TAX CONSIDERATIONS 101:
THE THEORY AND ART OF TRANSACTIONAL TAX PLANNING

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State Bar of Texas
ESSENTIALS OF BUSINESS LAW
COURSE 2016
March 3-4, 2016
Houston

CHAPTER 3

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Outside of his practice, Christopher enjoys astronomy and astrophotography, but has decreasingly been able to stay awake half the night looking at the stars since his 4 year old son was born. He also studies with the Dallas-Fort Worth branch of Schola Saint George, an international school of "chivalric" martial arts dedicated to promoting the study of Historical European Martial Arts.

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The purpose of this paper and the presentation to which it relates are a little different from the usual approach of a CLE presentation.

Tax law is constantly changing. Unless you regularly practice in that area, it is likely that all but the most fundamental aspects of tax law that this paper would discuss is likely to change before you would have a chance to put it into practice.

What doesn't really change is the *how* of practicing tax law. With a primer on tax research and enough fundamental tax law to enable the discussion, the true focus of this paper is an understanding of the mindset and approach that makes tax law advice valuable.

Accordingly, detailed discussion of any of the tax law referenced in this paper is beyond the scope of this paper. To do justice to even a single such provision would require a deviation from the main thrust of this paper longer than the paper itself. In each case, the reader should assume that this paper is discussing the general case in "broad brush stroke" terms only and that multiple layers of exceptions, exclusions, and special rules apply, leaving exceptions to the exceptions to the exceptions to the general rule. It is my intent to provide enough of a roadmap to Federal tax law that the reader retains before him or her the journey of discovery that awaits in delving into the depths of the issues that this paper can only identify as they fly quickly past. Nevertheless, even providing the slimmest of roadmaps to Federal tax law gives reading this paper the feel of "drinking from the firehose" and for that I sincerely apologize.

I. THE PLACE FOR TAX PLANNING

Before we can address the *how* of tax law, we must first understand the *why* and *where* of it. The *why* is, at its core, actually quite simple – helping clients structure their affairs to pay less tax.

The general public should be forgiven for seeing the tax lawyer and creative accountant as specializing in finding "loopholes" in the tax law. The reality is that while tax law might have gaps and holes (some of which are actually quite large), true "loopholes" are the exception. In the same way that criminal law informs us not only what is a crime but more importantly, what isn't a crime, tax law contains the roadmap of its own limitations.

In defining what is taxed and how, tax law also describes what isn't taxed or what is taxed to a lesser degree. And there is generally a reason why those items are not taxed or are taxed less. Non-taxable corporate reorganizations are non-taxable to allow businesses to restructure themselves as necessary to be more efficient in the marketplace without taxes getting in the way. Capital gains has a lower tax rate than other income to encourage investment over consumption. When one taxpayer is required to withhold tax from a payment to another taxpayer, it is generally because that is seen as the most efficient means for the tax to be collected (or sometimes, the only practicable way to collect the tax at all). While personal consumption is not generally tax advantaged, home mortgage interest is tax deductible to encourage home ownership.

Most of a transactional tax lawyer's work centers around navigating clients around those rules so that the best (read: lowest tax) answer can be found.

It is a taxpayer's right to structure their affairs as they see fit for the reasons they see fit. In the words of Learned Hand,

> Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.[1]

In the same way our duty to "zealously pursue clients' interests"[2] encourages us to identify ways that a client might improve his or her bottom line, it encourages us to help clients find ways to reduce taxes. If a client mentioned that one item in their business caused an overhead rate between one quarter and one half, you would pay close attention to that issue as part of pursuing your client's interests. Income taxes generally fall into this category.

But our clients' interests are not limited to their own taxes. A good attorney should also consider a counterparty's tax issues. Often, solving the other side's tax issues for them adds something to the negotiating table. If my client were buying something and I found a way to lower the *seller's* taxes by 5% without hurting my client, could a willingness on my client's part to help the seller be worth a 5% reduction of the purchase price?

There are, of course, limits.

First and foremost, there are rules and breaking those rules comes at a cost. Chapter 75 of the Internal Revenue Code of 1986, as amended (the "***IRC***"), defines a series tax crimes including felony "attempt to evade or defeat tax,"[3] and felony tax fraud.**[4]**

[1] *Helvering v. Gregory*, 69 F.2d 809, 810-11 (2d Cir. 1934).

[2] Preamble, Texas Disciplinary Rules of Professional Conduct.

[3] IRC § 7201.

[4] IRC § 7206.

For the client, there is more going on than just taxes. I frequently tell clients that "the tax tail should not wag the money dog." Losing a dollar of profit to save tax on that dollar is a losing proposition so long as tax rates are less than 100%.

Often, business reasons dictate that a tax planning technique is just not acceptable. Sometimes this is because the deal has already been negotiated to death and "deal fatigue" has set in preventing further changes. The true art of a transactional tax practice is in solving the tax problem without disturbing the non-tax issues.

While corporate directors have a duty to avoid waste, courts have been extremely reluctant to equate failure *for some reason* to engage in tax planning with waste. The Delaware Chancery Court has said on multiple occasions that

> This Court rejects the notion that there is a broadly applicable fiduciary duty to minimize taxes.[5]

But, that statement was based on the fact that there was an identified reason why the proposed tax planning technique would limit the business. Ultimately, this is a business judgment rule issue – is it a valid exercise of business judgment of the management of a company to decline to engage in tax planning. That does not mean that ignoring tax planning opportunities without good reason is acceptable.

Primary among those limits for attorneys are the ethics rules. Rule 3.03 of both the Texas Disciplinary Rules of Professional Conduct and the ABA Model Rules of Professional Conduct mandate candor toward the "tribunal." While this rule is written in terms of litigation before a court, "tribunal" is defined to include "administrative agencies." As tax returns include a "penalty of perjury" statement as part of the required signature,[6] advising a client to take a position contrary to applicable tax law on their return can be seen as implicating all of the perjury issues discussed in the comments under Rule 3.03.

Depending on the nature of the advice given, the IRS's own ethics rules within Circular 230[7], may also apply, adding even further ethical duties more tailored to tax practice. Circular 230 regulates those "practicing before the Internal Revenue Service," which includes something as ordinary for an attorney as "rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion."[8] Chief among the requirements imposed on a practitioner by Circular 230 include various duties with respect to solicitation of clients,[9] the requirements for written advice,[10] and various duties with respect to the management of a professional practice subject to Circular 230.[11]

Finally, tax return preparers are subject to various duties *and penalties* under the IRC.[12] While a tax return preparer includes someone who prepares a part of a return, it also includes (as part of the related term "nonsigning tax return preparer") advising a client "with respect to events that have occurred at the time the advice is rendered."[13] The regulations provide, in illuminating example, that:

> Attorney A, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding a completed corporate transaction. The advice provided by A is directly relevant to the determination of an entry on the taxpayer's return, and this advice leads to a position(s) or entry that constitutes a substantial portion of the return. A, however, does not prepare any other portion of the taxpayer's return and is not the signing tax return preparer of this return. A is considered a nonsigning tax return preparer.[14]

That seems an easy line to cross even if you don't think you're giving tax advice.

II. FINDING YOUR WAY AROUND - TAX RESEARCH

Tax law is a complex and ever-changing area of the law. Even experienced tax lawyers are continually researching and reviewing the relevant authorities to check for changes to existing authorities or new authorities.

Federal income tax law has been developed over generations of clever people trying very hard to structure their affairs for the best possible tax position squaring off against other extremely clever people

[5] *Freedman v. Adams*, 2012 WL 1345638 (Delaware Chancery March 30, 2012).

[6] For example, IRS Form 1040 U.S. Individual Income Tax Return, available at https://www.irs.gov/pub/irs-pdf/f1040.pdf, requires the taxpayer to sign that "Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete."

[7] Subtitle A of Part 10 of 30 C.F.R.

[8] Circ. 230 § 10.2(a)(4).

[9] Circ. 230 § 10.30.

[10] Circ. 230 § 10.37.

[11] Circ. 230 § 10.36.

[12] *E.g.* IRC § 6694 imposes a substantial penalty for tax return preparers in connection with an "unreasonable" position on a tax return of a client.

[13] Treas. Reg. 301.7701-15(b)(2)(i).

[14] Treas. Reg. 301.7701-15(b)(2)(ii) Ex. 1.

trying to reply in the form of additional Federal tax law. The state of Federal income tax law as we find it is the evolving result of those generations of what amounts to an arms race. As a general rule, even the strangest or most obscure provision or exception has behind it some story of the development of a technique, a counter-technique, a counter to that counter-technique, and so on.

As this paper concentrates on how to practice tax law instead of on tax law itself, it is therefore important to have a basic understanding of where to go to research tax law.

A. Code & Regulations

The core authority for Federal tax law is the IRC, housed in Title 26 of the United States Code. Particularly given its complexity, it is a relatively well-organized statute with a well-defined organizational structure (for which exceptions are surprisingly rare). It is broken into a series of subtitles on a subject matter basis. The income tax provisions are located in Chapter 1 of Subtitle A, with tax procedure described in Subtitle F. Chapter 1 is further broken into Subchapters that are further broken into Parts, often with multiple Subparts, each representing an outline-format organization of various topics. Some of the key segments of the IRC that you will see explored in this paper include:

- Subchapters C and S – tax of corporations,
- Subchapter K – tax of partnerships, and
- Part III of Subchapter O – certain nontaxable exchanges (including like-kind exchanges).

For example, IRC § 1001, which defines the calculation of gain or loss on the disposition of property is located in Part I (Determination of Amount of and Recognition of Gain or Loss) of Subchapter O (Gain or loss on Disposition of Property) of Chapter 1 of Subtitle A. IRC § 7701, which holds many key definitions for the IRC, is located in Chapter 79 (Definitions) of Subtitle F (Procedure and Administration).

Secondary only to the IRC are the IRS's regulations. These are part of Title 26 of the Code of Federal Regulations. Title 26 has only one Chapter, which is broken into Subchapters that generally mirror the Subtitles of the IRC. Those Subchapters are broken into Parts. Of the various Parts, the main two are:

- Part 1 – income tax, corresponding to Chapter 1 of subtitle A of the IRC; and
- Part 301 – procedure and administration, generally, corresponding to most of Subtitle F.

A given section of the regulations is identified by its Part number, followed by a dot, followed by a section number that (with few exceptions) reflects the Section number of the IRC to which the regulation relates (and sometimes a parenthetical letter identifying the subsection of the IRC to which the regulation relates), then a dash and a number indicating which such regulation it is. So, for example, IRC § 1001 (mentioned above) is part of Chapter 1, so the first regulation under it is Treas. Reg. 1.1001-1. The first regulation under IRC § 7701 is Treas. Reg. 301.7701-1 (Part 301 for administration, -1 for the first regulation). For IRC sections with particularly complex or voluminous regulations, there will often be a table of contents regulation identified with a zero after the dash. Temporary regulations, normally created as an interim measure until more permanent regulations can be drafted and discussed, are indicated with a capital "T" following the regulation number. Regulations proposed by the IRS are generally denoted "Prop. Reg." and are normally numbered in the same manner as the regulation would be when finalized. While these proposed regulations are not binding law yet, they often include the IRS's existing position (which they will generally assert whether or not binding on taxpayers) and are normally available for taxpayers to rely upon to their benefit.

B. Case Law and Courts

Practicing Federal tax law isn't merely a matter of statutory interpretation. As with most other complex areas of the law based on statutes, there is also extensive common law filling in gaps between the language of the statute and creating additional doctrines that inform the application of the statute (and regulations). Tax law is no different. In fact, the vast majority of the final part of this paper is court developed common law.

The United States Tax Court is a specialized trial court that exclusively for Federal tax cases.[15] All Tax Court trials are bench trials. The final document in the IRS audit and appeals administrative process, the Notice of Deficiency, is the start of the Tax Court process. It is therefore often referred to as the "ticket to Tax Court." Tax Court petitions must be filed within 90 days following the Notice of Deficiency.[16]

Federal District Courts only have jurisdiction over refund claims. This means that to appear in District Court, the taxpayer must have paid the tax in question (often "under protest"), requested a refund of that tax, and had the refund denied before brining suit in the District Court. Because the "ticket to Tax Court" Notice of Deficiency is also only the start to the collections process, taxpayers don't need to pay the tax before entering Tax Court. Between the specialized court, the lack of a jury, and no need to come up with the tax

[15] *See* IRC §§ 6213, 6214, and 7441 et seq.

[16] IRC § 6213(a).

before brining suit, the Tax Court is the primary jurisdiction for Federal tax cases.

Above the trial court level, the differences between Federal tax law and other Federal cases evaporate. Tax Court cases are appealed to the Circuit Courts and from there the Supreme Court (although it rarely choses to hear tax cases) as usual.[17]

C. Administrative Authorities

Tax law is, generally an administrative practice, in that taxpayers have one common counterparty – the IRS. As such, the IRS's various administrative authorities represent significant body of law, often addressing cutting-edge issues that have not yet filtered up to the courts, Congress, or the regulation publishing process.

The IRS issues revenue rulings ("***Rev. Rul.***") which are the administrative equivalent of case law. These generally take the form of a recited fact pattern or series of related fact patterns that explore a given legal issue, followed by a discussion of law and a ruling on that issue, often with some discussion how the outcome might change in alternate facts. Occasionally, these are in response to taxpayer requests, but more often, they are the IRS's attempt to combine recurring issues into a formal determination.

Taxpayers may also apply to the IRS for private letter rulings binding only between the IRS and the taxpayer to which they are issued.[18] A private letter ruling is based upon the taxpayer's statement of facts, and are invalid to the extent that those facts are inaccurate. Each year, the IRS issues a revenue procedure, usually the third of the year, detailing areas in which it will not issue private letter rulings.[19] These "no-rule" areas generally represent issues which the IRS has not yet explored sufficiently to issue private rulings, for which the IRS receives excessive requests and consider continued private rulings a waste of resources, or which include in them some key factual issue that would make the private letter ruling pointless. Because requests for private letter rulings can be withdrawn during the process, it is rare to find "negative" letter rulings. Taxpayers suspecting they will lose in a letter ruling often wish to terminate the process early to avoid a letter ruling to their detriment and because the IRS is now well aware of the facts, so the intended plan or reporting position may need to be changed to protect the taxpayer from later assessment and collections.

The IRS publishes two classes of "operational" authorities that describe the operations of the IRS: revenue procedures ("***Rev. Proc.***") and the Internal Revenue Manual ("***IRM***"). Rev. Procs. generally describe situations in which the IRS will make certain determinations[20] or will not challenge a particular legal issue[21]. They are the operational equivalent of the revenue rulings. The IRM can be considered

Finally, the IRS issues a library of other, less directly structured, administrative authorities, many of which are not binding with respect to a given taxpayer. Whether these are notices (generally accompanying the issuance of some regulation or other authority) or technical advice memorandum or Chief Council memorandum (which amount to internal memorandum within the IRS discussing particular issues), they can be extremely useful to understand how the IRS is thinking about an issue or what it is thinking about an issue that it is not yet ready to make more formal declaration about.

D. Tax Treaties

When transactions cross national borders and more than one tax system applies, there is often the problem of *both* countries taxing a cross-border transaction. To avoid this problem, the various countries prepare and execute tax treaties.[22]

Strictly speaking, these treaties are compacts on avoiding dual taxation, taking the form of agreements between countries as to how they will apply their tax laws. The treaties are amended by "protocols" and described by officially produced "technical explanations" drafted by (and considered binding on) the government parties to the treaty.

E. The Accountants

Possibly *the* most important resource for a transactional lawyer (other than calling a specialist tax attorney such as your humble author) to grapple with Federal tax law is the client's existing accountant or accountants. First and foremost, they often know more about the client's business and its economics and existing tax issues than the client does. Accountants deal with tax issues much more regularly and in much more detail than non-tax transactional attorneys do, so are more likely to already know or be able to quickly locate answers for questions. However, where there is uncertainty or ambiguity in the law, accountants may not be uniformly equipped to identify or deal with those "grey areas."

[17] IRC § 7482.

[18] *See, e.g.* Rev. Proc. 2016-3.

[19] *id*.

[20] *E.g.* Rev. Proc. 2016-3.

[21] *E.g.* Rev. Proc. 2002-22 (creating a safe harbor in which the IRS will not assert that a group of tenants-in-common will be deemed partners in a partnership).

[22] The IRS provides a list of tax treaties to which the U.S. is a party at https://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z

In addition to being a resource for you, it is important to involve the client's accountant in any tax advice you may give because they have a vested interest in that advice. After the transaction is over and you have returned to your office to work on other matters for other clients, the accountant still needs to understand what happened and why so they can account for the transaction appropriately. They have their own professional ethical rules that they will need to satisfy regarding the appropriate nature of the tax positions taken in the books they maintain and the tax returns they prepare. And, to top it all off, as a return preparer, the IRS can assess a penalty against them for preparing a tax return with an "unreasonable" position.[23]

Even if motivated merely by self-interest, it is important for transactional attorneys to coordinate with their client's accountants. Most transactional attorneys will have the client's ear for the duration of a transaction, while the accountants will normally have their ear constantly. It is, therefore, important, if only from a client relations and retention standpoint, to make sure that the accountants are comfortable with the advice you have given your mutual client. Ignoring their concerns can often be a quick way to turn a satisfied client that would have called again into an unsatisfied one that will never return.

III. THE LAY OF THE LAND – TAX COMPUTATION

Federal income tax planning starts with the ability to compute the amount of income tax under various scenarios. Computing the amount of income tax starts with the difficult task of defining what exactly is "income." Earlier attempts to do so, like that of *Eisner v. Macomber*, 252 U.S. 189 (1920) tried to approach it from common lay views on what constitutes income – compensation and gains, defining income as

> gain derived from capital, from labor, or from both combined

While this definition initially matches our intuitive idea of income, it misses some key issues, like the fact that windfalls (i.e. "found" money) are also income. Compare it with the so-called Haig-Simons definition, the current view in the field of economics, that income is consumption plus change in net worth.

The current legal definition, from *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) follows this approach, defining income as:

> undeniable accessions to wealth, clearly realized, and over which the taxpayer has complete dominion

Now that we know where we are going, we need to know how we will actually get there. This process – computing taxable income and from there income tax – is the core of tax law. Everything else this paper will discuss is part of this process or the administration of this process.

A. Gross Receipts, Net Gains, and Net Income

The starting point in determining taxable income is gross income "from whatever source derived" including compensation for services, business income, interest, rents, royalties, dividends, alimony, annuities, income from insurance, pensions, and the like.[24]

However, when disposing (whether by sale, exchange, or otherwise) of property (whether real or personal, tangible or intangible), only the gain derived from the disposition is considered income.[25] The amount realized in this context is the consideration received (whether in cash or in-kind, and including relief from debt). Gain in this context, is the amount realized minus the basis of the property disposed. Basis is generally the amount paid for property,[26] except where acquired in a nontaxable transaction, where the basis is generally a "carryover" basis equal to the basis of the original property disposed in the nontaxable transaction (often modified by gain realized in the transaction or alternate property acquired in the transaction which is usually called "boot").[27] One special rule to consider and a common factor in estate planning is that assets subject to the estate tax (generally a decedent's property at death, but other types of property are included as well) are given a basis in the recipient's hands equal to their fair market value at the time of the decedent's death.[28] This rule, called the "step-up at death" serves both to prevent documentation problems – it may not be possible to find Grandma's receipt for that necklace to establish cost basis – and as a "compensation" for the potential exposure to the estate tax. While an asset is held, basis is increased by capitalized expenses and decreased by depreciation deductions (see below for further discussion of both concepts).

The fact that payments are made in kind instead of in cash have no bearing – barter is taxable just as is payment.[29] Payments in kind are considered payments equal to the fair market value of property received. For example, IRC § 83 considers property received in exchange for services to be compensation for those

[23] IRC § 6694.
[24] IRC § 61(a).
[25] IRC § 1001.
[26] IRC § 1012.
[27] *E.g.* IRC §§ 362, 722, 723, 1015 (gifts) 1031(d), and 1033(b).
[28] IRC § 1014.
[29] Treas. Reg. 1.61-1.

services. However, reflecting the *Glenshaw Glass Co.* requirement that the accession to wealth be one "over which the taxpayer has complete dominion," such property is not income until it has "vested."[30]

Gifts are not considered gross income.[31] For this purpose, a gift arises from a "detached and disinterested generosity" and are made "out of affection, respect, admiration, charity or like impulses."[32] No matter how disinterested an employer's heart may be, gifts from employers to employees are generally not respected as gifts but are treated as compensation.[33] More generally, business gifts are also subject to some scrutiny as to whether they are business expenses (deducted by the donor but income to the donee) or gifts (not deductible to the donor but not included in income for the donee).[34]

Borrowed money is not considered income on the idea that it is not an "accession to wealth" as the borrowed funds come with an offsetting liability to repay the loan. Similarly, the principal part of loan repayments are not included in income, while the interest part is.[35] If, however, debts are forgiven, the debtor realizes income, called "cancellation of indebtedness income,"[36] subject to certain limitations.[37] Debts assumed by the acquirer of property are considered amounts realized in the disposition, increasing the amount of gain.

B. Exclusions and "Above the Line" Deductions

Some classes of income are excluded, usually for policy reasons. We have already discussed that gifts are not subject to tax. Other examples include proceeds of insurance paid by reason of death, disability, or health insurance[38] and compensation for injuries or sickness (note: compensation for lost wages or earning ability on account of injury or sickness are considered replacements for that compensation and are considered income).[39]

1. Deduction-Exclusion Equivalence

Often, instead of excluding amounts realized from income, they are included in income with an offsetting deduction. These are functional equivalents. Take the example of contributions to certain retirement accounts (i.e. 401(k) accounts named for the IRC subsection that defines them) are functionally excluded. Because it can be difficult or impossible at the time the compensation that funds those contributions to identify that they will fund those contributions, the compensation is considered income and the contribution is deducted. In essence, the income inclusion and the deduction offset and end up in the same place as if the compensation had been excluded in the first place.

There is often discussed the idea of "above the line" deductions. Deductions in the tax computation come in two different forms – those that are deducted from gross income before determining "adjusted gross income" ("AGI") (called "above the line" deductions) and those deducted *from* AGI (called "below the line" deductions). Literally, there is a line in tax returns (for example, Line 37 of IRS Form 1040 U.S. individual income tax return) where the AGI is determined. "Above the line" deductions are above that line in the form and "below the line" deductions are below.

For example, take the personal exemption. In part to avoid imposing tax on those that have only just the barest amount of income required to survive, the tax system effectively exempts a certain amount of income per individual, called a "personal exemption." To effect this, instead of excluding the first few dollars of income each year, the personal exemption takes the form of a deduction based on the number of taxpayers joining in the return and their dependents.[40]

2. Depreciation

Not all business costs arise when they generate income. Some assets produce income for a while after they have been purchased. Manufacturing equipment may wear out over time (or over a predictable number of units produced). Customer lists become out of date as customers leave the market, move to other vendors, or change their contact information. Mineral deposits in the ground eventually run out once all of the finite mineral is extracted. A software license (which you bought up front) may have a limited duration. In each of these cases, purchasing an asset that has a limited lifetime represents a cost that should be spread across its use. Eventually, the manufacturing equipment or list or mine need to be replaced if further units are to be produced. This is where depreciation and its closely related cousins depletion (as in mineral deposits) and amortization (as in the limited-life license) come into the determining of income. As the equipment or mine or license age, the cost of that equipment should offset the loss of value of that equipment.

For depreciation, IRC § 167 permits the deduction of "a reasonable allowance for the exhaustion, wear and

[30] IRC § 83. In the terms of the IRC, "vested" means that it is first transferable or no longer subject to a "substantial risk of forfeiture."

[31] IRC § 102(a). Note that the estate and gift taxes may apply to gifts and are outside the scope of this paper.

[32] *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

[33] IRC § 102(c).

[34] IRC § 274(b)

[35] IRC § 61(a)(4).

[36] IRC § 61(a)(12).

[37] IRC § 108.

[38] IRC § 101(a). "Insurance" for this purpose is defined in IRC § 7702.

[39] IRC § 104.

[40] IRC § 151.

tear (including obsolescence) … of property used in the trade or business, or held for the production of income."[41] The amount of depreciation taken reduces the basis of the asset, therefore potentially increasing the amount of gain at sale. The amount of that "reasonable allowance" is based on the "applicable depreciation method" applied over "the applicable recovery period" and using the "applicable convention."[42] The applicable depreciation method might be straight line (cost divided by life in years each year), but more commonly it is the "200 percent" or "150 percent" declining balance method (200% or 150% times the undepreciated value as of the start of the year divided by the remaining life of the asset, normally switching to straight line in years when that provides a better result). The 200 percent declining balance method (and to a lesser degree the 150 percent method) deliberately shifts deductions forward (meaning early years have higher deductions for depreciation) both because that is often accurate – the fastest loss of value for a car is when you drive it off the lot and it becomes a "used" car – and as a pro-taxpayer stance. The applicable convention represents a series of simplifying assumptions for dealing with the year in which the asset is placed in service – for example, assuming under the "half-year convention" that all assets are put in service on the exact mid-point of the year (so getting half of the depreciation for the first year). The applicable recovery period is the assumed life of the asset – often another source of pro-taxpayer assumptions, such as that real property improvements last 27.5 years for residential and 39 years for nonresidential property.[43]

3. Offset for Losses

Current year losses "not compensated for by insurance or otherwise" are deductible.[44] Individuals are denied losses unless they arise in a trade or business, in a transaction entered into for profit, or "casualty" losses that "arise from fire, storm, shipwreck, or other casualty, or from theft."[45]

For years in which losses exceed income, first, no tax is generally due (tax on negative income is zero, absent special cases). The excess losses are then available to carry back to the prior two tax years and then for carrying forward to the next year (eventually expiring after 20 years).[46]

C. Non-Deductible Capitalized Expenses

We have already discussed that the purchase price of property creates its basis, which will offset the amount realized when that property is disposed. Because that basis created will later offset potential income, if it were deductible it would be over-counted in determining taxpayer's income.

As such, it is said to be "capitalized" instead of deducted.[47]

The same goes for expenses improving property. Capitalized expenses are defined as:

> Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate"[48]

and

> Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.[49]]

D. AGI

Having considered gross income (or net gain from dispositions of property), reduced by the "above the line" deductions and exemptions, but capitalizing instead of deducting appropriate capital expenses, we come to the first real definition of "income" for purposes of the Federal income tax: "adjusted gross income" ("AGI"). AGI forms the basis of many income-tied thresholds within the tax code (for example, the phase-out of tax benefits for tuition payments for high-income persons who, so the policy argument goes, do not need government support to obtain education[50]).

However, we are not ready to apply the marginal tax rates to determine the amount of tax quite yet. We must now consider some issues not really

E. "Below the Line," "Itemized," and "Standard" Deductions

While some deductions are really offsets to establish effective tax exemption, some are not. Of course, not all expenses are deductions – the Haig-Simons definition points out that consumption is just a way of utilizing income, not an offset reducing it (if we allowed deductions for consumption, it would be a "savings" tax, not an "income" tax).

But, some deductions exist as a matter of policy to shape taxpayer behavior and not because they represent something which is not "income." Chief among these examples is the deduction for charitable donations.[51] This deduction exists to encourage charitable giving, in

41 IRC § 167(a).
42 IRC § 168(a).
43 IRC § 168(c).
44 IRC 165(a).
45 IRC 165(c).
46 IRC 172.
47 IRC § 263.
48 IRC § 263(a)(1).
49 IRC § 263(b).
50 IRC § 25A(d).
51 IRC § 170.

part to reduce the need for government spending. A charitable soup kitchen reduces the need for government-provided food for the needy. Educational charities reduce the need for government spending on public education or allow for specialized education which might not be appropriately provided by government.

These deductions are taken out after AGI is computed, and are, therefore, "below the line" deductions. Most must be specified in an itemized list within the tax forms, so are considered "itemized deductions." For taxpayers with few such itemized deductions, the effort of maintaining paperwork and completing the itemized deduction part of the tax return is considered too cumbersome. SO, taxpayers are provided with a "standard" deduction per person. Taxpayers are entitled to take either the "standard" deduction or their documented and reported itemized deductions, whichever is more to their benefit.

These deductions, particularly because they are not tied to some theoretical concept of what constitutes "income" but are instead based on encouraging certain behaviors in the taxpaying public, are subject to significant limitations, including the so-called "Pease" limitations for taxpayers with large AGIs, which can eliminate up to 80% of itemized deductions. [52]

F. Taxable Income

Now that we have further adjusted AGI to address policy concerns embodied in the "below the line" deductions, we have the "income" upon which tax is actually based. As with AGI, this is a specific line in a given tax return.[53]

G. Character

But, before we can calculate tax, we must deal with the fact that not all taxable income is created equal. Income of different characters has different tax treatments, and potentially different tax rates.

1. <u>Ordinary Income vs. Capital Gains</u>

Although there are certain other issues in "character,"[54] the foremost is that of ordinary income or capital gain.

We have already discussed the fact that only *net gain* from dispositions of property is included in gross income and therefore AGI and taxable income. But, depending on the taxpayer's relationship to the property in question, that net gain (or loss) may have significantly different treatments.

IRC Subchapter P discusses just how capital gains are treated differently than all other income (called "ordinary income"). That whole difference turns on whether, in the hands of the taxpayer, the asset disposed of is a capital asset. IRC § 1221 defines capital asset to be "property held by the taxpayer (whether or not connected with his trade or business)" with certain key exclusions. The largest and most iconic of these exclusions is that of inventory. Literally excluded are:

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business[55]

Colloquially, both of these are referred to as "inventory." Because a given asset can be ordinary income in one taxpayer's hands while the same asset is a capital asset in another's, we speak of the differences in those taxpayers, generally speaking of "investors" (who hold the asset as a capital asset) and "dealers" (who hold the asset to sell to a customer as part of their business). The last time I sold a car was when I traded it in for my new one, about 5 ½ years ago. I do not regularly sell cars. If and when I do sell my car, it will be a capital asset. I am, within this category, a car "investor" because I held it for some reason other than sale to buyers (specifically, for personal transportation). However, the car dealership I buy my new car from sells cars regularly. That dealership is a "dealer" in that the cars on the lot are held primarily for sale to buyers like myself.

While this dealer-investor distinction seems conceptually straightforward, it has proven difficult for courts to define. For example, some courts believe that the standard must be "primarily for sale"[56] or "primarily for sale to customers in the ordinary course of business."[57] The current standard in the Fifth Circuit is to examine the seven *Winthrop* "pillars":

(1) the nature and purpose of the acquisition of the property and the duration of the ownership;
(2) the extent and nature of the taxpayer's efforts to sell the property;

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[52] IRC § 68.

[53] *E.g.* IRS Form 1040 Line 43.

[54] For example, we will see that different types of income trigger employment, self-employment, or net investment income taxes or are subject to limitations based on the at-risk rules or the passive activity rules, while others do not.

[55] IRC § 1221(a)(1). The reference to "inventory" is a reference to the rules for determining inventory as part of establishing a business's deduction for cost of goods sold under IRC Subpart D.

[56] *Malat v. Riddell*, 347 F.2d 23 (9th Circ. 1965).

[57] *Suburban Realty Co. v. U.S.*, 615 F.2d 171 (5th Cir. 1980).

(3) the number, extent, continuity and substantiality of the sales;
(4) the extent of subdividing, developing, and advertising to increase sales;
(5) the use of a business office for the sale of the property;
(6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
(7) the time and effort the taxpayer habitually devoted to the sales.[58]

When gain (or loss) is realized from dispositions of capital assets, it is further divided into "long term" or "short term" capital gains and losses. "Long term" refers to gains and losses from property held for more than 1 year (including any holding period inherited from prior property, often as a result of nonrecognition transactions discussed below).[59] Gains and losses are then netted, with long term capital gains offsetting long term capital losses to produce net long term capital gain or loss[60] and the same is done to short term gains or losses for the year to produce net long term capital gains or losses.[61] If there is a net short term gain and a net long term loss (or vice versa), they are then netted against each other to produce an overall net long or short term gain or loss, as the case may be. Only then are net long term or short term gains or losses considered income. This whole process is important because net long term capital gains of individuals are subject to a lower tax rate than is ordinary income.[62] No rate preference exists for corporations. Short term capital gains retain the higher tax rate, making the one-year holding period of long term capital gains so essential. At the same time, capital losses, whether short or long term, have limited ability to offset ordinary income. For corporations, they cannot, while for individuals, they can only offset $3,000 of ordinary income per year.[63] Otherwise, excess capital losses are carried back to up to the prior 3 years of a corporation (no carryback for individuals) and then carried forward (in the case of corporations, only up to 10 years).[64]

2. Depreciation and Recapture

As we have discussed, depreciation (and depletion or amortization) produce ordinary income offsetting deductions for the wear and tear (or obsolescence or using up of finite minerals) of assets with a limited life. Each depreciation deduction taken also reduces the basis in the asset depreciated. So, depreciation in excess of economic loss of value will produce gain as if the asset appreciated in value instead.

However, because that gain is likely to be lower-taxed long term capital gain, the IRC introduces the concept of "recapture."[65]

When a depreciable asset is sold for gain, the lesser of that gain or the depreciation deductions taken are recast as *ordinary income*, no matter what the character of the gain would have been. So, an asset purchased for $100, with $10 in depreciation deductions taken, and sold for $95 will have $5 of recapture. If, however, that asset was sold for $105 instead, the seller would have $10 of depreciation recapture ordinary income while the remaining $5 would stay long-term capital gains.

3. Qualified Dividend Income

It used to be the case that corporate shareholders concerned themselves with the method of extracting corporate earnings based strictly on tax implications.

Take a simple example: I own 50% of the stock in a corporation. That corporation has $200 of net earnings to distribute. Should it buy back a proportionate share of each shareholder's stock or should it pay a distribution? Either way, I remain a 50% shareholder in the corporation. So, why should I care? Answer: because the two outcomes have vastly different tax implications.

Before rules were enacted[66] that considered both situations equally and determined which outcome was appropriate, the former (repurchase, called a "redemption") created capital gains (in that I disposed of my stock in which I had basis), while a distribution (called a "dividend") created ordinary income. Because of the tax preference on capital gains, taxpayers often wanted the former when the latter was more appropriate. Ultimately, this problem was solved this problem in a relatively novel way by taking away the difference. Now, "qualified dividend income" ("QDI") (generally, dividends from domestic corporations), remain ordinary income but are taxed at capital gains rates.[67] While some taxpayers remain concerned about the difference (for example, because of the limited ability to offset capital losses against ordinary income including QDI), in the vast majority of cases, taxpayers just don't care anymore.

H. Tax

1. Ordinary Income Tax

Subject to special rules for net long term capital gains and QDI, taxable income is finally used to compute the amount of tax. U.S. Federal income tax

[58] *U.S. v. Winthrop*, 417 F.2d 905 (5th Cir. 1969).
[59] IRC § 1222(3) and (4).
[60] IRC § 1222(7) and (8).
[61] IRC § 1222(5) and (6).
[62] IRC § 1(h).
[63] IRC § 1211.
[64] IRC § 1212.
[65] IRC § 1245
[66] IRC § 316.
[67] IRC § 1(h)(11).

uses a tiered marginal rate system, meaning that each tier is subject to a specific tax rate, with that rate increasing with each subsequent tier. While this seems complicated, the tiered system prevents, for example, a dollar of additional income over a threshold into a new rate tier from causing all of the income below it to suddenly be subject to a higher rate as well (therefore effectively imposing a massive effective marginal rate to that additional dollar, potentially significantly into the triple or quadruple digit percentages). For individuals, the tiers and their rates are defined in IRC § 1 and depend on whether the person is married filing jointly, married filing separately, single, or head of household (generally, unmarried persons with dependents in their household[68]). IRC § 11 defines those rates for corporations.

As a general rule, for purposes of planning a transaction, transactional tax attorneys take the simplifying step of assuming that all of the income in the transaction will be taxed at the client's top marginal rate (usually assumed to the be top marginal rate generally). Under IRC § 1 (for individuals) this is currently 39.6%[69] and under IRC § 11 (corporations), this is 35%.

2. AMT

Unfortunately, applying the IRC §§ 1 and 11 tiered rates to taxable income is not the final word in determining tax. In an attempt to cap certain deductions and other tax benefit provisions, Congress enacted the "alternative minimum tax" (the "AMT") of Part VI of the IRC.[70] Often derided as a "parallel tax system," the AMT is conceptually relatively simple – taxable income is recomputed (now called "alternative minimum taxable income") without certain deductions and with limits applied to others[71], and if that alternative minimum taxable income exceeds a threshold amount, tax is computed on the excess (called "taxable excess") at a generally lower rate than under IRC §§ 1 or 11 (for individuals, 26% up to a threshold after which 28%[72] while for corporations, a flat 20%[73]). Tax is then the *greater* of tax under the usual system of IRC §§ 1 and 11 or under the AMT.

As with marginal rates, in the usual case transactional tax attorneys ignore the AMT unless specifically assisting a client with respect to a material deduction which is among those limited in the AMT.

3. Employment and Self Employment Taxes

When an employer pays compensation to an employee, that compensation is subject to a series of taxes under Subtitle C of the IRC. In short, those taxes take the form of an "employee contribution" which is subtracted from employee compensation and an "employer contribution" which is economically the responsibility of the employer (i.e. it does not get subtracted from employee compensation).[74]

Individuals that work for themselves are not subject to those employment taxes. Instead, as part of U.S. Federal income tax, *in addition to ordinary tax and the AMT*, self-employed individuals are subject to an additional 12.4% tax on income from self-employment, [75] an additional 2.9% tax on income from self-employment,[76] and a third additional 0.9% tax on self-employment income over a threshold.[77]

As a general statement, these additional taxes represent the total of the employer and employee contributions if the self-employed person were to be his or her own employee.

4. 3.7% NII Tax

Part of employment taxes represent a contribution toward Medicare. For self-employment income, this contribution is offset by the 2.9% and the 0.9% additional self-employment taxes. However, historically, investment income has not been subject to any Medicare contribution tax.

This changed with IRC § 1411, enacted as part of the funding bill that accompanied the Affordable Care Act.[78] IRC § 1411 imposes a 3.8% tax on "net investment income." While the definition of "net investment income" is complicated[79], as a general statement, this 3.8% additional is often treated during

[68] IRC § 2(b).

[69] IRC § 1.

[70] IRC §§ 55 et seq.

[71] The specific "alterations" of the AMT are listed in IRC §§ 56 and 57.

[72] IRC § 55(b).

[73] IRC § 55(c).

[74] Note that withholding of income taxes from employee compensation under IRC § 3402 is a different topic discussed below.

[75] IRC § 1401(a).

[76] IRC § 1401(b)(1).

[77] IRC § 1401(b)(2). The threshold is $250,000 for married filing joint returns, $125,000 for married filing separate returns, and $200,000 for all other individual taxpayers, but those thresholds are reduced for compensation subject to FICA under IRC § 3121(b)(2).

[78] P.L. 111-152 § 1402(a)(1).

[79] IRC § 1411(c)(1) and (2) define it to be "interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2)," "net gain … attributable to the disposition of property other than property held in a trade or business not described in paragraph (2)" as well as all income derived from a "paragraph (2)" trade or business. THis "paragraph (2)" refers to trades or businesses which are passive (see the discussion of passive activity loss rules below) and "trading in financial instruments or commodities."

planning phases as if it were an increase in the long-term capital gains tax.

I. Credits

Having computed the amount of tax (whether ordinary tax, AMT, self-employment tax, net investment income tax), next we turn to "credits" against tax that are subtracted from tax.

In some cases, credits are based on an idea that tax should not apply. For example, to avoid double-taxing the same income, Federal income tax provides a limited credit for foreign taxes on income subject to U.S. tax.[80] Another example is the "earned income tax credit" which is intended to reduce effective tax rates on the working poor.[81]

But, normally, credits represent the same kind of taxpayer incentives that formed the basis of most "below-the-line" deductions, just with more potency. In a deduction, for each dollar spent in a qualifying way reduces the taxpayer's taxable income, so results in a less than one dollar reduction in tax (for planning purposes, I usually just assume 40 cents on the dollar for clients). If the same provision is written as a credit, that qualifying dollar spent reduces taxes by one dollar. In many cases, tax credits are a mechanism for the Federal government to spend money on desirable outcomes while having the marketplace administer the process. Examples include low-income housing credits that replace government funded low-income housing by providing a dollar-for-dollar credit for investment in private low-income housing projects that meet certain metrics, [82] and a series of credits for converting to green energy sources or reducing energy use.[83]

J. Deposits, Estimated Payments, and Withholding

Having determined the amount of tax and subtracted the relevant credits against tax, we have determined the total tax that the taxpayer has to pay. However, the taxpayer may already have paid some of that tax.

A number of provisions require payors to withhold against certain payments and remit the withheld amount instead to the IRS. Possibly the most common example is employer withholding against employee wages.[84] But, other withholding exists, often in surprising places. Withholding is required when paying a foreign person (or someone who will not appropriately document their non-foreign status) for United States real property interests (including "United States real property holding corporations," which are generally corporations more than one half the value of which is united states real property).[85] Amounts withheld under these rules are treated as if they had been paid to the taxpayer recipient (i.e. the withholding payor is generally immune from suit for failing to pay the amount to the taxpayer recipient) who then paid it against his or her tax for the year in question.

In addition, taxpayers whose existing withholding is not sufficient to pay their tax may be subject to penalties for failing to make quarterly estimated tax payments.[86] As such, many self-employed persons and many employed persons with significant outside income are required to make these quarterly payments. As with withholding, they are applied against the tax for the year in question.

Finally, it is possible to pay the IRS a "deposit" against tax, which limits interest accruing on tax (generally useful only after taxes have become delinquent).[87]

K. Refunds

After subtracting credits and further subtracting withholding and other prepayments of tax, it is possible that the taxpayer is owed tax instead of owes tax. This is referred to as a "refund." Some tax credits are considered "refundable" tax credits,"[88] while most are not. The amount of a refund is reduced to the extent that it is attributable to a nonrefundable tax credit. For the "business related credits,"[89] instead of generating a refund, they can be carried back one year or forward to the following 20 years.[90] For personal nonrefundable credits, the credit that would have generated a refund is lost.

The reason that tax refunds are so prevalent for the majority of the public is that wage withholding, while generally applied at less than the applicable tax rate, does not factor in many non-work-related deductions, credits, or exemptions. Contrary to the way "refund season" is portrayed in the mainstream media, it is not free money. It is instead money you may have been able to keep up front and *earn interest on during the year*. While many people are proud of their refunds, to a transactional tax attorney, a client receiving a refund is something to be avoided – they should have been able to keep the extra money in the first place and, at a minimum, earn some interest on it.

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[80] IRC §§ 27(a) and 901.
[81] IRC § 32.
[82] IRC § 42.
[83] IRC §§ 45, 45h, 45i, 45j, 45k 45l, 45m, and 45n.
[84] IRC § 3402.
[85] IRC § 1445.
[86] IRC § 6654.
[87] IRC § 6603.
[88] Refundable tax credits are located in Subpart C of Part IV of the IRC, IRC §§ 31 et seq.
[89] IRC §§ 38 et seq.
[90] IRC § 39.

L. State & Local Income Taxes

This paper addresses *Federal* income taxes. But, many states and local jurisdictions impose an additional income tax (or income-like tax). For most, this takes the form of a mirror of the Federal income tax system, often with minor modifications. In essence, they import Federal income tax laws and make some minor modifications. However, that is not always the case. The Texas franchise tax is a prime such example. When it was enacted, because of state constitutional and cultural restrictions on income taxes in Texas, instead of creating an "income" tax, the Texas legislature came up with another alternative tax base. In essence, instead of taxing "taxable income," it taxes "taxable margin." To summarize, where income allows businesses to deduct both the cost of the goods it sells and the compensation it pays to its employees, taxable margin allows only *one or the other and not both* to be deducted.[91] Federal income tax choice of entity rules (discussed below) are also ignored.

IV. THE FIRST BIG TRICK - TIMING

Most of the foregoing is really just a matter of background. There are some key issues where a transactional attorney can change the outcome for a client (examples include counseling clients to maintain long term capital gain character instead of short term capital gain or ordinary income, as well as the not insignificant task of assisting clients to properly document and preserve deductions and credits as an administrative practice). But the real fun is in this and the following two parts of this paper: altering the timing of income to create free money, establishing nonrecognition to avoid tax entirely, and structuring business entities to direct and control taxable income.

A quick review of the prior part will reveal that the Federal income tax system almost entirely misses the point of the time value of money. Since invested money grows, a dollar today is worth more than a dollar tomorrow. But, a dollar of income today is (leaving aside changes of taxpayer situation and tax laws) exactly the same of a dollar of income tomorrow. If a taxpayer is able to delay realizing income, the tax on that income is effectively a zero-interest loan from the government – I pay a dollar less in tax today (saving that dollar and effectively receiving the proceeds of that "loan") and sometime later pay a dollar more in tax (paying back the "loan"). If that dollar in tax is prudently invested, the income from that investment is effectively free money. As we will later discuss, even some non-taxable transactions are actually, viewed in the long term, really just a deferral play. So, in many ways, transactional tax planning is the task of finding that free money through deferral.

A. Annual Accounting Periods - Simple Deferral

While all of the above is complicated enough, it would be so much more difficult to do continuously. So, the Federal income tax is based on annual accounting periods.[92] Generally, this means period defined by 12 months (usually the "calendar year" which ends with December although a fiscal year ending other than with December is also allowed)[93], but some taxpayers may use one based on 52-53 weeks, always ending on the same day of the week.[94]

However, sometimes there is a reason why the full year gets cut into two short years. For example, when a partnership or corporation is formed other than on the first day of the tax year or terminates other than on the last day of a tax year, it creates a short tax year (sometimes called, when arising as part of a transaction, a "stub" year).[95] An often overlooked part of many purchase and sale transactions involve deciding how precisely to deal with the pre-closing and post-closing "stub" years.

This artifice of the annual accounting period queues up the first (and possibly the largest) tax planning strategy: deferral. As we will discuss shortly, even tax exemption is often just a form of deferral in disguise.

The simplest example of deferral is a transaction closing on the last day of the tax year. If it closes that day, the tax implications are in one year. If it closes the following day, the tax implications are in the following year. If that transaction creates income for one party, closing one day later means the difference of a whole year as to when the tax must be paid. Assuming tax rates stay the same, this created delay of one day less than one year does not cause the tax bill to increase: a dollar of taxable income this year creates the same amount of tax as a dollar of taxable income in the next year. The time value of money impact (i.e. the interest that a taxpayer can earn parking the tax on that dollar of income) isn't factored in to the calculation of tax. That almost a year delay is, in effect, an interest-free loan from the United States treasury: the taxpayer receives a dollar (by way of less tax in the first year) and has to repay it (by way of more tax in the following year), but need not pay any interest on it. Any income that this dollar can generate in the intervening year is free money (although potentially taxable).

As a tax lawyer, most of the time, deferral (which may be potentially indefinite deferral) is often the best outcome I can create for a client.

[91] Tex. Tax Code § 171.101. Both potential deductions factor in significant differences from their computation under Federal income tax law.

[92] IRC § 441.

[93] IRC § 441(b)(1).

[94] IRC § 441(b)(2).

[95] IRC § 441(b)(3).

B. Base Accounting Methods – Cash and Accrual

So, when a transaction splits across tax years, how do we know which one to include it in? Subject to some specialized issues in certain specialized cases[96] (and subject to large amounts of ink spilled on the special case of inventory accounting for purposes of determining the deduction for cost of goods sold) there are two options: the cash method or the accrual method.[97]

Under the cash method, income and deductions are included in the tax year in which they are paid.[98] By contrast, the accrual method relies upon the "all-events test" where income and deductions are included in the tax year in which:

(1) all the events have occurred that fix the right to receive such income of fix the liability; and
(2) the amount of income or liability may be determined with reasonable accuracy[99]

The difference between the cash and accrual methods can be demonstrated by an example. Assume our taxpayer (using the calendar year) runs a furniture store and allows its customers 7 days from the date furniture is delivered to pay for it. The taxpayer delivers a piece of furniture on New Year's Eve, for which the customer pays on New Year's Day (6 days early, a quality customer indeed). Under the cash method, our taxpayer has income in the latter year because that's when it paid. Under the accrual method, our taxpayer has income in the former year (in which all events have accrued – the furniture is delivered, so the customer must pay *eventually*).

Now assume the customer never pays, instead vanishing (so no later collection is possible). If our taxpayer is on the cash method, not getting paid means no income. If our taxpayer is on the accrual method, there is a bit of a problem. The income was in the first tax year because all events occurred in that year. But, when the customer fails to pay in the following year, there is a bad debt deduction in the subsequent year. To add insult to injury, the accrual method taxpayer, in addition to getting stiffed for furniture, has to give the United States Treasury an interest free loan (in that his taxes increase in the prior year and decrease in the following year by equal amounts) that he wouldn't have had to make under the cash method.

While for some taxpayers, the accrual method is to their advantage (i.e. where customers generally pay large up-front deposits which are not earned until later[100]), as a general rule, cash method defers income and expenses. For profitable businesses, the deferral of income is advantageous. This is why IRC § 448 forbids the cash method to C-corporations (see below for the distinction between C- and S-corporations), partnerships with C-corporations as partners, and "tax shelters".

The way this distinction between cash method and accrual method sales is handled is to consider a "basis" in the accounts receivable of our taxpayer. Under the cash method, no income until payment means that accounts payable have no basis. Under the accrual method, the accounts payable have a basis equal to the amount of income (generally, the full amount of the account payable).

Taken one step further, assume our furniture dealer taxpayer doesn't want to be in the business of extending credit, so "factors" his accounts receivable (generally, meaning he sells them to a third party for less than their full amount but then has no part in or economic exposure to the possibility that the customer will not pay or will pay later). In that case, the cash method taxpayer (no basis in the account receivable) realizes income when factoring the receivable, while the accrual method taxpayer realizes the full income at sale and then an offsetting deduction when factoring (under some circumstances this is simplified to just realizing income upon factoring, which is normally equivalent, but can miss some fine distinctions).

C. Special Accounting Methods – The Installment Method

One of the special cases presents a powerful tool for tax deferral: the installment method. Under the installment method, gain is realized ratably as payments are made on the installment obligation (dispositions of the installment obligation are generally considered payments of on the installment obligation).[101] However, recapture (i.e. of excess depreciation deductions) is realized in the year of disposition instead of under the installment method.[102]

1. <u>The Installment Method</u>

The installment method applies to "installment sales, which are "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."[103] It was not available to our furniture dealer example because it is

[96] Generally, these special cases are in Subpart B of Part II of Subchapter E of the IRC (IRC §§ 451 *et seq.*).

[97] IRC § 446(c).

[98] Treas. Reg. 1.446-1(c)(1)(i).

[99] Treas. Reg. 1.446-1(c)(1)(ii).

[100] Attorney trust deposits, because they must be segregated under the Texas Rules of Professional Conduct, end up avoiding tax problems, even under the cash method, because they are not "received" by the attorney until "paid" from the trust account.

[101] IRC § 453(c).

[102] IRC § 453(i).

[103] IRC § 453(b)(1).

not available to dealer dispositions or dispositions of inventories of personal property.[104] "Dealer" determinations have some special rules that apply[105] but generally return to the same standards discussed above that applied in determining whether or not an asset was a capital asset the sale of which creates capital gains (or losses).

So, if I sell my chest of drawers (I am, unlike our prior example, not a dealer in furniture) that I bought for $50 (and have taken no depreciation deductions) for $100, paid half now and half in one year (plus interest), I realize all $50 of gain immediately, but only recognize it as I get paid. That means I realize $25 now and $25 with the other payment. If I sold office furniture used in my law practice for which I had taken $30 in depreciation deductions, I would realize all $30 recapture in the first year, and the remaining $20 would be under the installment method.

The regulations define special rules apply where the total amount to be realized is unknown or subject to change or where the full amount changes (i.e. because of renegotiation of the installment obligation).

2. The Installment Method

If this is all too much for me (or for some reason I wish to avoid the installment method because, for example, I expect my top marginal rate to increase), I can elect out of the installment method.[106] In that case, I have received two items in the first year: a payment of $50 and a note of the buyer for $50. Generally, the note would be worth $50, so I would receive all $100 in the initial year, meaning that an election out of the installment method is a loss of deferral (and the free loan that it implies).

However, if the installment obligation had some reason to be worth less than full amount, I might have less than $50 of gain in that initial year. This can come up in purchases with an "earn out" or other conditional incentive payment. Often, when buying a business, the purchase price will be a set amount plus some additional amount if the business, post-sale, makes over a certain threshold (generally called an "earn out" or "incentive payment" or something similar, and sometimes there can be multiple "tiers" of thresholds with different earn-out amount computations).

Under the rules for contingent installment obligations, I might be required to include the full earn-out in my calculations, despite the low probability of it occurring.[107]

But, if the earn out is risky enough and substantial enough, the installment method can end up over assuming the amount of gain. In that case, making the election out allows the installment obligation's value to be discounted by the unlikely payments, although it would generally accelerate the gain recognition to the year of sale. In effect, the choice becomes the loss of deferral (and its implied free loan from the Treasury) and loss of the uncertainty discount. It is important in those situations to consider carefully (often by spreadsheeting the difference using the client's own internal rate of return on capital) which outcome is in the client's better interests.

V. THE SECOND BIG TRICK - REALIZATION AND RECOGNITION

We have already discussed realization in a couple of contexts: the *Glenshaw Glass Co.* definition of "income" required that accessions to wealth be "clearly realized" before it could be considered income, gain from dispositions of property was the excess of the "amount realized" over the basis of the property disposed, and the deferral of gain in the installment method. However, mere "realization" is not enough: it must then be "recognized" for it to be considered income. Generally, this is automatic – amounts realized are recognized as well. But, it is not always the case. Part III of Subchapter O of the IRC includes a number of provisions that define situations where realized income is not recognized (or may be recognized later).

But, there are many more such examples, including nonrecognition transactions involving partnerships and corporations discussed below in the discussion of tax choice of entity rules.

As a general statement, nonrecognition provisions take a similar form. An investment (whether in property, a business entity, or in a business) changes form without really ending the investment. Examples include involuntary conversions where the converted property is replaced,[108] exchanges of property so similar as to be considered "like kind," or the contribution of property to a corporation[109] or to a partnership[110] owned (in greater or lesser degree) by the contributor. Often, where some of the investment "leaks out" as other types of property (usually referred to as "boot" property) or fails to be continued, partial recognition will occur.

Often transactions discussed as being "non-taxable" are actually nonrecognition transactions at their heart. Take the example of the purchase by one corporation (the "acquirer") of all of the stock of another

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[104] IRC § 453(b)(2).

[105] IRC § 453(l).

[106] IRC § 453(d).

[107] Treas. Reg. 15A.453-1(c)(2) requires installment obligations with contingent payments but a "stated maximum selling price" to assume the full maximum selling price will be received, with offsets only created when it is clear that this assumption is incorrect.

[108] IRC § 1033.

[109] IRC § 351.

[110] IRC § 721.

corporation (generally called the "target") in exchange for voting stock of the acquiring corporation. This is a "B" reorganization defined under IRC § 368(a)(1)(B). The target's former shareholder clearly realized gain (or loss) in his target stock (i.e. he received acquirer stock with a fair market value). Nevertheless, the gain is not recognized (or is recognized only to the extent of boot which is not acquirer voting stock).

It is important to realize that these nonrecognition provisions are exceptional items of legislative grace and are generally to be interpreted *narrowly*.

A. Nonrecognition Example: § 1031 Like-Kind Exchange

Because each of these nonrecognition rules generally follow a pattern, we will examine one of them as an example. The chosen example is that of the "like-kind" exchange under IRC § 1031, an ever-popular choice among real estate investors.

Under IRC § 1031, exchanges of "like-kind" property are exempt from tax. The exchanging of one property for another is a "realization" of gain or loss (in that property is disposed for something of value) so the mechanism of IRC § 1031 is to deny realization of that gain.

The definition of "like-kind" in this context depends on the class of property and the taxpayer's use of it (for example, dealers are denied like-kind exchange treatment[111]). Some of the rules can be quite arbitrary. IRC § 1031(e) says, in its entirety, that "For purposes of this section, livestock of different sexes are not property of a like kind." In the context of real property, it is extremely broad, leading to its popularity in real estate investment circles. While there are many different ways to structure an exchange to qualify (often involving one or more "straw men" authorized under IRC § 1031, its regulations, and other IRS administrative authorities interpreting it), we will example the simples (although rarely seen) case of two non-dealer taxpayers that wish to "swap" deeds.

Generally, swapping deeds to real property would qualify and result in nonrecognition.[112] This even applies to losses.[113] If one taxpayer receives something else in the exchange (called "boot"), such as cash or non-like-kind property, gain is recognized to the extent of that boot.[114] So, a taxpayer exchanging property worth $100 (basis $75) for like-kind property and $10 of boot cash will realize $25 of gain, of which only $10 (the lesser of gain or boot) is recognized for tax purposes.

B. Nonrecognition, Basis, and the "Wallpaper Problem"

This seems a classic situation of tax exemption. But, if we look further, really, it is mere deferral.

The quid-pro-quo of a like-kind exchange is that the basis in the property received (called the "replacement property") is equal to his basis in the property given up (called the "relinquished property") plus any gain recognized.[115]

This is where what I call the "wallpaper problem" comes in. When hanging wallpaper (admittedly not a common activity for attorneys attending this CLE presentation, but please bear with me), one often finds bubbles left behind in hung wallpaper. Quickly, before the glue dries, you will want to push that bubble down to smooth out the wallpaper and avoid an unsightly bulge sticking out from the wall. Unfortunately, the air in the bubble needs to go somewhere. So, unless it is carefully pushed out from under the wallpaper panel entirely, the bubble will pop right up in another place. The problem didn't go away, it just moved.

This carryover basis rule is the glue with which we hang the wallpaper and the gain is the bubble. If we avoid recognizing the gain up front (pushing down a bubble), it is probably just going to pop up somewhere else.

Let's compare two alternatives for a taxpayer with an asset worth $100 with basis of $75 and : in one our taxpayer completes a like-kind exchange avoiding tax while acquiring new property worth $100 and in the other, our taxpayer sells for cash and buys the new property.

The bubble gets pushed down when the former avoids recognizing the $25 of gain that they both realized.

The bubble pops up when our taxpayers sell the new property for $100. For the exchanger taxpayer, his carryover basis is still $75, so he will realize $25 in gain in the subsequent sale. The other taxpayer may have already been taxed on $25 of gain, but now has a cost basis of $100, so realizes no gain. The exchanger didn't avoid the $25 of gain entirely – he merely delayed it.

Of course, if they sold for $120, the exchanger realizes $45 of taxable gain while his taxable counterpart realizes the same $45 of gain, just $25 in the first sale and the additional $20 in the subsequent sale.

For depreciable property, the bubble instead pops back up when it comes time for depreciation deductions. The exchanger only has $75 of basis to depreciate, while the other taxpayer realized $25 of gain but now has $100 to depreciate. This is another case where it might be to your client's advantage to avoid short term benefits of nonrecognition. If nondepreciable property (i.e.

[111] IRC § 1031(2)(A).
[112] IRC § 1031(a).
[113] IRC § 1031(c).
[114] IRC § 1031(b).
[115] IRC § 1031(d).

nondepreciable unimproved land) is exchanged for depreciable property, the gain may be better than losing the depreciation. If the gain is long term capital gain, its lower rate may be worth (even net of time value of money) accelerating to increase subsequent ordinary depreciation deductions. Depending on the life, the taxpayer's marginal rates (whether changing because of changes in law or changes in taxpayer situations), it *might just be worth it*.

So, you ask, how do we push the bubble out from under the wall paper panel entirely? While sometimes a taxpayer will have offsetting losses to offset realized gains when the bubble pops back up, usually, the only way to do this is to hold onto the property until death. When a decedent's heirs receive the step-up in basis at death,[116] the bubble gets erased along with the decedent's basis, eliminating the problem. Of course, for taxable estates in excess of the estate tax exemption,[117] this comes at quite the cost with a top marginal rate on estates of 40% and marginal rates higher than long term capital gains rates applying after just $20,000 above the estate exemption.[118] And, that's tax on *value*, not just gain, so shifting from income tax to estate tax can become a shift from net gain tax to gross receipts tax.

VI. BUILDING TAX RESULTS – TAX LAW CHOICE OF ENTITY RULES

Federal tax law's choice of entity regime is generally referred to as the "check-the-box" rules based on its fundamental electivity – you can chose whether or not to "check the box" on a form.[119]

A. State Law vs. Tax Law Choice of Entity

State business organizations law, for example, the Texas Business Organizations Code, define the formation and operation of business entities themselves. I will, for purposes of this paper, generally refer to this as "state law."[120] State law choice of entity rules only tangentially interact with the US tax law choice of entity rules.

The check-the-box rules classify state law entities into one of two categories: corporations and "eligible entities."[121] Corporations can only be taxed as corporations[122], while eligible entities may elect to be taxed as partnerships or corporations. By default, an eligible entity is classified as a partnership.[123]

B. (C-)Corporations

As discussed above, corporations are generally subject to tax both at the entity level under IRC § 11 and at the shareholder level when distributing dividends (admittedly at capital gains rates for "QDI" under IRC § 1(h)(11)). Distribution of property in kind actually triggers both levels of tax – the corporation is taxed as if it sold the property distributed for its fair market value and then the shareholder is treated as receiving a distribution equal to the fair market value of the distributed asset. The one piece of good news is that self-employment tax does not apply to corporate distributions.[124]

Corporations subject to this general double-layer of tax are sometimes referred to as "C-corporations" after Subchapter C which contains the tax rules under which they exist (as compared to electing small business corporations, discussed below, which are referred to as "S-corporations" after Subchapter S which contains the rules applicable to them).

As a corporation is subject to its own tax, it has its own deductions. This includes compensation deductions for ordinary and necessary business expenses for, e.g. compensation paid to employees, even when the employee in question is also a shareholder.[125] Provided that the compensation is fair market compensation for the goods or services provided to the corporation by that shareholder (see below under the heading "Gut-Check Doctrines" for doctrines that may reclassify excessive compensation as constructive dividends), this is one way to limit the exposure to the double-layer of tax. Some C-corporations are able to "zero out" their income and avoid tax by paying market compensation to its shareholders.

Much of Subchapter C focuses on preventing third or fourth layers of tax and avoiding taxing transactions seen to be mere shifts in corporate identity. Provided that the contributing shareholder(s) control (technically defined by IRC § 368(c); generally speaking owning 80% or more of the corporate stock) the corporation immediately after a contribution, contributions to capital (whether in exchange for corporate stock or with respect to already-held stock) are tax exempt to the

[116] IRC § 1041.

[117] Currently $5.45M per individual, so well managed couples can push up to $10.9M in gain bubbles out from under the edge of the nonrecognition wallpaper panel.

[118] IRC § 2001.

[119] IRS Form 8832, available at https://www.irs.gov/pub/irs-pdf/f8832.pdf

[120] While certain specialized classes of entities, particularly involving banks, are actually defined and governed by Federal law, this paper will refer to even Federal non-tax business entity law as "state law."

[121] Treas. Reg. 301.7701-3(a).

[122] *id*.

[123123] Treas. Reg. 301.7701-3(b)(1). Foreign entities default to partnership treatment where some owner does not have limited liability and corporations otherwise. Treas. Reg. 301.7701-3(b)(2).

[124] IRC § 1402(a)(2).

[125] IRC § 162.

shareholder.[126] Similarly, corporate reorganizations which do not alter the ultimate investment are potentially tax exempt if they meet one of the classes of "reorganization" defined by IRC § 368(a)(1) (which often turn on that same IRC § 368(c) definition of "control"). Each clause of that subsection defines the basic requirements for a class of reorganizations. Each class is generally referred to by (in the literature and other authorities, but not generally by the IRC or Treas. Reg.) the letter that enumerates the applicable clause. So, for example, IRC § 368(a)(1)(F) states that "F-reorganizations" are "a mere change in identity, form, or place of organization of one corporation, however effected." As a special case, in contrast to the general the liquidation of a corporation "controlled" (a competing definition under IRC § 1504(a)(2)) by another is generally tax free as well.[127]

Supporting provisions outside of Subchapter C include the deduction for wholly (or nearly wholly) owned corporate subsidiary dividends (effectively excluding them from income) under IRC § 243 and the consolidated tax return regime of IRC § 1501 *et seq* that generally allows affiliated groups of corporations (defined based on that IRC § 1504(a)(2) "control" standard) to avoid tax on transactions within a group (although preserving tax attributes of these ignored transactions with potentially surprising results which may occur years or decades later).

C. Partnerships

> A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.[128]

In contrast to C-corporations, partnerships are not themselves subject to tax.[129] Instead, partnership income "flows" up to the partners, who are taxed on their "distributive share" of partnership income.[130]

As with corporations, contributions are tax-free, but there is no such "control" requirement[131] – a one percent partner contributing property to a partnership is not taxed on that contribution, while a one percent shareholder contributing to a corporation *is* taxed. However, unlike corporations, there are special rules that require any built-in gain at contribution (i.e. contributing property worth $100 with a basis of $75 has $25 of built-in gain) flow back to the contributing partner.[132]

Similarly, distributions by partnerships are generally tax free, provided that the partner doesn't receive cash in excess of his or her basis in the partnership interest.[133] Because partnerships provide more nontaxable options for restructuring, instead of the lengthy rules for corporate reorganizations under IRC § 368, partnerships are subject to some deceptively simple "continuation" and "termination" rules under IRC § 708. Among the most surprising is that of a partnership "technical termination" under IRC § 708(b)(2) where "within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits."

Partnerships, intentionally, provide an extremely flexible mechanism for managing and controlling the flow of taxable income. This flexibility often places partnerships at the center of tax "shelters" and other classes of abusive transactions. As a result, Subchapter K, which provides the rules for taxing partnerships and their partners, despite appearing relatively straightforward within the IRC has developed a deceptive level of complexity in the Treas. Reg. provisions under Subchapter K.

In a belief that pass-through taxation is not generally acceptable in the public markets and to prevent the tax-efficiency of Subchapter K from pushing out Subchapter C, publicly traded partnerships are treated as corporations unless they meet a technical test where more than 90% of the partnership's income meets the criteria for "passive type income."[134]

D. Disregarded Entities

Mirroring the old common law rule that a partnership must have two partners, an eligible entity that has only one owner[135] is "disregarded as an entity separate from its owner"[136] and commonly called a "disregarded entity."

E. Changes in Check-the-Box Elections

The partnership/disregarded entity vs. corporation election can be changed at will, provided that once

[126] IRC § 351.
[127] IRC § 332.
[128] IRC § 701.
[129] *id.*
[130] IRC § 702.
[131] IRC § 721.
[132] IRC § 704(c).
[133] IRC § 722.
[134] IRC § 7704. This "passive type income" is the basis for so-called "master limited partnerships" so common in the oil and gas arena.
[135] Whether or not husband and wife holding a membership interest in an LLC as community property is one or two owners for this purpose is up to the taxpayers themselves. Rev. Proc. 2002-69.
[136] Treas. Reg. 301.7701-3(b)(1)(ii).

changed it cannot be changed again for 60 months.[137]

In short, if a partnership converts to a corporation, it is treated as if the partnership contributed its assets to a corporation (likely tax-free under IRC § 351) and then liquidates (generally tax-free under IRC § 722).[138] A corporation converting to a partnership is treated as if it liquidated, distributing its assets to its shareholders (normally taxable both for the corporation and the shareholders), who then contribute them to a newly formed partnership.[139]

The 60-month limitation after a change of election does have a workaround using state law conversions. Most states' business organizations rules provide for formless conversions of an entity from one entity type into another entity type – for example an LLC into a corporation.[140] The same tax treatment applies to conversions as does check-the-box election changes. If an LLC taxed as a partnership wishes to become a tax corporation, instead of checking the box (which may not be permitted under the 60-month waiting period), it could use its state formless conversion statute to convert into a state law corporation. It would then be a per-se corporation taxed as a corporation *without regard to the 60-month waiting period*. To convert back, it merely uses its state law formless conversion statute to become an LLC or a partnership, at which point by default it is treated as a tax partnership (or disregarded entity), again, *without regard to the 60-month waiting period* for check-the-box election changes.

F. S-Corporations

As mentioned, not all corporations are C-corporations. A "small business corporation" can elect taxation under Subchapter S.[141]

> For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not—
> (A) have more than 100 shareholders,
> (B) have as a shareholder a person (other than [certain classes of trusts]) who is not an individual,
> (C) have a nonresident alien as a shareholder, and
> (D) have more than 1 class of stock.[142]

Living within the restrictions to stay a "small business corporation," and therefore avoid falling back to double-taxed C-corporation status, can be a heavy burden, particularly as the "one class of stock" requirement effectively mandates a "heads-up" economic ownership (by percentages, with no "bends" or "twists" in the economics, such as would exist from preferred stock).

Like partnerships, S-corporations don't themselves pay tax under IRC § 11.[143] Instead, their shareholders are taxed on their distributive share of S-corporation income.[144]

Otherwise, S-corporations are treated for tax purposes exactly like C-corporations. Contributions to capital are only tax exempt if they qualify under IRC § 351 (including the 80% control requirement of IRC § 368(c)) and distributions of property trigger unrealized gain or loss in the property. Reorganization provisions under IRC § 368 apply to S-corporations just as they do to C-corporations.

While it applied equally to C-corporations, the exclusion of corporate distributions from self-employment tax becomes especially important for S-corporations. If an S-corporation shareholder is also an employee and is paid a fair market compensation for the services as employee, then the distributions to him or her as shareholder are free of self-employment tax. This one strategy may be responsible for the profusion of S-corporations (instead of partnerships) in small, closely held businesses.

VII. LOSS DENIAL

While the general rules of the IRC and its regulations and supporting authorities include significant protections against abuse, they are subject to some outside attacks. One comes out of the sometimes overly-artificial lines drawn between taxpayers. Another arises when the fiction that debt is not income might not actually be so true. And yet another addresses concerns about transactions which are might not be economically beneficial other than after taxes. A series of loss denial rules serve to prevent these blind spots in general tax law from allowing abuse. While sometimes over-zealous,[145] these rules attack relatively well-defined situations, so can be well predicted.

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[137] Treas. Reg. 301.7701-3(c)(1)(iv). For this purpose, an initial election effective as of the date of formation is not treated as a "change" and does not start a 60-month waiting period.

[138] Treas. Reg. 301.7701-3(g)(1).

[139] Treas. Reg. 301.7701-3(g)(2).

[140] *E.g.* Tex. Bus. Org. Code § 10.101.

[141] IRC § 1362.

[142] IRC § 1361(b)(1).

[143] IRC § 1363(a). Built-in gain at the time a C-corporation converts to an S-corporation remains taxable under IRC § 11 at the corporation level for some time after the conversion. IRC § 1374.

[144] IRC § 1366(a)

[145] These rules apply without regard to whether or not abuse was intended and apply often in situations despite no tax benefit having been sought.

A. Related Party Losses

We have already discussed how the annual accounting periods create opportunities to defer income, sometimes for a year in exchange for delaying a transaction for a day. Another place where Federal income tax law draws hard and fast distinctions that may be more malleable in reality is the idea that taxable income is measured on a taxpayer-by-taxpayer basis. Sometimes, the taxpayers themselves consider income on a family-wide basis (whether that family is by blood, affinity, or common ownership) and can create tax losses by shifting assets or income around inside the family.

IRC § 1041 prevents the recognition of gain or loss as between spouses or as part of a divorce in response to the fact that spouses are two individuals acting as a single unit.

Similarly, the "kiddie tax" of IRC § 1(g) taxes parents (at the parent's marginal tax rates) on their minor children's net unearned income on the theory that income not from personal services is really *family* income, not individual income.

IRC § 1031 even contains special rules for like-kind exchanges between related parties.

But more broadly, IRC § 267 provides a rather far-reaching denial of losses in transactions between related parties. The concern is that a taxpayer might be willing transfer property "within the family" in order to generate losses and that negotiations between related parties are not nearly as likely to represent fair market, arms' length terms (so the loss might not be an actual marketplace loss).

For this purpose, "related" includes family;[146] shareholders and their corporations (above a 50% ownership threshold); partners and their partnerships; commonly controlled corporations and partnerships; and trusts with their grantors, their fiduciaries, and their beneficiaries.[147] For purposes of determining whether entities are related, ownership is attributed between related parties (with a different standard for what constitutes "related").[148]

Unlike nonrecognition provisions discussed above, there is no adjustment to basis coming out of a transaction to which IRC § 267 applies. So, my selling a depreciable asset with basis of $100 to my brother[149] for $80 doesn't create a loss for me, but only gives him an $80 basis to depreciate.

Nevertheless, IRC § 267(d) continues the "wallpaper problem" by reducing my brother's subsequent gain to the extent of my lost loss. So, if my brother later sold that same asset for $110, he would realize $30 of gain, but would only recognize $10 of that gain (the other $20 being offset to compensate for the loss I didn't realize). While this helps somewhat, *I* don't get the benefit of my loss, my brother does.

B. At-Risk Rules

Out of concern whether deductions attributable to nonrecourse debt for which the borrower does not have economic risk, IRC § 465 limits deductions to the amount that the individual has "at risk" in the activity as of the end of the tax year.[150] Excess losses blocked under the at-risk rules are suspended for later years in which the taxpayer has more at risk than offsetting deductions.[151] For this purpose, a taxpayer has "at risk" the amount of cash contributed to the activity and the borrowings for which he is personally liable (or which are secured by property, to the extent of the fair market value of the property).[152] Guarantees of debt don't count.[153] The amount at risk is reduced for permitted losses from the activity.[154] And, if, for some reason, the taxpayer's amount at-risk becomes negative, the taxpayer realizes "phantom" income sufficient to bring the amount at-risk back to zero.[155]

The at-risk rules only apply to individuals and closely held corporations[156] and only for certain specified activities: movie holding or producing or distributing, farming, leasing property subject to depreciation recapture, and exploring and exploiting oil and gas resources or geothermal deposits.[157]

So, for example, assume a taxpayer borrows $200 to buy farm equipment worth $150 and to pay a leasing manager employee a salary of $50. The taxpayer is not personally liable for the debt. While this seems extraordinary at first glance, it is common for taxpayers to form disregarded single member LLCs for such an activity (or some other pass-through) which is the borrower on the debt. In that case, the owner would not be liable for the debt, even if he guaranteed it. The taxpayer only has "at risk" the $150 cost of the equipment. Then assume that the taxpayer never

[146] "Family in this context is defined in IRC § 267(c)(4) to be "brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants." Contrast this with the competing definition of "related" in IRC § 318(a)(1) used for attributing stock ownership between related parties as part of qualifying (or not) for most of the nonrecognition provisions in Subchapter C, which *excludes* siblings.

[147] IRC § 267(b).

[148] IRC § 267(c).

[149] I am, actually an only child, but we will assume for the moment that I have a brother.

[150] IRC § 465(a)(1).

[151] IRC § 465(a)(2).

[152] IRC §§ 465(b)(1) through (3).

[153] IRC § 465(b)(4).

[154] IRC § 465(b)(5).

[155] IRC § 465(e).

[156] IRC § 465(a)(1)(A) and (B).

[157] IRC § 465(c)(1).

actually finds a customer to lease to, so has no income. So, while between depreciation and salary expenses, the taxpayer would ordinarily be able to deduct all $200, the taxpayer will only be able to have the first $150 in deductions, and then loses the additional deductions. If the equipment were to be lost after taking $50 of losses, the taxpayer's amount at risk would be *negative* $50 (no property securing the debt, so nothing at risk, reduced by the $50 in losses previously permitted), requiring $50 in phantom income to recapture the excess deductions previously permitted by the at-risk rules.

C. Passive Activity Rules

After satisfying the at-risk rules[158], our leasing taxpayer might *still* not be able to access the losses from the failing leasing activity.

Our hypothetical taxpayer must next deal with the passive activity rules of IRC § 469. Under those rules, passive losses and passive credits may only be used to offset passive gains. If a taxpayer has more passive losses in a given year than passive gains, the excess passive losses are suspended for the next tax year.[159] "Passive activities" in this context are any trade or business in which the taxpayer does not "materially participate" or leasing activities.[160] Material participation is defined in IRC § 469(h) to be involvement in the operations of the activity on a basis which is regular, continuous, and substantial.[161] In practice, "material participation" is defined by the safe harbors listed in Treas. Reg. 1.469-5T(a) which include:

- Participation for more than 500 hours in the year;[162]
- The individual's participation "constitutes substantially all of the participation in such activity of all individuals" for the year;[163]
- The individual actively participated in the activity for at least 5 of the prior 10 years;[164] and
- For personal service activities (health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or other businesses where "capital is not a material income-producing factor"[165]), the individual has been active in three prior years.[166]

Limited partners are automatically passive unless they meet the 500-hour test, the 5-of-the-last-10-years test, or the 3-years test for personal service activities.[167]

Since the hours spent in an activity can define whether or not it is passive, best practices for taxpayers generally involve keeping some kind of work log. Also, there is a general trend of valuing passive income generators (sometimes called "PIGs" in the literature) since while passive losses can only offset passive gains, *passive income can be offset by passive or active income*.

VIII. GUT-CHECK DOCTRINES

It is often said of tax planning that "pigs get fat, hogs get slaughtered." There is

Continually ask yourself "what's really going on here?" and "is this too good to be true?" Because when it is too good to be true, even if the actual words of the IRC or the Regulations say it is true, it still just might not be true.

A. Step Transaction

On the theory that merely jumping through extra hoops *shouldn't* be enough to change the tax treatment of a transaction, the courts have created the "step transaction doctrine." This doctrine, as described by the Tax Court,

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced.[168]

This doctrine can collapse steps together or reorder steps, but cannot be used to imply steps that were not otherwise present.[169] There are three competing standards for when to apply this doctrine. The End Result Test, as described by the Fifth Circuit applies when "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result."[170] The Mutual Interdependence Test applies when "on a reasonable interpretation of objective facts the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[171] The Binding Commitment Test is the most narrow, capturing only situations where there is a binding commitment to complete all steps.[172]

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158 Treas. Reg. 1.469-2T(d)(6)(i).
159 IRC § 469(b)
160 IRC § 469(c)(1) and (2).
161 IRC § 469(h)(1).
162 Treas. Reg. 1.469-5T(a)(1).
163 Treas. Reg. 1.469-5T(a)(2).
164 Treas. Reg. 1.469-5T(a)(5).
165 Treas. Reg. 1.469-5T(d).
166 Treas. Reg. 1.469-5T(a)(6).
167 Treas. Reg. 1.469-5T(e)(1) and (2).
168 *Smith v. C.I.R.*, 78 T.C. 350, 389 (1982).
169 *Grove v. C.I.R.*, 490 F.2d 241 (2nd Cir. 1973).
170 *Kanwha Gas & Utilities co. v. C.I.R.*, 214 F.2d 685 (5th Cir. 1954).
171 *Redding v. C.I.R.*, 630 F.2d 1169 (7th Cir. 1980).
172 *E.g. C.I.R. v. Gordon*, 391 U.S. 83 (1968).

B. Substance Over Form

Nothing captures the "what's really going on here?" question more than the principle of substance over form. This general principle of Federal tax law, sometimes called the "economic substance doctrine" or a prohibition of "sham transactions" says that the tax consequences of a transaction are based on the substance, not the form, of a transaction.

In an attempt to codify this doctrine, IRC 7701(o), which provides that a transaction will lack economic substance (so will be recast) unless

> (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Ultimately, this statement is merely interpreted as invoking the pre-existing common law of the economic substance doctrine.[173] In fact, it is almost directly taken from the seminal case on point, *Rice's Toyota World v. C.I.R.*, 752 F.2d 89 (4th Cir. 1985) interpreting the cornerstone case of the "sham transaction" form of the doctrine in *Frank Lyon Co v. U.S.*, 435 U.S. 561 (1978).

But, in enacting IRC § 7701(o), Congress backed it with new penalties. IRC § 6662(b)(6) and (i) provide for penalties (or an increase to the pre-existing substantial understatement penalty) for any undisclosed transaction which fails to have economic substance under IRC § 7701(o).

This doctrine also shows up in a number of cases, creating a "business purpose" requirement for IRC provisions which is not actually present in the language of the IRC. The most prevalent of these is the contribution to capital of a corporation. IRC § 351, which provides for nonrecognition in these cases (and which multiplies the "wallpaper problem" by giving the shareholder and the corporation both carryover bases) never says anything about a business purpose. However, there is customarily inferred a "business purpose" requirement.[174] No matter what the text of the IRC says, a capital contribution to a corporation without a business reason (therefore presumably done strictly for tax purposes) cannot be a nonrecognition provision.

Ultimately, applying the principal of substance over form (whether as "sham transaction" or "economic substance doctrine" or merely a "business purpose" requirement).

C. Transfer Pricing

IRC § 482 states, cryptically that

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

This provision more broadly addresses the same concern that IRC § 267 and the related party loss rules did – that transactions "in the family" (literally, "owned or controlled directly or indirectly by the same interests") may not represent arms-length pricing. While IRC § 267 is more mechanical in nature, defining to whom it applies and how in a precise way, and only applies to losses, IRC § 482 provides the IRS (under the Secretary of the Treasury, the "Secretary" mentioned) the authority to revise non-arm's length transactions. That is exactly the standard at the heart of IRC § 482 – that of the arm's length deal. Specifically, Treas. Reg. 1.482-1(b)(1) defines this standard as follows:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

This concept is applied by tax practitioners throughout the code. Generally considered, any transaction which isn't on arm's length terms to be suspect and anticipate that it will have some kind of challenge applied to it. The standard of IRC § 482 that the parties to the

[173] Notice 2010-62.

[174] *See, e.g.* Rev. Rul. 55-36, citing *Gregory v. Helvering*, 293 U.S. 465 (1935).

transaction must be "owned or controlled directly or indirectly by the same interests" is so loosely defined as to be effectively conclusory – so the theory goes, if they aren't acting on arm's length terms, they *must* have or be controlled by "common interests."

Transfer pricing has become a specialization area among tax practitioners. Almost all of the rules are provided in the regulations, and those regulations are extremely prolix, with general rules and specialized rules for tangible[175] and intangible,[176] property, for using comparable profits to identify appropriate arm's length terms,[177] rules for cost-sharing,[178] rules for controlled services,[179] and even rules as to which rules to apply.[180] Even beyond those rules, there are whole industries of "experts" that will provide opinions, who have their own rules and standards for providing those opinions.

D. General Anti-Abuse Rules

Finally, there are general anti-abuse rules. There is no overarching anti-abuse rule for the IRC as a whole (IRC § 7701(o) codification of substance over form may have been intended to fill some of that gap). But, there are

Generally, these are small in scope. For example, IRC § 1031(f) contains special rules for like-kind exchanges between related parties. IRC § 1031(f)(4) denies IRC § 1031 in its entirety to "any exchange which is a part of a transaction (or series of transactions) structured to avoid the purposes of this subsection [(f)]."

But, Subchapter K include not one but *two* general anti-abuse rules that potentially apply to *all* partnerships. First, any transaction involving a partnership which is contrary to the "intent of subchapter K" can be recast by the IRS.[181] Second, the IRS can treat any partnership "formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K" as a mere collection of partners, not as a distinct entity in its own right.[182]

How do we know if something is outside of the "intent of subchapter K?" The regulations provide factors to examine, but it all starts with asking the question, "is this too good to be true?" If the answer is yes, the next question needs to be "what's really going on here?"

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[175] Treas. Reg. 1.482-3.

[176] Treas. Reg. 1.482-4.

[177] Treas. Reg. 1.482-5, and -6.

[178] Treas. Reg. 1.482-7 and -7T.

[179] Treas. Reg. 1.482-9.

[180] Treas. Reg. 1.482-8.

[181] Treas. Reg. 1.701-2(b) ("if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances").

[182] Treas. Reg. 1.701-2(c).