

The 2001 Tax Act A Vanishing Act

C. Wells Hall III
Interviewed by Jerald David August

Reprinted from the January/February 2002 Issue of Business Entities



Q:What is your favored entity for engaging in business operations and how has your choice varied over the past ten years?

A:For real estate ventures, I recommend the manager-managed limited liability company. An LLC provides limited liability and the tax advantages of a partnership, including the pass through of losses to members and an inside basis adjustment when the outside membership interests are transferred on sale or the death of a member. I know that some states impose franchise taxes and entity level taxes on LLCs, and in that case, I would go with the limited partnership to operate a real estate venture.

For other business operations, the choice of entity depends primarily on the nature and type of the owner or owners. The LLC is the most flexible from the standpoint of admitting nonindividuals as owners, including corporations, partnerships and other LLCs. If you want the entity to be a member of a consolidated group, of course, we choose a domestic corporation or an LLC electing association treatment, and in some cases we choose a single-member LLC defaulting to disregarded entity treatment. If you want to break consolidated group status for some

reason, we use a partnership, an LLC, or an intervening foreign corporation.

Finally, if we are dealing with a group of individuals, with no venture capital funds or corporate investors, and we have no need for a preferred return to an investor, an S corporation may be the entity of choice. This is especially the case if all of the shareholders are active in the business, when it may be desirable to cap the salaries at reasonable levels and pass through the income to the shareholders free of the 2.9% health insurance tax, which now applies to all self-employment earnings. Interestingly enough, most clients are willing to forgo some of the fringe benefits denied to S corporation shareholders (compared with employees of a C corporation), provided they can minimize the HI tax. Of course, these fringe benefits would not be available to a member of an LLC, either.

My choice of entity decision is different today than it was ten years ago. Ten years ago, LLCs were not recognized under state law, at least in my part of the country. We used limited partnerships and general partnerships to own real estate. When we wanted limited liability, we formed an S corporation to

serve as the sole corporate general partner of the partnership. We were careful to comply with the four-factor test established in the regulations after the Supreme Court's decision in *Morrissey* to ensure partnership treatment. LLCs have streamlined the choice of entity decision today.

Q:Where your client is a C corporation, is your first inclination to consider converting to S corporation status?

A:My first inclination is to determine why the corporation is not an S corporation already. Sometimes there is a historical reason that no longer exists. Sometimes the shareholders have been deterred by the differential in rates between corporate and individual taxpayers, and they have not analyzed the long-term effects. The anticipation of the sale of the business and the tax on built-in gains during the ten-year recognition period has been a consideration during the recent boom years. Now that the economic situation is less promising, I am recommending that clients look at it again, since the built-in gains component may be lower than it was last year or the year before. If the economy turns around and a sale of either the stock or assets occurs during the next ten years, we may have

capped the double tax to the amount of the current built-in gain. The pass-through of future earnings will increase shareholder level basis and minimize the capital gains tax. The cost of the Section 338(h)(10) election, which is usually important in an acquisition context, resulting in a deemed asset sale, is not as great for the seller of an S corporation.

Of course, there are many situations where a C corporation provides enough benefits to justify not making the S election, including the availability of fringe benefits to shareholder employees, and where the existence of an ineligible shareholder precludes an S election. Hopefully, with favorable legislation, we will be able to consider the S election in more of these situations in the future.

Q:Where a C corporation is considering converting to Subchapter S, what are the main variables involved?

A:Let's assume the corporation is over the hurdle of having all eligible shareholders, or that you are going to redeem or buy out an ineligible shareholder to make the corporation eligible for the S election. Also, we will need to end up with one class of stock except for differences in voting rights, so a recapitalization may be necessary, coupled with

redemptions of preferred shareholders.

Assuming all of this is possible, you first need to consider the disadvantages of the S election and make sure that they do not outweigh the advantages. This may seem backwards to some, but the disadvantages are usually the reason that an S election has not already been made or that it should not be made. The imposition of the BIG tax on assets disposed of during the ten-year recognition period should be factored in. The inclusion of the LIFO reserve in taxable income of the corporation in its final C year may be a factor. If the corporation has substantial passive income, the tax on excess passive income will be a major negative if the corporation has undistributed C earnings and profits. Denial of certain employee benefits provided by the corporation to 2% or greater shareholders may be an important consideration.

The calendar year requirement, or use of a year resulting in a three month or less deferral, hardly ever prevents a corporation from making an S election today.

Once you identify the disadvantages, you may be able to address them and mitigate them one by one. For example, the BIG tax will be triggered if there is a sale of the business within ten

years, but now may be a good time to cap the BIG tax, because of projected future earnings, growth, and appreciation. The payment of tax on the difference between the LIFO and FIFO inventory amount is spread over four years and may be insignificant. Employees can now deduct much of their health insurance premium cost on their individual returns, and may not value other corporate provided fringe benefits enough to forgo the S election.

Once you get over the disadvantages, the advantages of an S election push you over the top. The increase in basis for a shareholder resulting from the income of the corporation in excess of that required to pay individual level taxes, will more than outweigh the slight differential in tax rates. The 2001 tax bill further compresses the rate differential. An S corporation can distribute earnings with only one level of tax, and distributions to shareholders active in the business are not subject to the self-employment tax. A significant consideration is the 2.9% HI tax on self-employment income, which does not have a cap. S corporations are not subject to the corporate AMT. Nor are they subject to the accumulated earnings tax or the personal holding company tax. Net losses are passed through to shareholders and may be taken into account to the extent of shareholder basis, subject to the passive loss rules and the at-risk limitations. Losses of a C corporation do not pass through to shareholders, but are allowable as deductions only against future taxable income under the NOL carryover rules. Shareholders can deduct the interest on debt incurred to purchase S corporation stock against their share of income from the S corporation.

Wells Hall is a partner in the Tax Transactions Practice Group of the Charlotte, North Carolina, office of Mayer, Brown, Rowe & Maw. He is active in the Section of Taxation of the American Bar Association, having served as Chair of the S Corporation Committee from 1996 through 1998, and is currently a member of the Committee on Committees. He is currently a member of the Board of Regents of the American College of Trust and Estate Counsel. He is a former Chair of the Tax Section of the North Carolina Bar Association (1986-1988) and a past Chairperson of the National Association of State Bar Tax Sections (1990-1991). He is a member of the Board of Advisors of this Journal. Wells has published numerous articles in leading tax periodicals and served as a speaker on S corporation and estate planning topics at a number of tax institutes. Jerald David August, who is Editor-in-Chief of this Journal, is a partner in the West Palm Beach, Florida, law firm of August & Kulunas, currently serves as a member of the Council of the ABA Section of Taxation, is a former Chair of the ABA's S Corporation Committee, and is a nationally recognized and widely published tax authority.

Clients always ask why they can't convert a C corporation to an LLC. This would be prohibitively expensive from a tax standpoint since a corporate level and shareholder level tax would be incurred on the liquidation of the corporation. Conversion from C to S is still seamless from a tax standpoint, except for the taxation of the LIFO reserve and the BIG tax on sales of assets during the recognition period. The latter can be controlled, and at least the corporation has the money to pay the taxes from the sale of assets during the recognition period, or Section 1031 exchanges can be arranged.

Q:In the estate planning area, recent legislation introduced the electing small business trust to hold S corporation stock. Compare the practical differences between the ESBT and the single income beneficiary qualified Subchapter S trust? When would you recommend one over the other?

A:The most common example of the use of a QSST in an estate plan is the QTIP marital deduction trust holding S corporation stock during the life of the surviving spouse. There is only one beneficiary during the life of the surviving spouse. No distribution of income or principal can be made to anyone other than the surviving spouse. Income must be distributed on an annual basis to the surviving spouse to qualify for the marital deduction for estate tax purposes. These same QTIP criteria will make a trust eligible to hold S corporation stock upon its election to be treated as a QSST.

On the other hand, an ESBT can have multiple beneficiaries and need not require the current distribution of income. The statutory requirements set forth in Section 1361(e)(1) include the

requirement that the beneficiaries are individuals, estates, or certain nonprofit organizations. No interest in the trust may have been acquired by purchase. A timely ESBT election must be filed within two and a half months of the transfer of the stock to the trust. Finally, it cannot also have made a QSST election with respect to the stock of the same S corporation, and the trust cannot be an exempt trust. The potential current beneficiaries, under the proposed regulations are all counted for purposes of the 75-shareholder limitation, and all of them must be permitted S corporation shareholders.

From a substantive standpoint, the biggest difference between an ESBT and a QSST is the fact that an ESBT is taxed at the trust level at the highest marginal rate on the income attributable to the S corporation stock. On the other hand, a single beneficiary of a QSST is taxed directly on the income attributable to the S corporation stock, whether or not it is distributed. In both cases, an election must be timely filed. In the case of a QSST, the beneficiary must consent to the election. This is not required for an ESBT election, which may be made by the trustee.

Because of the tax rates, we usually recommend that the estate plan of an S corporation shareholder be structured around QSSTs rather than ESBTs. This makes estate planning for S corporation shareholders less flexible. Where sprinkling of income is important, as in the case of an incapacitated beneficiary, we may recommend the ESBT election to avoid the current income distribution requirement.

Q:What additional reforms are needed to the ESBT rules?

A:While the proposed regulations address many of the open issues that have arisen under the statutory provisions providing for ESBTs, there are still a number of problems. The eligibility of a grantor trust to make the ESBT election and the taxation of partial grantor trusts are still significant issues. Tax practitioners rarely plan to make the ESBT election; it is only there as a backup in the event a complex trust ends up holding S corporation stock and there are no other options if the S election is to be continued. Still, we are thankful that the ESBT is there as a backup plan on the death of the S corporation shareholder.

The final ESBT regulations will hopefully provide that an ESBT election can be made with respect to the grantor trust portion of a trust and override grantor trust treatment. Tax would be paid at the higher rate but reporting and compliance would be simplified. After all, ESBT status is elective — why shouldn't a grantor trust be able to elect to be taxed as an ESBT with respect to the S corporation stock owned by the trust?

We would like to see a complex trust eligible to own S corporation stock, perhaps with some limitations to prevent the end run around the shareholder limitations, and provide that the trust is taxed under the normal rules of Subchapter J. If income is distributed to beneficiaries, it would carry out distributable net income sourced from the S corporation. If the trust accumulates income, it would be taxed at the trust level. We have been dealing with the same issues for years when a partnership interest is held by a complex trust. There is no substantive reason why S corporation income of a complex trust should not be taxed the same

way. The obstacle to reform in this area is revenue driven, since taxing an ESBT at the maximum individual rate was the tradeoff for making a complex trust eligible to hold S corporation stock in 1996. We need to continue to work to get legislation permitting a complex trust to hold S corporation stock without the complex ESBT rules.

Q:After 1996, an S corporation can have an ESOP as a shareholder. How can this new reform be used effectively and what limitations are there to its use?

A:The Small Business Job Protection Act of 1996 first permitted qualified plans, including an ESOP, to hold stock in an S corporation. Under the original legislation, the trust was required to treat the interest in an S corporation as an interest in an unrelated trade or business. Items of income passed through from the S corporation and any gain or loss on the disposition of stock in the S corporation was unrelated business taxable income. The Taxpayer Relief Act of 1997 repealed the UBTI provisions of the SBJPA as they relate to ESOP shareholders of an S corporation. Qualified plans that are not ESOPs are still subject to UBTI. As a result of the '97 legislation, the income passed through to the ESOP and any gain on the disposition of S corporation shares by the ESOP is not subject to current tax.

The '97 legislation also permitted S corporation ESOPs to require that participants take distributions in the form of cash instead of stock, and extended the scope of the prohibited transaction exemptions to permit the purchase of stock by an S corporation ESOP from a party in interest or a disqualified person.

In the 2001 tax bill, Congress decided that the S corporation ESOP was too good to be true, at least for closely held and family S corporations. The new tax bill includes an anti-abuse provision. The anti-abuse provisions are triggered if disqualified persons own 50% of the S corporation's outstanding stock. The anti-abuse rules impose an excise tax on the allocation of S corporation stock to the account of disqualified persons, treat the allocation as currently taxable to the participant, and impose an excise tax on any synthetic equity, which includes stock options, warrants, and restricted stock, or other rights that give the holder the right to acquire or receive stock of the S corporation in the future.

Under the new law, it will be difficult to establish an S corporation ESOP without providing broad-based employee coverage and benefiting rank-and-file employees as well as the highly compensated shareholders. The new law is effective immediately for new ESOPs. For existing S corporation ESOPs, the anti-abuse provision is effective for plan years beginning after 12/31/04. This gives existing S corporation ESOPs time to wind down or restructure in order to avoid the sledgehammer effects of the new excise taxes.

There are still significant tax advantages for using an S corporation ESOP in the buy out of substantial S corporation shareholders, taking a company private, and setting up a 100% owned S corporation ESOP that will avoid the anti-abuse provisions. The new anti-abuse provisions, on the other hand, continue to be a trap for the unwary.

Q:The one-class-of-stock rule has been an impediment to S

corporations having access to capital. How do the one-class-of-stock regulations resolve this problem and is additional help needed? If more help is needed, what form should such additional relief take?

A:The single-class-of-stock regulations contain a number of friendly rules and safe harbors that permit S corporations to issue restricted stock, options, warrants, and subordinated debt to permitted S corporation shareholders. However, there are significant limitations on issuing equity positions to venture capital investors not otherwise eligible to own S corporation shares directly. A tiered partnership or LLC arrangement can be used, but it is somewhat cumbersome and involves a second entity. If the entity structure is not already in place, you would probably choose an LLC as the entity for the business, or go with a C corporation with convertible preferred stock, as was the case in venture capital deals in the information technology era.

We have been advocating a proposed amendment to Section 1361(f), permitting S corporations to issue preferred stock for several years. It is included in the Subchapter S Modernization Act of 2001, introduced by Senator Hatch. The approach is simple. An S corporation would be permitted to issue qualified preferred stock, meeting the requirements of Section 1504(a)(4)(A), (B), and (C), which is already a term we are familiar with in the Code. The holder of qualified preferred stock in an S corporation would not be treated as a shareholder of the corporation. Therefore, the holders of preferred stock would not be limited to permitted S corporation shareholders. Qualified preferred

stock in an S corporation could be convertible into other stock. We have proposed that dividends on qualified preferred stock issued by an S corporation be treated as an interest expense of the corporation and interest income to the holder.

The qualified preferred stock proposal would permit venture capital funds to hold S corporation stock, and eliminate the need for an S corporation to enter into a joint venture arrangement with an investor who requires a preferential return. In other words, we would be able to do directly what we can do only indirectly today.

Q:What other rules in Subchapter S would you like to see changed or liberalized? What about an amendment that would permit nonresident shareholders, or allow all members of a family to count as a single shareholder?

A:The Hatch bill permits nonresident aliens to hold S corporation shares. Section 1446 would be amended to require an S corporation to withhold and pay a withholding tax on effectively connected income allocable to its nonresident alien shareholders. There is a possibility that the current provisions of Subchapter S violate U.S. international tax treaties that preclude discrimination against non-resident aliens, so this provision may be important for diplomatic reasons.

While the 75-shareholder rule takes care of most closely held situations, the treatment of the members of a family as one shareholder would expand the availability of Subchapter S to extended multi-generation family-owned businesses. With such treatment, members of the family would include lineal descendants of a common ancestor, up to six generations removed. The election

would still require the consent of all shareholders. Provided the corporation making the S election is willing to handle the reporting requirements of a large number of shareholders, this provision can only extend the utility of Subchapter S to situations anticipated by the original concept of a mom and pop operation.

Another important provision in the Hatch bill is the one authorizing convertible debt. The convertibility feature would not automatically disqualify debt as safe harbor debt, provided the terms of the convertible debt, taken as a whole, are substantially the same as the terms that could have been obtained from unrelated, arms-length lending institutions or venture capital investors.

Other important provisions of the Hatch bill would repeal excess passive investment income as a terminating event. We would like to see the bill amended to allow relief for inadvertent, invalid QSub elections and terminations, authorize exceptions to the application of the step transaction doctrine for QSub elections and terminations, provide for the taxation of ESBTs under Subchapter J, and grant basis to shareholders with back-to-back loans. The Hatch bill includes a provision reversing *Gitliz*, which would raise revenues to offset any losses from the taxpayer-friendly provisions of the bill. I do not believe the bill has been scored yet.

Q:What rules in the partnership area are too complex or confusing?

A:Frankly, I am not sure that I can agree with those who propose to scrap Subchapter K because of its complexity. As you know, the ALI Reporters Study on the Taxation of Private Business Enterprises advocated a single

conduit regime for the taxation of private business enterprises along the lines of a liberalized Subchapter S. Subchapter K was supposed to be dramatically improved or eliminated. The concepts of Subchapter C were rejected for private business because of Subchapter C's foundation in entity principles. The Reporters concluded that an entity level tax was a price that should be imposed only on public companies in return for their liquidity and their access to the capital markets. Private businesses, defined as those not traded on an established securities market, would all be granted conduit tax treatment.

The IRS recognized in 1996 that we have developed our business structures around entities classified as either partnerships or corporations, and that it should not be difficult for taxpayers to choose conduit or entity-level taxation, resulting in the liberalized check-the-box rules. Most of us are now very comfortable with the current regime. Sure, the substantial economic effect test of Section 704(b) is a complicated approach to preventing tax-motivated allocation arrangements. Creative taxpayers are able to use it to effectively allocate income and losses based on their tax positions, and obtain more favorable tax results than if they were allocated a straight percentage of income or loss. But the other anti-abuse provisions of Subchapter K provide safeguards against the abuse of a simple and flexible conduit system of taxation. Now that we have it, most of us are familiar with it, and we have a myriad of regulations and rulings in place to give us a roadmap for structuring arrangements. Why throw it all away and start over? I don't see that we should expend a lot of energy and capital in trying

to revamp the existing system based on its complexity.

Q:In the estate planning area, what are the most significant aspects of the transfer tax revisions made in EGTRRA? How will those changes affect estate planning? Will gifting be less favored? What about the sunset rule contained in the Act?

A:First of all, I have never aligned myself with those who oppose repeal of the estate tax based upon the need to limit the expansion of wealth or the many self-serving arguments that the estate planning bar and life insurance companies have advanced. However, the provisions of the new Act increasing the applicable credit amount to \$1 million in 2002, \$1.5 million in 2004, \$2 million and \$3.5 million in 2006 and 2009, are long overdue. I understand the budgetary restraints that caused us to sunset the full repeal after one year (full repeal in 2010 sunsets in 2011). I would like to see the gift tax exemption similarly increased.

Reduction of the rate to 50% in 2002 and 45% in 2009, followed by repeal, is overdue. Fifty-five percent is confiscatory.

As far as carryover basis is concerned, I think that we have learned before that it is unduly complex based upon our experience after the TRA '76, when carryover basis was enacted and then repealed. Some predict that this will happen again. Frankly, I believe that we can live with it provided the floor basis adjustment is adequate to cover most estates. Under current law, the \$1.3 million floor for estates needs to be raised substantially. The \$3 million basis adjustment for property passing to a surviving spouse seems disproportionate to the base floor of \$1.3 million. I'm

not sure that this was completely thought through, and it needs to be revisited.

The other significant provisions of the new law include a repeal of the qualified family owned business interest (QFOBI) deduction and expansion of the installment payment of the estate tax for closely held businesses. We would like to see the five-year deferral increased to ten years for qualified lending and finance businesses. There would be no revenue cost to this type of change, although the rules for scoring tax bills don't view the total cost because of the ten-year limitation on projecting tax revenues.

The 2001 Act changes will make estate planning easier for many estates. For larger estates, there is a new consideration with the possibility of repeal or lowering of rates. Why make taxable gifts and pay gift tax if the cost of transferring the assets on death may be reduced or eliminated?

In my view, the sooner Congress does something about the existing sunset provision, the better. We all know that it cannot stay like it is. The current administration should want to complete its legacy and either fully repeal the estate tax or complete the work that it started and make the higher exemptions and lower rates permanent.

Q:Knowing that further revisions are necessary, where do you see things ending up?

A:I would like to see the current administration set the exemption at \$3.5 million with a cost-of-living adjustment, put COLAs on the gift tax exemption, and raise the floor for carryover basis. Sure, future administrations can revisit the estate tax. But our clients will be able to plan for the

future and anticipate a stable tax system.

Q:There have been a series of recent cases in the Tax Court and in other courts dealing with family partnerships, most of which have been favorable to taxpayers holding or gifting interests in family businesses. What do you see as the most significant aspects of these decisions?

A:In a series of cases, the IRS's attack on family limited partnerships was addressed head on. The argument that the term "property" in Section 2703(a)(2) means the underlying assets in the partnership, and that the partnership form is the restriction that must be disregarded was rejected in *Strangi's Estate* 115 TC No. 35 (2000). The legal interest being valued is the interest in the limited partnership, LLC, or closely held corporation, and not the underlying assets. *Kerr*, 113 TC 450 (1999), another Tax Court case, and *Church*, 85 AFTR 2d 2000-804 (W.D. Tex. 2000), a District Court case, came to the same conclusions with respect to the application of Section 2703.

Kerr further held that Section 2704 did not apply to a family limited partnership because the partnership limitations were no more restrictive than the limitations allowable under the state limited partnership act. In *Knight*, 115 TC No. 36 (2000), the Tax Court once again held that Section 2704 did not apply to a family limited partnership, and also held that the partnership limitations were no more restrictive than state law.

Another IRS position is the "gift on formation" argument. This argument gained support when the Tax Court handed down its decision in *Trenchard*, TCM 1995-232, where it determined that

there was a gift on the formation of the corporation when the fair market value of the preferred voting stock taken back by the majority shareholder was less than the fair market value of the property contributed. It appeared that Trenchard had made a gift to the other shareholders because of the higher value of the real estate that he contributed, compared with the value of the other contributions. However, the Tax Court incorrectly assumed that the value of each shareholder's interest in the corporation must add up to the total value of the property contributed.

Unfortunately, the sum of the parts does not always equal the whole.

In *Shepherd*, 115 TC 376 (2000), the Tax Court held that there was a gift where contributions of assets of the taxpayer were allocated to the capital accounts of other partners. On the other hand, the court found in *Strangi* that when the contribution was allocated to the transferor's own capital account, when his beneficial interest in the partnership exceeded 99%, there was no gift at the inception of the partnership. With these cases, I think it is clear that practitioners can comfortably structure the formation of partnerships without exposure to the IRS's gift on formation argument, by ensuring that capital accounts are credited with the assets contributed by each partner.

Still troubling is the potential for the use of Section 2036 against limited partnerships. The IRS has achieved success in the Tax Court in *Estate of Reichardt*, 114 TC No. 9 (2000), where the decedent enjoyed the use of a personal residence that had been contributed to a family limited partnership and *Estate of Schauerhamer*, TCM 1997-242,

where the decedent continued to enjoy the property contributed to a limited partnership, retaining the right to income from the partnership assets during her lifetime.

Clearly, clients should not transfer personal residences and similar assets to limited partnerships, and a family member using assets should enter into a rental or lease agreement and pay a fair amount for it. Partnership assets should not be co-mingled with personal assets and personal expenses should not be paid out of the partnership account. As long as you follow these rules, there should not be any problems relating to Section 2036 with using a family partnership.

A very recent case law development in the valuation area is reflected in *Gross*, 88 AFTR 2d 2001-6858 (CA-6, 2001), where the Sixth Circuit affirmed the Tax Court's determination that in valuing an interest in an S corporation, the company's earnings should not be "tax affected" or reduced by an assumed corporate tax rate that would have applied if the company was a C corporation. This goes against the methodology used by a majority of appraisers. It is inconsistent with generally accepted accounting principles. It is inconsistent with the IRS training manuals and prior court decisions. The decision of the three-judge panel of the Sixth Circuit was a two-to-one vote. Judge Clay, who was outvoted, got it right. He concluded that the Tax Court's decision was clearly erroneous since it was based on a contested valuation approach, and suggested that the Commissioner should not act retroactively and reject a valuation method that had been consistently followed by the taxpayer. Unfortunately, Clay's

opinion reflected the minority view. Hopefully, we will get some better law in this area, or *Gross* will be limited to its facts in light of the persuasive analysis in Judge Clay's minority opinion. ■