I. Reporting Conservation Security Program (CSP) Payments

A. The Conservation Security Program provides for three tiers of conservation practices for which payments may be received. *Farm Security and Rural Investment Act of 2002, § 2001, adding Food Security Act of 1985, § 1238A(d)(1)(A).*

1. A Tier I contract is to be for a period of five years and includes conservation practices appropriate for the agricultural operation that, at a minimum, address at least one “significant resource of concern for the enrolled portion of the agricultural operation at a level that meets the appropriate non-degradation standard” and covers “active management of the conservation practices that are implemented or maintained under the conservation security contract.” *FSRIA of 2002, adding Food Security Act of 1985, § 1238A(d)(5).* As for payments, Tier I contracts are eligible for payment of an amount equal to five percent of the “applicable base payment for land covered by the contracts”, an amount not exceeding 75 percent (90 percent for a beginning farmer) of the average county costs of practices and an “enhanced payment” for additional enumerated practices. *FSRIA of 2002, adding Food Security Act of 1985, § 1238C(b)(1).* The annual payments to an individual or entity cannot exceed $20,000 under a Tier I contract. *FSRIA of 2001, adding Food Security Act of 1985, § 1238C(b)(2).*

2. A Tier II CSP contract is for a period of five to 10 years and is to include conservation practices appropriate for the agricultural operation that, at a minimum, address at least one significant resource of concern for the entire agricultural operation at a level that meets the appropriate non-degradation standard and covers active management of conservation practices that are implemented or maintained under the conservation security contract. *FSRIA of 2002, adding Food Security Act of 1985, § 1238A(d)(5).* For Tier II practices, an amount equal to 10 percent of the “applicable base payment for land covered by the conservation security contract” can be paid. *FSRIA of 2002, adding Food Security Act of 1985, § 1238C(b)(1).* That’s an amount not exceeding 75 percent (90 percent for beginning farmers) of the average county cost of adopting or maintaining practices and an enhanced payment for additional enumerated practices. The annual payments to an individual or entity cannot exceed $35,000 under a Tier II contract. *FSRIA of 2001, adding Food Security Act of 1985, § 1238C(b)(2).*

3. A Tier III contract is to be for a period of not less than five and not more than 10 years and includes conservation practices appropriate for addressing all resources of concern. *FSRIA of 2002, adding Food Security Act of 1985, § 1238A(d)(5).* Payments can be made equal to 15 percent of the “base payment for land covered by the conservation contract” up to 75 percent (90 percent for a beginning farmer) of the average county cost of adopting or maintaining practices and an enhanced payment for additional enumerated practices. *FSRIA of 2002, adding Food Security Act of 1985, § 1238C(b)(1).* Annual payments to an individual or entity cannot exceed $45,000 under a Tier III contract. *FSRIA of 2001, adding Food Security Act of 1985, § 1238C(b)(2).*

C.F.R. Part 14, are “…primarily for the purpose of conserving soil and water resources or protecting and restoring the environment.”

1. The Secretary is charged with making such a determination in order for the payments to be eligible for the cost share exclusion available under federal income tax law. 70 Federal Register 36,557 (June 24, 2005). The Secretary of the Treasury is obligated to make a determination that the payments under the program do not increase “…substantially the annual income derived from the property.” I.R.C. § 126(b)(1)(A).

2. The Secretary of Agriculture, in the June 24, 2005 notice, proceeded to state that “…this determination permits recipients to exclude from gross income, for Federal income tax purposes, all or part of the existing practice, new practice, and enhancement activity payments under the extent allowed by the Internal Revenue Service.” (Emphasis added.) I.R.C. § 126(b)(1)(B).

C. The exclusion provision (I.R.C. § 126)


a. Excludible amounts include those under—


(2) The rural abandoned mine program, 30 U.S.C. § 1236.

(3) The water bank program, 16 U.S.C. § 1301 et seq. See Charles Graves, 88 T.C. 28 (1987) (cost-share payments under Water Bank Program were eligible for exclusion even though contract entered into prior to effective date of statute but taxpayer failed to prove payments were excludible; taxpayer had deducted some of amounts in question, thus obtaining double benefit).


(6) The Great Plains Conservation Program, 16 U.S.C. § 590(b), as in effect before the amendment made by the Federal Agricultural Improvement and Reform Act, § 336(b), which merged the Great Plains Conservation Program into the Environmental Quality Incentives Program.


(9) The excludible portion of payments from any small watershed program administered by the Secretary of Agriculture that is determined by the Secretary of the Treasury to be substantially similar to the types of programs described above qualify for the exclusion. I.R.C. § 126(a)(9). Improvements made in connection with small watersheds under the “Stewardship Incentive Program” are within the scope of I.R.C. § 126(a)(2). Rev. Rul. 94-27, 1994-1 C.B. 26.


b. For amounts received under the above programs to be excludible—

(1) The Secretary of Agriculture must determine that the payments are made “primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.” I.R.C. § 126(b)(1)(A).

(2) The Secretary of the Treasury must determine that the payments are not “increasing substantially” the annual income from the property. I.R.C. § 126(b)(1)(B).

(3) An increase in annual income is not substantial unless it exceeds the greater of $2.50 per acre or 10 percent of the average annual income derived from the property prior to the improvement. Temp. Treas. Reg. § 16A.126-1(a).

c. A taxpayer may elect not to have the exclusion rules apply to all or part of an improvement. See Temp. Treas. Reg. § 16A.126-2(a). The taxpayer is to attach a statement to the income tax return indicating the dollar amount of the cost funded by a government payment, the value of the improvement and the amount that is being excluded from income. Temp. Treas. Reg. § 16A.126-2(b).

d. The exclusion is available to lessors of property. Ltr. Rul. 9014041, January 5, 1990 (no mention in ruling of type of lease; apparently, type of lease not relevant).

e. The exclusion is limited to improvements. Temp. Treas. Reg. § 16A.126-1(a) (regulations refer to “improvement” or “improvements” 19 times in a page and a half of regulation text). See Charles Graves, 89 T.C. 49 (1987) (no evidence payments related to improvements).

f. If property acquired, improved or otherwise modified by the application of payments excluded from gross income is disposed of within 20 years, part or all of the excluded payments are taxed as ordinary income. I.R.C. § 1255.

(1) The amount taxable as ordinary income is the lesser of—

(a) The gain realized on sale of the property, or

(b) The applicable percentage of the amount of the payment that had been excluded from income. The applicable percentage for the first 10 years after the date payments are received and excluded is 100 percent. I.R.C. § 1255(a)(3). Thereafter, the applicable percentage is reduced annually by 10 percentage points. After the nineteenth year, there is no recapture.

(2) The exclusion and recapture rules do not apply to government cost sharing payments to the extent a deduction is allowed in the year paid or incurred. I.R.C. § 126(b)(2).

g. If the exclusion is claimed, expenditures may neither be used to generate deductions or credits nor be added to the income tax basis of property acquired. I.R.C. § 126(d),(e).


a. The ruling states that the following would be excludible “to the extent permitted by § 126”—

(1) Existing practice and new practice components, and
Enhancement component. *Id.*

b. The ruling also states that payments for the stewardship component are not excludible. *Id.*

c. The regulations limit the exclusion to “improvements.” *Temp. Treas. Reg. § 16A.126-1(a).*

d. The Tax Court has referred to “…capital improvements subject to depreciation…and has stated—

“…nowhere…is there any indication that Congress intended to relieve from normal income tax obligations an outright payment for the use of land where there is no capital improvement subject to depreciation…. It is apparent that ‘cost sharing’ does not mean…reducing the amount of income received from property by entering into an agreement with the United States.” *Charles Graves, 89 T.C. 49* (1987).


“…. the Conservation Security Program is substantially similar to the type of program described in section 126(a)(1) through (8) of the Code within the meaning of section 126(a)(9). As a result, all or a portion of cost-share payments received under the CSP is eligible for exclusion from gross income to the extent permitted by section 126. (Emphasis added.)

a. The language of the ruling echoed the language appearing in the *Federal Register*, 70 *Federal Register* 36,557 (June 24, 2005), in June of 2005 in which the Secretary of Agriculture stated that “this determination permits recipients to exclude from gross income, for Federal income tax purposes, all or part of the existing practice, new practice, and enhancement activity payments to the extent allowed by the Internal Revenue Service.”


4. The misleading statements in the June 24, 2005 Notice and language in Rev. Proc. 2006-46 have contributed to the belief by some taxpayers, augmented by statements from Natural Resource Conservation Service offices, that perhaps the entire amount of CSP payments could be excluded from income. That would only be possible if the entire payment amount were to be directed into capital improvements. Considering the nature of the CSP program, that is highly unlikely.

II. Proposed Regulations on Private Annuities

A. On October 18, 2006, the Department of the Treasury issued new proposed regulations on private annuities which will affect most private annuities entered into after April 17, 2007, and some entered into after October 18, 2006. *Prop. Treas. Reg. §§ 1.72-6(e), 1.1001-1(j).*

1. The proposed regulations will render the private annuity less attractive as an estate and business planning tool. Basically, the new rules specify that, in a private annuity setting, the transferor and transferee of property are left as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract.

2. The established rule of deferring the gain on the property funding the private annuity over the transferor’s life expectancy would not be available. *See Rev. Rul. 69-74, 1969-1 C.B. 43.*
B. A private annuity involves a transfer of property (such as land) from the transferor (the annuitant) to a transforee (the obligor) who has not from time to time written annuities, in consideration of the obligor’s unsecured promise to make periodic payments of money to the annuitant for a specified time or for the life of the annuitant. See Harl, Agricultural Law § 49.01[1] (2006).

1. If the present value of the obligation to make the required payments is less than the fair market value of the property at the time of the transfer, the transaction is deemed a gift to the extent of the difference. I.R.C. § 2512(b). See Estate of Bergan v. Comm’r, 1 T.C. 543 (1943), acq., 1943 C.B. 2; Treas. Reg. § 25.2512-5; Rev. Rul. 69-74, 1969-1 C.B. 43. See also Cullison v. Comm’r, T.C. Memo. 1998-216 (gift from exchange of farmland for private annuity).

2. The present value of annuities is determined by applying an interest rate of 120 percent of the midterm applicable federal rate. [I.R.C. § 7520(a).]

C. With respect to income tax treatment of an unsecured private annuity, if the value of the property exceeds its adjusted basis, as it usually does with farm property, the rule has been that the annuitant did not recognize gain in the year of the transfer. See Lloyd v. Comm’r, 33 B.T.A. 903 (1936), acq., 1950-2 C.B. 3.

1. This is because there is no ascertainable fair market value if there is uncertainty as to the ability of the obligor as an individual to pay when the time for payment arrives. Rev. Rul. 69-74, 1969-1 C.B. 43. See Comm’r v. Kann’s Estate, 174 F.2d 357, 359 (3d Cir. 1949); Stern v. Comm’r, T.C. Memo. 1992-374 (gain on transfers of stock to foreign trust in exchange for private annuities deferrable).

2. If the promise to pay is secured, there is more certainty as to value and taxable gain may be recognized to the annuitant measured by the difference between the annuitant’s basis in the property transferred and the present value of the annuity contract. Estate of Bell v. Comm’r, 60 T.C. 469 (1973) (stock transferred placed in escrow to secure the promise to the annuitant and agreement provided for cognovit judgment in event of default); 212 Corp. v. Comm’r, 70 T.C. 788 (1978) (secured by rents from property, agreement not to sell or mortgage property without consent of transferors and confession of judgment in event of default).

3. The gain is reported ratably over the period of years measured by the annuitant’s life expectancy. Rev. Rul. 69-74, 1969-1 C.B. 43.

4. If the property transferred is a Section 1245 or Section 1250 asset, part of the gain otherwise taxable to the annuitant as capital gain is taxed as ordinary income. I.R.C. §§ 1245, 1250.

5. The cost of the property is uncertain to the obligor; therefore, the basis for the property for purposes of depreciation and for sale or exchange is likewise uncertain and is subject to adjustment for the total payments made. Rev. Rul. 55-119, 1955-1 C.B. 352. Annuity payments are not tax deductible. See Rev. Rul. 72-81, 1972-1 C.B. 98. The basis for cost recovery is the value of the prospective annuity payments to be made under the annuity; excess payments are added to the basis when and if made. After death of the annuitant, subsequent cost recovery is computed using the total payments actually made as the basis. In the event of sale of the property before the annuitant’s death, the basis for computing gain is the total of payments actually made plus the present value of future payments remaining to be paid based on the annuitant’s life expectancy as of the date of disposition of the property. For purposes of computing loss on the sale of the property before the annuitant’s death, the basis is the total of all payments actually made to the date of sale.

D. Under the proposed rules, for exchanges of property for an annuity contract after October 18, 2006, the amount realized is the fair market value of the annuity contract at the time of the exchange determined under I.R.C. § 7520. Prop. Treas. Reg. § 1.1001-1(j)(1)(j)(2).

1. The entire amount of the gain or loss, if any, is recognized at the time of the exchange. See Treas. Reg. § 1.451-1(a), Prop. Treas. Reg. § 1.1001-1(j)(1).
2. Thus, the transaction is treated essentially as a sale for cash with the proceeds used to acquire the annuity contract.

E. For a limited class of transactions, the effective date is delayed for six months (until April 17, 2007), for transactions in which—

1. The issuer of the contract is an individual;
2. The obligations are not secured, either directly or indirectly; and
3. The property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee (the obligor) during the two year period beginning on the date of the exchange. Prop. Treas. Reg. §§ 1.72-6(e)(2)(ii), 1.1001-1(j)(2)(ii). Thus, under the proposed regulations, the amount of gain recognized increases the transferor’s income tax basis in the property, reducing the gain to be reported over the annuitant’s life expectancy.

F. That provision embraces most annuities of the type used in farm or ranch settings. Those contemplating a private annuity should consider carefully the opportunity to utilize the established rules during the additional six month period.


III. Selected Problems with Like-Kind Exchanges

A. “Cashing out” with related party exchanges


a. If, within two years of a like-kind exchange of property with a related person, the related person disposes of the property or the taxpayer disposes of the property, the gain is recognized. I.R.C. § 1031(f).

b. The like-kind exchange rules recognize three exceptions to the two-year disposition rule—(1) dispositions involving the death of the taxpayer or the related person; (2) dispositions involving a compulsory or involuntary conversion; and (3) where the Internal Revenue Service is satisfied that avoidance of federal income tax is not a principal purpose of the transaction. I.R.C. § 1031(f)(2).

c. If a transaction is a related party exchange, Form 8824 must be filed for each of the two years following the year of the exchange.

2. A primary objective in enactment of the related party rules was to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of sale of the low basis property. See H.R. Rep. 247, 101st Cong., 1st Sess. 1340 (1989).

a. The related parties have, in effect, “cashed out” of the investment with the result that the original exchange is not accorded non-recognition treatment. See Ltr. Rul. 9931002, April 12, 1999 (parent-children transaction). See also Ltr. Rul. 200126007, March 22, 2001 (like-kind exchange
treatment denied for multi-party exchange involving related parties where there was “basis shifting”).

b. Revenue Ruling 2002-83, 2002-2 C.B. 927, issued in late 2002, illustrates the hazards to the tax treatment of the exchange if one of the related parties cashes out in the process. In that ruling, a taxpayer A transferred relinquished property (tract 1) with a fair market value of $150,000 and an income tax basis of $50,000 to a qualified intermediary in exchange for replacement property formerly owned by a related party, B. That property, tract 2, had a fair market value of $150,000 and a basis of $150,000. Individual C, who is unrelated to either A or B wanted to acquire tract 1. C ended up with the first tract, with a fair market value of $150,000. A few days later, B was paid the $150,000 sales price. A ended up with tract 2, C ended up with tract 1 and B “cashed out” of the deal with $150,000 in cash. Had A exchanged with B directly, it would have been a related party exchange and a sale within two years would have triggered gain on the exchanged property. I.R.C. § 1031(f)(1).

c. As a consequence, the exchange is viewed as an exchange which is part of a transaction – or series of transactions – to avoid the related party rule and the non-recognition provisions of I.R.C. § 1031 do not apply. I.R.C. § 1031(f)(4).

d. Using an unrelated third party to circumvent the related party rule is ineffective in avoiding the strictures of the related party provision. Essentially, the third party involvement is disregarded with the transaction viewed as an exchange by A with B, related parties, with a sale occurring within the two year period specified by the related party rule. I.R.C. § 1031(f)(1).

e. A similar fact situation was litigated in Teruya Bros., Ltd. & Subs. v. Commissioner, 124 T.C. 45 (2005), which involved an unsuccessful attempt to avoid the related party rules using a qualified intermediary. Again, a sale occurred within two years of the initial exchange and one of the parties “cashed out” within that time period. What occurred was that, in a series of transactions, the taxpayers transferred real properties to a qualified intermediary which sold the properties to unrelated parties. The qualified intermediary used the proceeds and additional funds from the taxpayer to purchase like-kind replacement properties from a related corporation. The taxpayer failed to demonstrate that tax avoidance was not one of the principal purposes of the exchanges. See I.R.C. § 1031(f)(2)(C). The court concluded that the use of the qualified intermediary was interposed to avoid the related party rule.

f. In a 2004 private letter ruling, Ltr. Rul. 200440002, June 14, 2004, IRS distinguished Rev. Rul. 2002-83, 2002 C.B. 927, in holding that there was no “cashing out” of a property interest and no sale was contemplated within the two year period even though one property ended up being acquired by a buyer. As the ruling notes—

“The ruling notes that neither party was in receipt of boot (or any other non-like kind property) in return for the relinquished property other than boot received in the exchange.”

The ruling notes that neither party was in receipt of boot (or any other non-like kind property) in return for the relinquished property other than boot received in the exchange. Ltr. Rul. 200440002, June 14, 2004.

g. This ruling provides one template for planning a transaction to avoid the trap of Rev. Rul. 2002-83, 2002-2 C.B. 927. The critical feature of the letter ruling is that there was no “cashing out” of their investment by one of the related parties. Ltr. Rul. 200440002, June 14, 2004. See Ltr. Rul. 9748006, August 25, 1997 (mere interposition of qualified intermediary between parties does not avoid related party rule).

B. Partitioning as an exchange (or not)
1. The regulations state that gain or loss is realized and recognized from the conversion of property into cash or from the exchange of property for other property different materially either in kind or extent. Treas. Reg. § 1.1001-1(a).

2. Rulings issued indicate that gain or loss in a partition is not recognized unless a debt security (such as a promissory note) is received or property is received that differs “materially...in kind or extent” from the partitioned property. See Rev. Rul. 56-437, 1956-2 C.B. 507 (conversion of stock in joint tenancy into tenancy in common); Ltr. Rul. 200328034, October 1, 2002 (partition of tenancy-in-common property was not sale or exchange); Ltr. Rul. 200328035, October 1, 2002 (same). See also Rev. Rul. 73-476, 1973-2 C.B. 301 (no gain or loss from partition of real estate owned in tenancy in common); Rev. Rul. 79-44, 1979-2 C.B. 265 (gain recognized on partition of farmland only to extent one received a note equal to one-half outstanding mortgage). See also Ltr. Rul. 9327069, February 12, 1993 (gain or loss not recognized on partition of land); Ltr. Rul. 9633028, May 20, 1996 (no gain or loss; not an exchange); Ltr. Rul. 200303023, October 1, 2002 (no gain or loss on partitions of tenancy in common property interest); Ltr. Rul. 200411022, December 10, 2003 (partition of tenancy in common property not sale or exchange; Rev. Rul. 56-437, supra, applied rather than Rev. Rul. 73-476, supra); Ltr. Rul. 200411023, December 10, 2003 (same).

3. Meeting the requirements for a partition as a non-exchange transaction is particularly important for related-party situations. A partition which is treated as a non-exchange transaction avoids the related party rules and side steps the “cashing out” problem.

C. Exchanges involving co-ownership of assets

1. Interests in a partnership are not considered like-kind. I.R.C. § 1031(a)(2)(D).
   a. The problem is that IRS has ruled, in some instances, that fractional interests in property may be deemed a partnership. See Ltr. Rul. 9741017, July 10, 1997 (co-ownership of rental properties deemed partnership; partnership returns filed for five years). See also Rev. Proc. 2000-46, 2000-2 C.B. 438 (IRS studying whether undivided fractional interests are eligible for like-kind exchange treatment). Compare Rev. Rul. 75-374, 1975-2 C.B. 261 (owners treated as co-owners of apartment building and not as partners in partnership); Rev. Rul. 73-476, 1973-2 C.B. 300 (exchange of tenancy in common interests in real property for a fee simple interest in real property was like-kind); Ltr. Rul. 9807013, November 13, 1997 (receipt of replacement property by entity owned by limited partnership was treated as receipt of real property by partnership; qualified for non-recognition of gain under I.R.C. § 1031(a)(2)); Ltr. Rul. 200019019, February 10, 2000 (exchange of fee simple interest in partnership-owned real property for real property interests in tenancy in common was like-kind). See also FSA Ltr. Rul. 9951004, September 3, 1999 (transaction deemed sale of partnership interest, not like-kind exchange). Compare Thomas C. Sandoval, T.C. Memo. 2000-189 (loss of property by condemnation followed by purchase of partnership interest; not like-kind under I.R.C. § 1033).
   b. Under Treas. Reg. § 1.761-1(a) and Treas. Reg. §§ 301.7701-1 through 301.7701-3, a partnership for federal tax purposes does not include mere co-ownership of property where the owners’ activities are limited to keeping the property maintained, in repair and leased.

2. Efforts to resolve the problem—
   a. In 2002, IRS issued a revenue procedure addressing the circumstances under which advance rulings will be issued in situations involving co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common. Rev. Proc. 2002-22, 2002-1 C.B. 733. The revenue procedure specifies conditions that must be met for an advance ruling—
      (1) Title held in tenancy-in-common (rather than by an entity).
(2) The number of co-owners 35 or fewer.

(3) The co-owners must not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying the co-owners as partners, shareholders or other members of a business entity or otherwise hold itself out as a partnership or other form of business entity.

(4) The co-owners may enter into a “limited co-ownership agreement” that may run with the land (e.g., an agreement specifying that a co-owner must first offer the co-ownership interest to the other co-owners).

(5) The co-owners must retain the right to approve the hiring of any manager, sale or other disposition, leases or the creation of a blanket lien.

(6) Each co-owner must have the rights of transfer, encumbrance and partition without the approval of others.

(7) If the property is sold, any debt must be satisfied before distribution of the proceeds to the co-owners.

(8) Each co-owner must share in all revenues generated by the property and all costs in proportion to the co-owner’s interest.

(9) The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

(10) A co-owner may issue an option to purchase the co-owner’s undivided interest (a “call” option) if the price for the call option reflects fair market value of the property as of the time of exercise of the option.

(11) The co-owners’ activities must be limited to those “customarily performed” in connection with maintenance and repair of the property.

(12) The co-owners may enter into management or brokerage agreements.

(13) All leasing agreements must be bona fide leases for federal tax purposes and reflect the fair market value for the use of the property.

(14) The lender, if any, with respect to the debt encumbering the property or debt incurred to acquire the co-ownership interest, must not be a related person.

(15) Payments, if any, to a “sponsor” for the acquisition of the co-ownership interest and the fees paid must reflect fair market values and may not depend on income or profits derived from the property.

b. If the conditions of Rev. Proc. 2002-22, 2002-1 C.B. 733, are satisfied, it is believed that the transaction should not be treated as involving partnership interests. See Ltr. Rul. 200327003, March 7, 2003 (undivided fractional interest in property eligible for like-kind exchange; not an interest in business entity); Ltr. Rul. 200625009, March 1, 2006 (undivided fractional interest not an interest in entity; conditions of Rev. Proc. 2002-22, supra, satisfied). See also Ltr. Rul. 200513010, December 6, 2004 (undivided fractional interest in property was not partnership; involved co-tenancy agreement and unanimous agreement required for sale, lease or re-lease). IRS has removed the provision signaling that rulings would not be issued in this area. Rev. Proc. 2003-3, 2003-1 C.B. 113 (deleting prior §§ 5.03, 5.06).
c. Authority is contained in the statute for a co-tenancy arrangement to be excluded from partnership treatment and not to be deemed a partnership. I.R.C. § 761(a)(1). That election, however, is limited to fact situations where the arrangement is for investment purposes and not for the active conduct of a trade or business. Id. See Treas. Reg. §§ 301.7701-1(a)(2); 301.7701-2(c)(1).

D. Potential recapture of depreciation

1. If Section 1245 property is disposed of in a like-kind exchange, Section 1245 recapture must be recognized to the extent of the amount of gain recognized without considering Section 1245 recapture plus the fair market value of non-Section 1245 property that is qualifying property. I.R.C. § 1245(b)(4); Treas. Reg. § 1.1245-4(d)(1).

2. For Section 1250 property, recapture must be recognized to the extent of the larger of (1) the excess, if any, of the gain reported as ordinary income because of additional (post 1969) depreciation had the property been sold over the fair market value of the Section 1250 property acquired in the exchange or (2) any gain on the exchange, regardless of the recapture provision. I.R.C. § 1250(d)(4). See Treas. Reg. 1.1250-3(d). The recapture of depreciation for Section 1250 property is partially or fully deferred until there is a disposition of the acquired property. I.R.C. § 1250(d)(4)(E).

3. The instructions for Form 8824, line 21, restate these rules and provide a location on the form for calculating the Section 1245 and 1250 recapture (“ordinary income” under recapture rules) to the extent non-Section 1245 and non-Section 1250 properties are received in exchange to the extent of additional depreciation.

IV. Trust Issues

A. Mergers

1. A merger of trusts may not constitute a taxable event for income tax purposes if the trusts have the same beneficiaries and the terms of the merged trusts are the same. Ltr. Rul. 9610021, December 8, 1995. See Ltr. Rul. 200607015, November 4, 2005 (no estate, gift, GSTT or income tax consequences; trust beneficiaries essentially the same before and after proposed change).

a. Trust mergers often pose questions in six areas—

   (1) Whether the proposed merger will cause any existing trust or resulting trust to recognize gain (or loss) from the disposition of property. See I.R.C. §§ 61, 1001.

   (a) In general, gains or losses on property transfer must be recognized if the transfer involves a conversion into cash or from the exchange of property for other property that differs materially in kind or extent from the property given up. Treas. Reg. § 1.1001-1(a). See Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991) (exchanged properties are materially different if their respective possessors enjoy legal entitlements that are different in kind or extent). See also Ltr. Rul. 200544007, July 28, 2005 (merger of several trusts did not result in material differences in kind or in entitlements of retirement plans held by trusts).

   (b) Therefore, in a trust merger context, if the trust beneficiaries possess the same interests before and after the merger, the interests of the beneficiaries are not considered to be materially different and a sale or exchange has not occurred, realized gain is not recognized. I.R.C. §§ 61, 1001. See Ltr. Rul. 200548018, August 15, 2005 (no material differences in kind or in entitlements of retirement plans held by trusts; no gain or loss, change of basis or holding period).
(2) Whether the income tax basis of the resulting trust in each asset received from another trust will be the same as the transferring trust’s basis in the same asset. See I.R.C. § 1015. If there is no recognition of gain or loss, the basis of assets should carry over in the merger into the resulting trust. Ltr. Rul. 200548018, August 15, 2005; Ltr. Rul. 200544007, July 28, 2005 (no change of basis in merger of several trusts holding retirement plan funds).

(3) Whether the holding period of each trust in the various assets will be the same as the transferring trust’s basis in the assets. I.R.C. § 1223(2). See Ltr. Rul. 200544007, July 28, 2005 (no change in holding period for assets in merger of several trusts holding retirement plan funds).

(4) Whether the proposed merger will cause any beneficiary of an existing trust or beneficiary of a resulting trust to have made a gift for purposes of federal gift tax (and state gift tax where state gift taxes are imposed). See I.R.C. § 2501.

(a) The transfer of property from one trust to another under authority reserved in the original trust generally does not result in federal gift tax liability. Matthew Lahti, 6 T.C. 7 (1946) (except for transfers to a trust for other beneficiaries); Estate of Hazelton, 29 T.C. 637 (1957) (if transfer is to a trust for other beneficiaries, there is possible gift tax liability on the person who is divested of interest under original trust).

(b) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. Treas. Reg. § 1.671-2(e)(5).

(c) IRS has ruled that the merger of an irrevocable inter vivos trust into a testamentary trust did not involve a gift where there was no change in the dispositive provisions with respect to the property previously held in the inter vivos trust. Ltr. Rul. 9619047, February 7, 1996 (terms of two trusts virtually identical except for few minor differences in non-dispositive provisions; merger for administrative convenience).

(d) Division of a testamentary trust on a pro rata basis did not result in gift where the division was in accord with the decedent’s will and a court order. Ltr. Rul. 9509008, November 29, 1994.

(e) The consolidation of trusts did not result in adverse tax consequences where the rights of beneficiaries were substantially the same before and after the consolidation. Ltr. Rul. 200548018, August 15, 2005.

(5) Whether the proposed merger will be considered a constructive addition for purposes of the generation skipping transfer tax and will subject distributions from the resulting trust to generation skipping transfer tax. I.R.C. §§ 2601, 2611(a).

(6) What the impact of the merger will be on the inclusion ratio of the resulting trusts. I.R.C. § 2642. See, e.g., Ltr. Rul. 200548018, August 15, 2005.

2. If both the executor of an estate and the trustee of a qualified revocable trust (QRT) elect, the trust may be taxed as part of the estate for income tax purposes and not as a separate trust during the election period. I.R.C. § 645, amended by TRA-97, Pub. L. 105-34, Sec. 1305, 111 Stat. 788 (1997). See Treas. Reg. § 1.645-1. For a useful discussion of the entity election for trusts, see Jones, Temporary Bliss: An Entity Election for Trusts,” 101 Tax Notes 1304 (Dec. 15, 2003).

a. A QRT is a trust that, on the date of death of the decedent, was treated as owned by the decedent. Treas. Reg. § 1.645-1(b)(1).
b. Initially, to make the election, a statement had to be attached to Form 1041. See Rev. Proc. 98-13, 1998-1 C.B. 370. See also Notice 2001-26, 2001-1 C.B. 942 (guidance allowed trusts electing to be treated as part of estate to use election procedures found in proposed regulations or in Rev. Proc. 98-13). The statement had to identify the election as made under I.R.C. § 645; show the date of death, names and addresses and taxpayer identification numbers of the decedent, the trust and the estate; state that the decedent had power to revoke the trust as of the date of death; and be signed by the executor or administrator of the estate and trustee of the trust. Id.

c. Under final regulations issued in late 2002, if there is an executor of the related estate, the trustees of each QRT joining in the election and the executor of the related estate make an election under I.R.C. § 645 and the regulations to treat each QRT joining in the election as part of the related estate by filing a form provided by IRS (Form 8855). Treas. Reg. § 1.645-1(c)(1).

(1) The election must be filed not later than the time prescribed for filing the Form 1041 for the first taxable year of the related estate (regardless of whether there is sufficient income to require the filing of that return). Treas. Reg. § 1.645-1(c)(1)(i).

(2) If an extension is granted for the filing of the Form 1041 for the first taxable year of the related estate, the election form is timely filed if it is filed by the time prescribed for filing the Form 1041 including extensions. Id.

(3) The trustee of each QRT and the executor of the related estate must agree, by signing the election form, that—

(a) With respect to a trustee, the trustee agrees to the election, the trustee is responsible for providing necessary return filing information to the executor, the tax burden is allocated reasonably between the electing trust and the related estate and the trust’s share of the tax obligations is timely paid. Treas. Reg. § 1.645-1(c)(1)(ii)(A).

(b) The executor must agree, by signing the election form, that the executor agrees to the election, the executor is responsible for filing a Form 1041 for the combined electing trust and the related estate, the tax burden is reasonably allocated, and the related estate’s share of the tax obligations is paid. Treas. Reg. § 1.645-1(c)(1)(ii)(B). See Notice 2003-33, 2003-1 C.B. 990 (guidance regarding determination of applicable date that terminates the election period for revocable trusts to be treated and taxed as part of estate under I.R.C. § 645).

(4) If there is no executor for a related estate, the trustee or trustees of the electing trust file the election. Treas. Reg. § 1.645-1(c)(2).

(a) An election to treat one or more QRTs of the decedent as an estate is made by the trustees of each QRT joining in the election, by completing the election form.

(b) The election must be made “for the first taxable year of the trust, taking into account the trustee’s election to treat the trust as an estate under section 645.”

(c) If an extension is granted for filing the Form 1041 for the first taxable year of the electing trust, the election form will be timely filed if it is filed by the time prescribed for filing the Form 1041 including the extension granted with respect to the filing of the Form 1041. Treas. Reg. § 1.645-1(c)(2)(i).

(d) If there is more than one QRT, the election may be made for some or all of the QRTs. If there is no executor, one trustee must be appointed by the trustees of the electing trusts to file Forms 1041 for the combined electing trusts filing as an estate during the election period. Treas. Reg. § 1.645-1(c)(3).
(e) If there is no executor, the trustee of an electing trust or a QRT for which an I.R.C. § 645 election will be made obtains a taxpayer identification number upon the death of the decedent as required and furnishes the TIN to the payors of the trust. Treas. Reg. § 1.645-1(d)(1). The trustee of the electing trust must file a Form 1041 under the TIN, treating the trust as an estate. If there is more than one electing trust, the Form 1041 must be filed by the filing trustee. Treas. Reg. § 1.645-1(e)(3)(ii).

(5) If a Section 645 election is made, the executor of the estate, if any, and the trustees of the QRT may treat the QRT as an electing trust from the decedent’s death until the due date for the Section 645 election. Accordingly, the trustee of the QRT is not required to file a Form 641 for the QRT for the short taxable year beginning with the decedent’s death and ending on December 31 of that year. Treas. Reg. § 1.645-1(d)(2)(i).

(6) If there is an executor, the trustee of the electing trust does not file a Form 1041 for the electing trust during the election period except for any final Form 1041. Treas. Reg. § 1.645-1(e)(2)(ii)(B).


(8) An estate is allowed an annual exemption of $600 of taxable income. I.R.C. § 642(b). A simple trust is allowed an exemption of $300, all other trusts $100. Id.

(9) The regulations specify that “an electing trust is treated as an estate for purposes of…the subchapter S shareholder requirements of section 1361(b)(1).” A trust treated as an estate should be able to hold S corporation stock under a valid I.R.C. § 645 election so long as the trust is treated as part of its related estate.

(10) The $25,000 deduction allowed for passive activity losses for individuals who actively participate in rental real estate activities is available to estates for up to two years after the death of the decedent. I.R.C. § 469(ii)(4)(A). An electing trust is treated as an estate for purposes of the special $25,000 deduction. Treas. Reg. § 1.645-1.

(11) Following termination of the election, if there is no executor, the taxable year of the electing trust closes on the last day of the election period.

(a) A Form 1041 is filed reporting the items of income, deduction and credit of the electing trust for the short period ending with the last day of the election period. Treas. Reg. § 1.645-1(h)(2)(ii).

(b) Upon termination of the election period, the taxable year of the estate is the same as the taxable year used during the election period. Treas. Reg. § 1.645-1(h)(4)(i).

(c) The taxable year of the new trust, at the termination of the Section 645 election, is the calendar year. Treas. Reg. § 1.645-1(h)(4)(ii).

V. Subchapter S Health Plans


B. The statute, I.R.C. § 162(l)(1)(A), allows an individual who is an employee to claim a deduction for insurance which pays for medical care for the taxpayer, spouse and dependents. Similarly, a self-employed
individual with earned income can be treated as an employee for this purpose. I.R.C. §§ 401(c)(1), 162(l)(1).

1. Moreover, the amount of the deduction cannot exceed the taxpayer’s earned income derived from the trade or business with respect to which the plan providing medical care coverage is established. I.R.C. § 162(l)(2)(A).

2. The deduction is limited further by the fact that a deduction is not allowed during any month during which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer. I.R.C. § 162(l)(2)(B).

C. In a private letter ruling issued in mid-2005, Ltr. Rul. 200524001, May 17, 2005, the question was posed whether a sole proprietor could claim the above-the-line deduction where the individual had purchased health insurance in the sole proprietor’s own name, not in the name of the sole proprietorship, and to treat the sole proprietorship income as the trade or business for which the plan was established. I.R.C. § 162(l)(2)(A). The ruling states that a sole proprietor could purchase health insurance in the sole proprietor’s name and claim an above-the-line deduction for the costs in providing coverage for the sole proprietor, the spouse and dependents. Ltr. Rul. 200524001, May 17, 2005.

D. For enumerated fringe benefits, including amounts paid under accident and health plans, an S corporation is treated as a partnership and any shareholder who owns more than two percent of the S corporation stock is treated as a partner. I.R.C. § 1372(a).

1. In 1991, the Internal Revenue Service ruled that accident and health insurance premiums paid by a partnership (or S corporation) on behalf of a partner are considered guaranteed payments, I.R.C. § 707(c), if the premiums are paid for services rendered in that capacity and to the extent the premiums are determined without regard to partnership income. Rev. Rul. 91-26, 1991-1 C.B. 184.

   a. With the status of guaranteed payments, the premiums are deductible by the partnership as salary and wages, I.R.C. § 162, and includible in the recipient’s gross income. I.R.C. § 61.

   b. If the requirements are met, the shareholder-employee may deduct the cost of the premiums to the extent permitted. I.R.C. § 162(l).

   c. The premiums are not excludible from the recipient’s gross income. I.R.C. § 106.

2. The problem is that if a sole-shareholder employee purchases health insurance in his or her own name instead of the corporation’s name, the S corporation has not established a plan to provide medical coverage. See I.R.C. § 162(l)(2)(A).

   a. In that case, there is no fringe benefit paid to the two percent shareholder, the S corporation is not treated as a partnership and the sole shareholder is not treated as a partner. I.R.C. § 1372.

   b. As a result of not being treated as a partner, the sole shareholder is not considered to be self-employed and, therefore, is not able to deduct the medical insurance costs as an above-the-line deduction. I.R.C. § 162(l)(1)(A).

   c. The sole shareholder can, of course, deduct the cost of health insurance as an itemized deduction but that deduction is subject to the 7.5 percent adjusted gross income limitation. I.R.C. §§ 62, 213(a). But to many that is a less than palatable solution.

   d. Moreover, that is a dramatically different outcome than is faced by a sole proprietor who purchases a policy in the sole proprietor’s name and is eligible for an above-the-line deduction. Ltr. Rul. 200524001, May 17, 2005.
3. The obvious solution is to have the S corporation purchase the health insurance in its own name.
   a. But the problem with that is that some states do not allow a corporation to purchase a health insurance plan with only one participant. This precludes the S corporation from acquiring a health insurance plan and means that the only practical solution is to have the sole shareholder purchase the plan in his or her own name.
   b. The Internal Revenue Service has made it clear that the state law limitation “…does not override the requirements that the S corporation must provide fringe benefits to its employees in order to have the 2% shareholder qualify for the IRC Sec. 162(l) benefits.” Headliner, “Health Insurance Covering S Corporation Shareholders,” Vol. 163, May 15, 2006.

4. In a perfect world, a Congress sensitive to inequities in the tax system would respond with an amendment to make it clear that a shareholder-employee purchase of health insurance would be deemed a plan providing medical coverage on the part of the S corporation. However, this is viewed as a minor issue, especially in an era when even major tax issues are commanding little Congressional attention.

VI. Passive Losses with an LLC, LLP or LP

A. Situation of an LLC, LLP or LP—

1. The passive loss rules do not refer to limited liability companies or limited liability partnerships but do refer to limited partners in a limited partnership. Temp. Treas. Reg. § 1.469-5T(e).
   a. Under these rules, losses attributable to limited partnership interests are treated as arising from a passive activity, Temp. Treas. Reg. § 1.469-5T(e)(2), unless a limited partner.
      (1) Participates for more than 500 hours. Temp. Treas. Reg. § 1.469-5T(a)(1).
      (2) Materially participated in five or more of the ten preceding years. Temp. Treas. Reg. § 1.469-5T(a)(5).
      (3) Or the activity is a personal service activity in which the limited partner materially participated for any three preceding years. Temp. Treas. Reg. § 1.469-5T(a)(6).
   b. In general, a partnership interest (and, for tax purposes, an LLC or LLP is considered a partnership) is treated as a limited partnership interest if so designated in the organizational documents or the liability of the holder of the interest is limited to a fixed, determinable amount under state law such as the amount contributed to the entity. Temp. Treas. Reg. § 1.469-5T(e)(3).
   c. However, a general partner who holds a limited partnership interest is not necessarily treated as a limited partner. Temp. Treas. Reg. § 1.469-5T(e)(3)(ii).

2. In a 2000 case, the members’ participation in the LLC was grouped with previous participation in a C corporation engaged in a similar business. Gregg v. United States, 186 F. Supp. 2d 1123 (D. Or. 2000) (no regulation mandated treatment of member of LLC as limited partner; taxpayer needed to satisfy only one test for material participation; flow-through losses properly characterized as ordinary).

3. In a 2005 case, an LLC argued, successfully, that its activity of owning real property and also providing substantial support services to its attorney-tenants was not a rental operation but fell within the “extra-ordinary personal services” exception to the passive activity loss rules under Temp. Treas. Reg. § 1.469-1T(e)(3)(ii) with material participation proved in the LLCs activities. Assaf F. Al Assaf, T.C. Memo. 2005-14 (IRS had argued, unsuccessfully, for a per se rule that LLCs were per se subject to passive activity loss rules). In another 2005 case, losses on equipment leased to the lessor’s law
firm (a C corporation) were deductible and not subject to the passive loss rules because incidental to a non-rental activity. Fred Misko, Jr., T.C. Memo. 2005-166 (losses occurred because law firm had no income in the two years in question and did not pay rent). See Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(D).

B. Self-employment tax uncertainty

1. In general, a member’s net earnings from self-employment include the member’s distributive share (whether or not distributed) of income or loss from any trade or business carried on by an LLC. Ltr. Rul. 9452024, September 29, 1994 (income allocated to each LLC member is included in that member’s self-employment income where the member “engage(s) in the daily activities [of the firm] and will perform substantial services…”).

2. An individual is considered to be a limited partner unless the individual—

   a. Has personal liability for the debts or claims of the entity,

   b. Has authority to contract for or on behalf of the partnership, or

   c. Participates in the partnership’s trade or business for more than 500 hours during the partnership’s taxable year. Prop. Treas. Reg. § 1.1402(a)-2(h). However, the Taxpayer Relief Act of 1997 prohibited IRS from issuing temporary or final regulations defining a limited partner for self-employment tax purposes before July 1, 1998. TRA-97, Pub. L. 105-34, Sec. 935, 111 Stat. 788 (1997). No action has been taken since to make the regulations final.

3. If a member of an LLC is treated as a limited partner for purposes of I.R.C. § 1402(a)(13), the member’s distributive share of income or loss from the LLC is not included in net earnings from self-employment, except for guaranteed payments for services. Id. See paragraph II (H), Chapter 14, for discussion of LLCs treated as limited partnerships for self-employment tax purposes (“federal defined partnerships”).

4. If LLC members are not liable for the LLC’s debts under state law, IRS cannot collect the LLC’s employment tax liability from its members other than, possibly, in the event of fraud. Rev. Rul. 2004-41, 2004-1 C.B. 845. See TAM 200418008, December 29, 2003.