)

- Circuit 230 Section 10.37(b)– Reliance on Written Advice and our written advice must be reasonable.
- Frivolous Return - Circuit 230, AICPA Due Care and Section 6694– Frivolous Return
- What is privileged Section 7525, A/C, Spousal
- Kovel Letter – how to get an appraisal.
- Does the appraiser know local law? All appraisals are local.
- Section 170(f) and 1.170A-13 – Qualified Appraisal
- Need a good Form 8283

Michael Goller Thoughts (cont.)

- New AICAP rules – nonsigning is still a return preparer.
- Circular 230 Section 10.3 Practice before the IRS who signs the POA.
- Circuit 230 – COI – Practitioners' own interest
- Circular 203 10.36 Department management
- Circuit 230 10.20 to 10.23 –Cooperation with IRS
- Burden of Proof Section 7491 - Cooperation