2015 Tax Law Update Series:
S Corporations – Nine Topics You Need to Know

Presented by
Gary M. Edelson
Jonathan R. Flora

May 18, 2015

MONTGOMERY McCRACKEN WALKER & RHOADS LLP
123 S. Broad Street
28th Floor
Philadelphia, PA 19109
t| 215.772.1500
f| 215.772.7620
www.mmwr.com

MONTGOMERY McCRACKEN

Table of Contents

S Corporations – 9 Topics

Gary M. Edelson
and
Jonathan R. Flora

May 18, 2015

Table of Contents

Table of Contents (continued)

Introduction

Gary M. Edelson, Esq.

Gary has represented S corporations, limited liability companies and partnerships (including private investment vehicles), registered investment companies and grantor trusts in connection with matters on issues related to income tax, taxation of pass-through entities, estate and gift tax, mergers and acquisitions, taxation of qualified plans and tax-exempt entities that invest in pass-through entities.

Jonathan R. Flora, Esq.

Jonathan advises clients on federal, state and local tax issues. He has represented clients on tax planning and structuring for a broad range of transactions, such as joint ventures, mergers and acquisitions, divestitures, reorganizations, redemptions, liquidations, securitizations, issuance of securities, licensing, workouts and tax-free exchanges.

1) Real Estate or Expensive Equipment Lease to S Corporation

Real Estate or Expensive Equipment Lease to S Corporation

- Non-tax reasons for leasing the real estate or expensive equipment to S corporation include:
  - protecting the asset from creditors of the business
  - estate planning
  - ability to give equity interest in real estate independent of the stock
  - lenders concerns - protecting the collateral

Real Estate or Expensive Equipment Lease to S Corporation

- Need to consider passive activity loss rules. See Treasury Regulation §1.469-2(f)(6).
- If lease at loss: Passive.
- If lease at profit: not passive: *See* Regulation 1.469-2(f)(6). Applied item of property by item of property. *See* Joseph Veriha v. Commissioner 139 T.C. 45.

Real Estate or Expensive Equipment Lease to S Corporation

- Be careful of 3.8% NIIT. Unless ordinary course of business exception applies, rental income is net investment income.
- Two potential exceptions:
  - If Treasury Regulation §1.469-2(f)(6) applies to convert the passive income to non-passive income, then ordinary course of business exception applies.

Real Estate or Expensive Equipment Lease to S Corporation

- Grouping election under Treasury Regulation 1.469-4(b)(1). See Treasury Regulation §1.1411-4(g)(6). To make grouping election, must have identical ownership between the S corporation stock and ownership of pass-through entity that holds the rental real estate or equipment.

2) Loans to S Corporation

Loans to S Corporation

- Many non-tax reasons for loans including:

  (1) Proportion of ownership.
  (2) Debt versus capital.
  (3) Banking considerations, including restrictions on dividends.

Loans to S Corporation

- Consider the 3.8% NIIT. *See* Treasury Regulation §1.1411-4(g)(5) regarding treatment of self-charged interest. To the extent the self-charged interest rule applies, the interest is treated as derived in the ordinary course of a trade or business and therefore not subject to the 3.8% NIIT.

- *See* definition of applicable percentage in Treasury Regulation §1.469-7(c). For example, 50% shareholder loans $100 to S corporation and receives $5 of interest income. Only $2.50 of interest is treated as derived in the ordinary course of business.

Loans to S Corporation

- Consider the OID rules. See example 10 in Treasury Regulation §1.1272-1 (debt instrument payable on demand that provides for interest at a constant rate subject to OID rules).

- Potential mismatch of income – interest income but loss potentially suspended due to insufficient shareholder basis.

Loans to S Corporation

- Second class of stock - is the loan a second class of stock?

- Debt should be "straight debt" to avoid second class of stock. No contingent debt instruments, no convertible debt instruments, must be held by an eligible shareholder.

Loans to S Corporation

- Must consider whether repayment of debt will trigger capital gain or ordinary income. Losses absorb basis of stock first and then basis of debt. Basis in debt is only increased by "net increases" in basis.
- If open account debt is repaid:
  - ordinary income
- If debt instrument is repaid
  - capital gain treatment

See IRC §1271. Ability to use open account debt is confined to $25,000. *See* Treasury Regulation §1.1367-2(a)(2).

Loans to S Corporation

- If low basis debt cannot be repaid, consider contribution to capital. *See* IRC §108(e)(6) and IRC §108(d)(7)(C).
- Avoid exchanging debt for more stock. *See* IRC §108(e)(10) (forgiveness of debt to the extent the value of stock is less than debt).

3) Acquisition of Stock by Employee – Necessity of § 83(b) Election

Acquisition of Stock by Employee Necessity of § 83(b) Election

Overview

1. Grant of stock to employee is taxable. § 83

   Amount of Tax = FMV – amount paid (if any)

2. If stock is not vested, employee is not treated as a shareholder and timing of income is delayed until stock becomes vested.
3. Fair market value (and taxable income) is measured at time of vesting.

Acquisition of Stock by Employee – Necessity of §83(b) Election

- Example:
  - Employee pays $100,000 for stock worth $1 million.
  - Stock is not vested (and no §83(b) election is made).
  - Stock vests 5 years later when it is worth $5 million.
  - Employee has ordinary (wage) income equal to $4,900,000 on the date the stock becomes vested.
  - Holding period begins on date stock vests, and tax basis is $5 million

Acquisition of Stock by Employee – Necessity of §83(b) Election

- Same Facts with an 83(b) Election
  - Employee recognizes taxable income in year of grant of $900,000 (difference between FMV and cost)
  - Employee takes a tax basis in the stock of $1 million.
  - Holding period begins on date of grant.
  - No tax consequences when Stock vests 5 years later when it is worth $5 million.
  - Subsequent transactions result in capital gain

Acquisition of Stock by Employee – Necessity of §83(b) Election

- Upsides of making an 83(b) election
  - Potentially less ordinary (wage) income
  - Accelerates the start of the holding period for long term capital gain
- Downsides of making at 83(b) election
  - Accelerates income
  - Irrevocable
  - No loss allowed if stock is forfeited

Acquisition of Stock by Employee – Necessity of §83(b) Election

- Is the employee viewed as a shareholder while stock is not vested? Treasury Regulation §1.1361-1(b)(3):
  - If IRC §83 applies, shares are not treated as outstanding until the stock is vested, unless the shareholder makes §83(b) election.
- Require employee to make §83(b) election if any doubt as to whether stock is vested.

Acquisition of Stock by Employee Necessity of 83(b) Election

Non-tax Considerations for Employee Grants

1. Class of Non-voting stock
2. Require Execution of a Shareholder's Agreement
   - Restriction on transfer
   - Drag along rights

Acquisition of Stock by Employee – Necessity of §83(b) Election

- Mechanics of an 83(b) Election
  - Employee completes Election Form
  - File with IRS within 30 days after grant
  - Provide Employer with Election Form
  - Attach Election Form to Tax Return for Year of Grant
    - Efile?

Acquisition of Stock by Employee – Necessity of §83(b) Election

Trap for the Unwary

- §83 applies even if fair market value is paid.
- If §83(b) election is made, no income if fair market value is paid.
- If no §83(b) election is made and stock is not vested and later becomes vested, the appreciation in the stock is income in the year it vested.
  - See, Alves v. Commissioner, 79 T.C. 864

Acquisition of Stock by Employee – Necessity of § 83(b) Election

Transfers by a Shareholder

- Sometimes a majority or 100% shareholder will transfer his or her stock to an employee.

Q: Does the fact that the corporation is not issuing the stock make a difference?

Acquisition of Stock by Employee – Necessity of § 83(b) Election

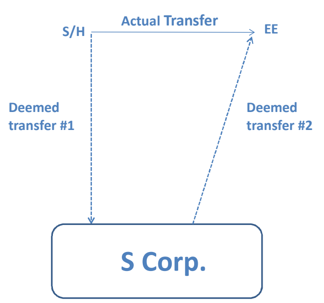
A. No. Thanks to a special rule for transfer of stock to employee by shareholders.

- Treasury Regulation § 1.83-6(d)

Under the regulations, there is:

- a deemed transfer to the corporation by selling shareholder and
- a deemed acquisition by employee from corporation

Illustration of Reg. § 1.83-6(d)



Acquisition of Stock by Employee – Necessity of §83(b) Election

- Example:
  – 100% shareholder sells 10% of the stock of the S corporation on June 30 to a key employee
  – Purchase price = $100,000
  – FMV = $1 million.
  – Assume stock is immediately vested

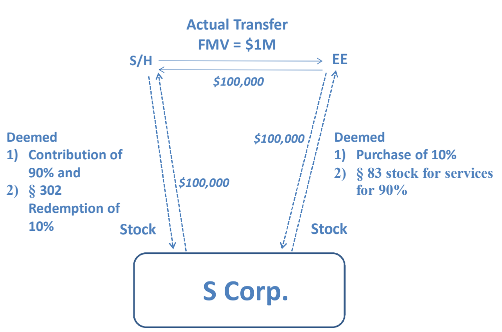
Acquisition of Stock by Employee – Necessity of §83(b) Election

- Results:
- For the Shareholder:
  - 100% shareholder is deemed to sell 10% of the stock to the corporation in exchange for $100,000.
  - Under IRC §302(b)(2) treated as an S corporation distribution in redemption of stock to shareholder.
- For the Employees:
  - Employee has gross income equal to $900,000.
  - The employee is shareholder for half year.

Acquisition of Stock by Employee – Necessity of §83(b) Election

(tax consequences – continued)

- For the Corporation:
  - Corporation reports a deduction equal to $900,000.
  - A portion of the deduction is shared with the employee. The majority of the deduction passes through to the 100% shareholder.



4) What To Do If the S election Is Not Timely Made

What To Do If the S election Is Not Timely Made

- An S election must be made no more than two months and fifteen days after the beginning of the year the election needs to be effective or any time during the prior preceding taxable year.
- IRC §1362(b)(5) provides that if an election is made for taxable year after the date permitted for making the election and the IRS determines that there was reasonable cause for the failure to timely make the election, the IRS may treat the election as timely made for the taxable year.

What To Do If the S election Is Not Timely Made

- Relief is available under Revenue Procedure 2013-30
- Revenue Procedure 2013-30 is available if:
  - the corporation intended to be classified as an S corporation as of the intended effective date;
  - the corporation failed to qualify as an S corporation solely because the S election was not timely made;

What To Do If the S election Is Not Timely Made

- the corporation had a reasonable cause for its failure to timely file the S election;
- the corporation acted diligently to correct the mistake upon discovery;
- IRS Form 2553 is filed within three years and seventy-five days of the intended effective date; and

What To Do If the S election Is Not Timely Made

- the corporation can file a statement from all the shareholders who were shareholders during the period stating that they have reported the income on all tax returns consistent with the S election being effective

What To Do If the S election Is Not Timely Made

- Revenue Procedure 2013-30 is not available if:
  - the corporation failed to qualify as an S corporation;
  - more than three years and seventy-five days have passed since the intended effective date;
  - the corporation lacked reasonable cause for its failure to timely file the S election;

What To Do If the S election Is Not Timely Made

- the corporation failed to act diligently to correct the oversight after discovery; or
- the shareholders failed to consistently report the income on all tax returns for the years in which the S election was intended.

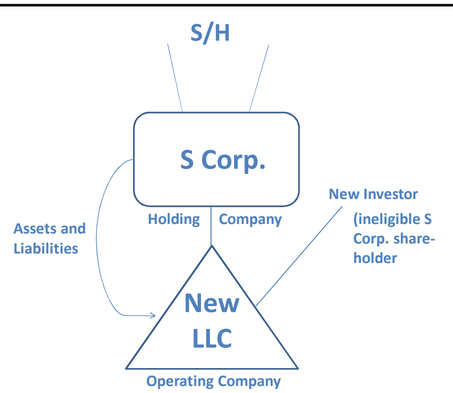
5) S Corporation – Use of Partnerships

S Corporation – Use of Partnerships

- A valid S corporation, among other things, must meet the following requirements:
  - cannot have more than 100 shareholders;
  - cannot have as a shareholder a person other than an individual, estate or certain trusts;
  - cannot have a non-resident alien as a shareholder;
  - cannot have more than one class of stock.

S Corporation – Use of Partnerships

- An entity classified as a partnership (e.g., LLC or LP) combined with a S corporation is a useful tool to accommodate an ineligible S corporation shareholder.
- For example:
  - S corporation drops business into LLC and an ineligible shareholder becomes a member of LLC.
- Revenue Ruling 94-43 permitted the use of a partnership to avoid the 100 shareholder rule.



S Corporation – Use of Partnerships

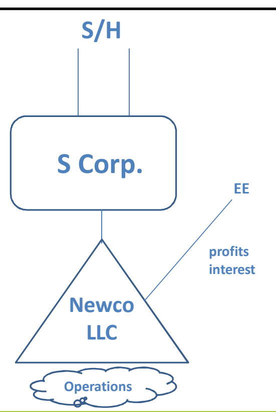
- A partnership with an S corporation as a partner can be used to solve problems arising from the one class of stock rule.
- For example:
  - New investor wants a preferred return but it is not available because of the single class of stock rule.
  - S corporation and an investor form an LLC. Investor contributes money. The S corporation contributes assets.
  - LLC distributes a preferred return to the investor.

S Corporation – Use of Partnerships

- S corporation and LLC combination can be used to solve imputed income to employee when equity is issued for services.
- For example,
  - key employee wants to become an equity owner but has no money.
  - Stock is very valuable.

S Corporation – Use of Partnerships

- S corporation and existing shareholders form LLC.
- S corporation contributes business assets and existing shareholders contribute cash.
- LLC then issues to key employees "profits interest" which are non-taxable to the employees.
  - *See* Rev. Proc. 93-27 and Rev. Proc. 2001-43.



S Corporation – Use of Partnerships

- Private Equity.

Private Equity Buyer of business wants existing equity owners to retain a 25% interest to have “skin in the gain”.

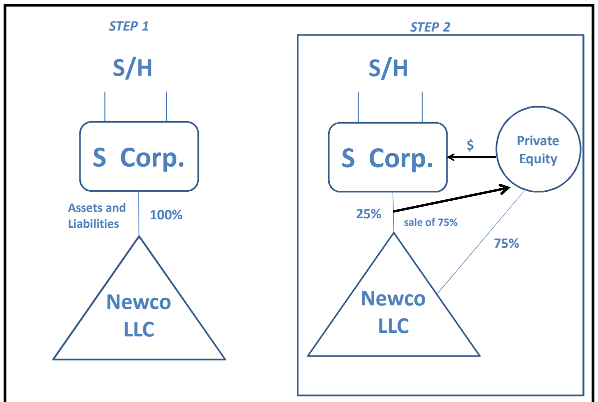
- Problem:

If Buyer buys assets or all the stock from S corporation shareholders, shareholders recognize 100% of the gain and will rollover 25% on any after tax basis.

S Corporation – Use of Partnerships

Solution: To avoid this:

- S corporation drops business into single member LLC.
- Buyer buys 75% of the equity interest in LLC and S corporation retains 25%.
- S corporation shareholders recognize only 75% of the gain and 25% is rolled over tax free.
- 754 election is available



S Corporation – Use of Partnerships

- Lender demands warrants. But Lender is an ineligible shareholder.
- The warrants are so far in the money (eg penny warrants) that they may be deemed exercised.
- To avoid an ineligible shareholder, S corporation forms a single member LLC and contributes business to single member LLC. Single member LLC then issues options to lender who loans money to LLC.

6) S Corporation Shareholder's Will

S Corporation Shareholder's Will

- Only two types of non-grantor trusts are permitted shareholders of an S corporation:
  - Qualified subchapter S corporation trust ("QSST"); and
  - Electing small business trust ("ESBT")
- Unless shareholder's Will provides for a direct transfer of the stock to an eligible shareholder, the shareholder's Will must provide for the stock to be placed in one or more QSSTs or one or more ESBTs.

S Corporation Shareholder's Will

- QSST requirements:
  - All trust income is required to be distributed currently to a single income beneficiary;
  - The current income beneficiary must be a U.S. citizen;
  - The trust must require that during the life of the current income beneficiary, there will be only one current income beneficiary and the beneficiary's interest terminates on the earlier of the beneficiary's death or at the termination of the trust;

S Corporation Shareholder's Will

- The trust must provide that if the trust terminates during the beneficiary's lifetime, all the trust's assets will be distributed to the beneficiary; and
- The beneficiary makes a QSST election.
- If QSST election is made, beneficiary is taxed on the S corporation's income as if he owned the stock.

S Corporation Shareholder's Will

- ESBT. An ESBT must meet the following requirements:
  - All the beneficiaries must be individuals, estates, charities or other organizations described in IRC §170(c)(2);
  - No interest in the trust can be acquired by purchase;
  - An election must be made by a trustee;
  - If ESBT election is made, all of the S corporation's income is taxed at a flat rate equal to the highest marginal rate applicable to trusts.

S Corporation Shareholder's Will

- Necessity of Shareholder's Agreement. If more than one shareholder, the shareholders should have a shareholder's agreement, among other things, prohibiting a transfer to an ineligible shareholder. A shareholder's agreement may impose an obligation to pay damages in the event a shareholder transfers stock to an ineligible shareholder.

7) S Corp vs LLC – The Choice

S Corp vs LLC – The Choice

Benefits of an S Corp include:

- ease of formation;
- simplicity – people understand shares;
- potential disposition through tax free reorganization with another corporation;
- ISOs; and

S Corp vs LLC – The Choice

(Benefits – continued)

- potential savings of self employment tax- social security tax applies only to actual W-2 wages, and not to S distributions
  - Note that W-2 comp must be reasonable.
  - Versus LLC – working members will pay self-employment-social security on their full share of company income

S Corp vs LLC – The Choice

(Benefits – continued)

Net Investment Income

- 3.8% Medicare tax on NII – trade or business income if passive activity. Active shareholder in S corp should avoid NII on distributions (but not wages)
- Active LLC member will avoid NII but pay increased 3.8% Medicare tax (over threshold)

S Corp vs LLC – The Choice

Detriments of an S Corp include:

- Limitation on number of shareholders.
- Limitation on type of shareholders.
- Limitation on distributions – one class of stock requirement.
- Limitations on tax free formation: § 351 vs § 721.

S Corp vs LLC – The Choice

(Detriments – continued)

- Less flexible management alternatives.
- Tax basis in stock does not include share of corporate liabilities.
- Distribution of appreciated assets triggers gain – bad for real estate

S Corp vs LLC – The Choice

Retirement Provisions.

- IRC §736(a) allows a portion of payments to retired members to be classified as deductible guaranteed payments or a distributive share of income while payments for stock are never deductible. See IRC §162(k).

S Corp vs LLC – The Choice

- Need to understand owner's objectives.
- For example:
  - Sale by going public or tax free reorg – use S corp.
  - Sale to private equity fund – use LLC.
  - Keep business in family – use LLC – IRC § 754 election.

S Corp vs LLC – The Choice

LLC Election to Be Taxed as an S Corp:

- LLC is a default partnership, but it can elect to be treated as a corporation.
- Election is usually made on Form 8832, but by making an S election, it will be deemed to have elected corporate status. See Reg. 301.7701-3(c)(1)(v)(c).
- But only if it meets all the requirements of an S corporation.

S Corp vs LLC – The Choice

LLC's Election to Be An S Corp.

- Requirements in Operating Agreement
  - No ineligible shareholders
  - Single Choice of stock rule, so no waterfalls, preferred returns, etc.
    - -- Best to use "units" and distribute on a per unit basis
  - Remove partnership terminology – No special allocations; no regulatory allocations; no capital accounts

8) Trapped in a C Corp Liquidation or S Election

Trapped in a C Corp Liquidation or S Election

- If C corp converts to LLC classified as a partnership, C corp is deemed to liquidate. Corporate Level Gain recognized under IRC §331. Basis in stock is increased. Shareholders recognize gain or loss under IRC §336.
- If C corp converts to an S corp, no deemed liquidations, however, numerous landmines.

Trapped in a C Corp Liquidation or S Election

- IRC §1374. The recognition period is a ten-year period beginning on the effective date of the S election. The corporation needs to measure its net unrealized built-in gain. Inventory is valued by the amount a willing buyer would pay a willing seller for the inventory on the purchase of the S corp's entire business.
- IRC §1375 and IRC §1362(b)(3)
  - IRC §1375 imposes a tax on S corp's excess net passive income defined as a fraction of the corporation's net passive income, the numerator of which is the passive investment income in excess of 25% of gross receipts and the denominator of which is the amount of passive investment income.

Trapped in a C Corp Liquidation or S Election

- Termination of S Election. An S Election terminates if a corporation has subchapter C earnings and profits and more than 25% of its gross receipts are from passive investment income for three consecutive taxable years. An S election can terminate even if tax under IRC §1375 is zero.

Trapped in a C Corp Liquidation or S Election

- Both the tax under §1375 and the potential for termination under §1362(b)(3) can be eliminated by a corporation distributing all of its subchapter C earnings and profits by the last day of the taxable year. The corporation can make a "deemed divided" election in accordance with Treasury Regulation §1.1368-1(f)(3).

Trapped in a C Corp Liquidation or S Election

- LIFO Recapture. A converted C corp that used the LIFO method of inventory accounting must include in its gross income for its last taxable year as a C corp its LIFO Recapture Amount. The LIFO Recapture Amount is the difference between the value of the inventory at the close of the last taxable year as a C corp determined under the FIFO method, and the value of its inventory determined under the LIFO method. The increase in tax attributable to the inclusion is payable in four installments, the first of which is due with the corporation's final return as a C corp.

Trapped in a C Corp Liquidation or S Election

- If a decision is made to liquidate, the C corp's major issue is whether the goodwill and the going concern value of the business is owned by the corporation or by the shareholders. *See* Bross Trucking Inc., TC Memo 2014-107; also see Martin Ice Cream, 110 T.C. 189. If shareholders own the goodwill and going concern value, then the liquidation may not be so expensive.

Trapped in a C Corp Liquidation or S Election

- Sometimes an LLC classified as a partnership is the better choice. Factors include:
  - (1) the one class of stock rule;
  - (2) the eligible shareholder rule;
  - (3) 100 shareholder limit;
  - (4) desirability of Section 754 elections;
  - (5) stock basis rule vs. the partnership basis rule that includes debt;
  - (6) IRC §311 entity level gain on distributions in kind vs. IRC §731 – no gain or loss recognized on distributions in kind; and,
  - (7) need to issue profits interest to employees tax free.

9) S Corporation – 336(e) Election

S Corporation – 336(e) Election Background

- 336(e) was enacted as part of Tax Reform Act of 1986
- It lay dormant subject to Regulations to be issued by IRS
- IRS issued proposed regulations on August 25, 2008
- Finalized Regulations issued on May 2013
- Modeled after 338(h)(10) – treats certain stock sales as asset sales

S Corp – 336(e) Election

How is it Different from 338(h((10)?

- Main Difference: buyer does not have to be a corporation
  - For example, the buyer can be an individual, a group of individuals or a partnership
- Focus is on disposition, not the purchaser. Can qualify if multiple unrelated purchasers acquire 80% or more in 12 month period
- If both 336(e) and 338(h)(10) apply, 338(h)(10) trumps
  - Protective 336(e) election

S Corporation – 336(e) Election

- A "Qualified Stock Disposition"
  - Section 336(e) allows taxpayers to elect to treat a sale of at least 80% of the stock of the S corporation as a sale of the assets.
- Requires a valid S corporation –
  - Due Diligence!
  - If Target inadvertently blew S election, 336(e) election will be invalid

S Corporation – 336(e) Election

- If a Section 336(e) election is made,
  - the S corporation is treated as having sold all of its assets to an unrelated party at the close of the stock disposition date.
  - The S election continues until the end of the day.
  - The S corporation is then deemed to distribute the net proceeds to the shareholders in a liquidation, governed by IRC §§331 and 336.

S Corporation – 336(e) Election

- The S corporation whose stock is sold is treated as if it had sold all of its assets to a new corporation for the "Aggregate Deemed Asset Disposition Price"
  - This is generally equal to the purchase price of the stock plus the liabilities of the S corporation.

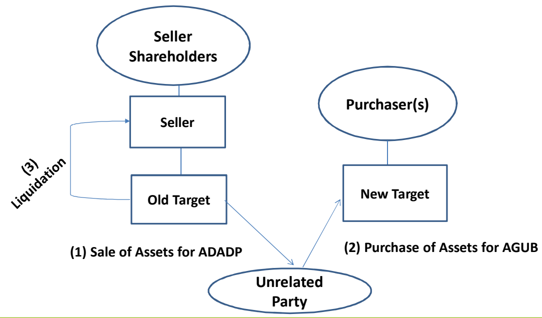
S Corporation – 336(e) Election

- The S corporation is treated as a new corporation immediately after the stock disposition.
- The new corporation is treated as having purchased the assets for the "Adjusted Grossed-Up Basis", generally the cost of the stock recently purchased plus the basis of non-recently purchased stock plus liabilities.

S Corporation – 336(e) Election

- The adjusted grossed-up basis is allocated to the individual assets using the residual method the same as used for a Section 338(h)(10) election.

S Corporation – 336(e) Election



S Corporation – 336(e) Election

- Shareholders who do not sell stock must report the full amount of gain from deemed asset sale that they would have reported if the shareholder sold stock.
- The non-selling shareholder then adjusts the basis in the retained shares to the fair market value.
  - Non-selling shareholders may not want to consent.

S Corporation – 336(e) Election

- If the S corporation has a Qualified Subchapter S Subsidiary ("Q sub"), the Q sub election continues through the end of the day of the sale.
- The Q sub is treated as a disregarded entity and the S corporation is treated as selling the Q sub's assets and not the stock.

S Corporation – 336(e) Election

Other Consequences of Making a Section 336(e) election:

- If buyer is an eligible shareholder, buyer can make a new S election. If the buyer does not make an S election, the corporation becomes a C corporation.
- Because the S corporation is deemed to have sold all of its assets, some of the gain on the deemed sale can be ordinary income due to depreciation recapture or the fact that the assets deemed sold are not a capital asset, such as inventory.

S Corporation – 336(e) Election

- In the case where the buyer is a partnership or other ineligible shareholder, the corporation would no longer be an S corporation in the hands of the buyer.
- However, with a step up in basis, the buyer could immediately cause the corporation to convert to a single member LLC.
  - Although the conversion to a single member LLC is a taxable event, with a step-up in basis the quantity of the gain should be zero.

S Corporation – 336(e) Election

Planning Point: The stock purchase agreement,

- Should require the Section 336(e) election to be made by the selling shareholders
- May require buyer to compensate seller for the additional tax compared to a stock sale without a Section 336(e) election or Section 338(h)(10) election having been made.

S Corporation – 336(e) Election

Mechanics of Election

- All of the shareholders must enter into a written agreement to make the election (including any non-selling shareholders).
  - Note that purchaser is not required to participate, unlike 338(h)(10)
- The S corporation must retain the agreement
- The S corporation must attach a 336(e) election statement to its timely-filed return for the year of sale.

Questions

Gary M. Edelson, Esq.

Gedelson@mmwr.com

215-772-7264

Jonathan R. Flora, Esq.

JFlora@mmwr.com

215-772-7278

MONTGOMERY McCRACKEN

Gary M. Edelson
Partner

123 South Broad Street
Philadelphia, PA 19109

Phone: 215-772-7264
Fax: 215-772-7620
gedelson@mmwr.com

Areas of Practice
- Business Succession Planning
- Tax
- Trusts and Estates

Admissions
- Pennsylvania
- New York

Education
- Capitol University Law School
- Ohio State University

Gary M. Edelson concentrates his practice on issues related to income tax, taxation of pass-through entities, estate and gift tax, mergers and acquisitions, taxation of qualified plans and tax-exempt entities that invest in pass-through entities. In connection with these matters, Gary has represented “S” corporations, limited liability companies and partnerships (including private investment vehicles), registered investment companies and grantor trusts.

Gary represents clients in the real estate, health care, manufacturing, investment management and computer software industries. He represents large publicly held companies in dispositions and acquisitions of large real estate holdings by pass-through entities using like-kind exchanges, as well as large privately held pass-through entities in the sale of partnership interests to large pension funds. He was counsel to senior management personnel in sales of large blocks of low basis publicly traded stock using charitable remainder unitrusts.

Selected Publications
- Quoted in "Tax returns need full disclosure on health coverage," *Newsday*, February 1, 2015

Professional Activities
- American Bar Association
- Pennsylvania Bar Association
- Philadelphia Bar Association

Academic Achievements
Gary received an LL.M. in Taxation, *summa cum laude*, in 1979 from Temple University School of Law in Philadelphia, Pennsylvania. and received his J.D. degree, *summa cum laude*, in 1976 from Capitol University Law School in Columbus, Ohio, where he was notes editor for the *Law Review.* A *summa cum laude* graduate of the Ohio State University, Gary earned a B.S. in Business Administration in 1973. He also received a Griffen Foundation Scholarship and the Phi Alpha Kappa Award for the highest grade-point average in corporate finance.

MONTGOMERY McCRACKEN

Jonathan R. Flora
Partner

123 South Broad Street
Philadelphia, PA 19109

Phone: 215-772-7278
Fax: 215-772-7620
jflora@mmwr.com

Areas of Practice
- Tax
- Trusts and Estates

Admissions
- Pennsylvania; California; District of Columbia; Washington
- U.S. Tax Court
- U.S. District Court for the Central District of California and the Southern District of California

Education
- New York University
- University of California, Davis
- University of Maryland School of Law
- Towson University

Jonathan R. Flora advises clients on federal, state and local tax issues. He has represented clients on tax planning and structuring for a broad range of transactions, such as joint ventures, mergers and acquisitions, divestitures, reorganizations, redemptions, liquidations, securitizations, issuance of securities, licensing, workouts and tax-free exchanges. Jonathan routinely advises pass-through entities on operating, allocation and distribution issues, and he provides tax advice and counsel to tax-exempt and nonprofit entities.

Prior to joining Montgomery McCracken, Jonathan was a partner in the Tax group of Schnader Harrison Segal & Lewis LLP.

Selected Representations
- Lead tax attorney on numerous acquisitions and divestitures of portfolio companies by private equity funds, often involving complex LLC preferred returns, tax-free management rollover and highly leveraged target companies
- Provided tax planning and advice to sellers on a multimillion dollar stock sale of biotechnology company to a Fortune 500 company
- Tax opinion for seller on tax-free reorganization under Section 368(a)(2)(D) (forward subsidiary merger)
- Tax opinion for $50 million offering of subordinated notes by a public company
- Provided tax advice to a health insurance company on a multimillion dollar sale to a Fortune 500 heath provider
- Advised individual owners on tax consequences arising from purchases and sales of businesses, including amounts and character of gain, treatment of installment payments, earnouts, contingent consideration, and disposition and cancellation of options (NQOs and ISOs)
- Lead tax attorney in structuring a forward triangular merger of a U.S. corporation with the domestic subsidiary of a Norwegian parent to qualify as tax free under Sections 367 and 368

- Structured and rendered a tax opinion under Sections 367 and 368 on behalf of a target corporation and its shareholders for a tax free reverse triangular merger involving a Canadian buyer
- Represented a Spanish public company in structuring tax aspects of its corporate entrance in the U.S. wind energy market as turbine manufacturer and developer
- Structured syndicated investments to pass through production tax credits to investor in a limited liability company which develops wind energy projects
- Planned and implemented a vehicle for use by management of a private equity fund for co-investments in portfolio companies
- Represented property management and development company in structuring several joint ventures for property development and management activities, including negotiation and drafting operating agreements for the limited liability companies
- Organized numerous limited liability companies, partnerships and corporations

Selected Publications

- Featured in "Montgomery McCracken Adds Tax Partner in Philly Office," *Law360*, April 29, 2014

Professional Activities

M&A Tax Report, editorial board member
American Bar Association, Tax and Business Sections
Philadelphia Bar Association, Tax Section council member

- National Association of Bond Lawyers

Academic Achievements

Jonathan received his LL.M. (Tax) from New York University and received his M.A. from the University of California, Davis. He graduated from the University of Maryland School of Law, order of the coif, with a J.D. and from Towson University, *summa cum laude,* with a B.S. degree.

Taxing Issues

Tax Updates by Jon Flora, LL.M.

In this Issue:

Unwinding a Seemingly Valid 1031 Exchange

Jon Flora

Partner
Montgomery McCracken

Office: 215.772.7278
Email: jflora@mmwr.com
My Attorney Profile

Periodic updates for Transactional Practioners

In North Central Rental & Leasing, a court unwound a carefully orchestrated 1031 exchange used by an equipment rental company to replace its outdated equipment. 115 AFTR 2d 201 (8^{th} Cir. 2015).

> Background: In a typical 1031 exchange, a taxpayer sells property (the "relinquished property") to a third party buyer. A qualified intermediary ("QI") is used to hold the cash proceeds from the sale. The taxpayer then identifies new property ("replacement property") and the QI uses the cash to buy the replacement property from another third party. So through some tax fictions steps, two cash sales transactions are treated instead as a single 1031 exchange of property with the QI (who, of course, collects its fee).

In North Central, the taxpayer modified the like kind structure a bit. Its sale of old rental equipment (the relinquished property) was standard to form. And the cash proceeds were paid to a QI. But rather than have the QI pay Caterpillar directly for the new equipment (the replacement property), the taxpayer's parent company bought the new equipment from Caterpillar. The QI used the cash proceeds to buy the new equipment from the parent. Caterpillar gave the parent six months to pay for the replacement property, so the parent had cash available from the sale to the QI for six months before it had to pay Caterpillar.

On its face, and respecting the form of the transaction, the exchange might work. But the court struck the whole thing down. It did so because it found the transaction overly complex and involving unnecessary parties.

The court first reasoned that the parent wasn't a necessary party to the transaction, but was only there to receive the cash that it was required to pay Caterpillar for the new equipment. The Court really didn't like the fact that Caterpillar gave the parent six months to pay for the new equipment. It labeled the ability to delay payment as "hundreds of de facto interest- free loans."

The court also found the QI unnecessary to the transaction. It concluded that the parent could have made the exchange directly with the taxpayer. That's an odd conclusion after having just determined that the parent was also unnecessary. And an unnecessary QI? QI's admittedly serve no function whatsoever outside of the Section 1031 world, but section 1031 and the regulations mandate their use. The court dismisses this argument by a reference to the "intent behind the transactions" and the fact that the parent was involved. Neither point seems particularly relevant, but it was enough for the court.

Section 1031 is a powerful tool. But outside of traditional real estate swaps, the rules can be complicated, which may not bode well in court.

Stay Connected:

Attorney Advertising

This publication should not be considered legal advice and should not be relied upon without consultation with appropriate professional advisers. This publication is intended to provide general information only and nothing in it should be acted upon without consultation with legal counsel. Receipt of this publication does not create an attorney-client relationship between the recipient and Montgomery McCracken.

Montgomery McCracken Walker & Rhoads LLP is a Pennsylvania Limited Liability Partnership. The firm is headquartered at 123 S. Broad Street | Philadelphia, PA 19109. © 2015 Montgomery McCracken Walker & Rhoads LLP.

Taxing Issues
Tax Updates by Jon Flora, LL.M.

In this Issue:

When is a Member of an LLC not a Tax Partner?

Jon Flora

Partner
Montgomery McCracken

Office: 215.772.7278
Email: jflora@mmwr.com
[My Attorney Profile](#)

If at any point you'd like to unsubscribe from my periodic updates, please do so by clicking the link below.

The IRS invokes the magic of "substance over form" to rule that an LLC member is not really a partner after all, thereby unraveling all of the taxpayer's planned tax benefits.

A limited liability company is usually taxed as a partnership. Since LLCs are governed by state law, it seems easy to figure out who the members and, therefore, who the tax partners are. But in recent Chief Counsel Advice, the IRS ruled that an LLC member was not a partner for tax purposes. Even though the taxpayer had ordered all of the steps to achieve the intended result, the IRS unwound them. CCA 20150718.

The taxpayer assigned his membership interest in an LLC to a tax exempt organization, and he reported a charitable deduction. The organization accepted the assignment. One would think the organization is a partner at this point, but not so fast! The next day, the organization sold the entire interest to a corporation in exchange for an installment note. The note required no payments up front - instead, the full amount was due on or before 20 years. As it turns out, the same taxpayer and his partner controlled the LLC, the exempt organization and the corporation.

The IRS denied the charitable deduction. It said that in substance, the exempt organization never received a partnership interest, but instead received only a "mere" promise to pay indirectly through the corporation. According to the IRS, "the simple expedient of drawing up papers does not control for tax purposes when the objective economic realities are to the contrary." The IRS relied on case law holding that a true partner must have a meaningful stake in the success or failure of the enterprise. In this case, the exempt organization had a one day right to distributions, which the IRS found inadequate.

Some observations:

Case law supports a very similar structure to the one the taxpayer employed. In Palmer v. Comr., 62 T.C. 684 (1974), a taxpayer donated shares of a corporate stock to a charity, then caused the corporation to redeem the stock from the charity. The taxpayer controlled both the corporation and the charity. The IRS attempted to unwind the transaction based on substance over form, but the Tax Court respected the taxpayer's position. Afterwards, the IRS agreed to follow the holding in Palmer. Rev. Rul. 78-197. In the CCA, the IRS distinguishes Palmer because that decision did not deal with the validity of a charitable deduction. That factor is not obviously relevant to the Palmer holding, and whether it is a valid distinguishing feature remains to be seen. In short, the facts of the CCA aren't great, but the IRS's method of unwinding the transaction isn't too great either.

Also of note, while the IRS is free to recast a transaction using substance over form, a taxpayer doesn't have that same freedom. Instead, a taxpayer is bound by the form of his or her own transaction. Com. v. Danielson, Carl L., (1967, CA3). So when tax planning, get the documents right! Although it won't guarantee success, it's a necessary condition to get there.

Stay Connected:

Attorney Advertising

This publication should not be considered legal advice and should not be relied upon without consultation with appropriate professional advisers. This publication is intended to provide general information only and nothing in it should be acted upon without consultation with legal counsel. Receipt of this publication does not create an attorney-client relationship between the recipient and Montgomery McCracken.

Montgomery McCracken Walker & Rhoads LLP is a Pennsylvania Limited Liability Partnership. The firm is headquartered at 123 S. Broad Street | Philadelphia, PA 19109. © 2015 Montgomery McCracken Walker & Rhoads LLP.