Business Planning Group

Income Tax Dynamics of Seller Financed Sales to Purchasers Other Than Grantor Trusts: Finding the Sweet Spot between General Income Tax, Chapter 14, and Code § 409A

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Income Tax Dynamics of Seller Financed Sales to Purchasers Other Than Grantor Trusts: Finding the Sweet Spot between General Income Tax, Chapter 14, and Code § 409A

I. Introduction

Planning for transfers of family business[1] interests is more complex than ever, now that Congress has imprinted the Code § 409A nonqualified deferred compensation rules over all other income tax principles. First, consider some general income tax principles. Next, Chapter 14 provides special rules for valuing business equity interests for transfer tax purposes that drives how we structure family business ownership. Finally, combining these ideas while avoiding the traps of Code § 409A is challenging.

II. General Income Tax

First, consider income tax efficiency when selling business interests. Additionally, special considerations apply based on the type of entity. S corporation stock ownership is subject to special restrictions. Partnership interests offer unique opportunities for efficiency.

A. Income Tax Efficiency

A business' value is the present value of the expected future cash flows to its owners. A buyer uses these cash flows to pay the purchase price:

- ***Third-Party Financing***. A third-party lender provides cash to pay the purchase price in a lump sum. Business risk is shared between the buyer and the third-party lender, with the buyer assuming substantially all of the risk. Because the seller receives all cash up-front, the seller's risk is minimal.

- ***Seller Financing***. A series of payments from the buyer to the seller is evidenced through a promissory note. From a technical legal viewpoint, the buyer has all of the risk. However, as a practical matter, the seller is subject to business risk because the buyer is much less likely to pay if the business' cash flow is insufficient to service this debt. At any given point in time, the buyer is likely to withhold part or all of the remaining payments if the business' cash flow is less than expected.

- ***Equity Financing***. The seller receives payments based on the business' performance over a short period of time following the transfer, or the timing of buyer's payments depends on the business' profitability.

[1] For purposes of this discussion, "business" refers to a trade or business described in section 162 of the Internal Revenue Code of 1986, as amended (the "Code"). The author recognizes that "business purposes" may exist for entities that conduct investment activity described in Code § 212 and does not in any way intend to impugn the legitimacy and substance of such activity. The author has merely chosen to focus on Code § 162 activity herein.

When the buyer uses debt to pay for the business, two layers of tax are imposed:

- First, the buyer pays income tax on the earnings used to repay the debt.
  - For a partnership or S corporation, if owners are taxed on income from operations at a 40% ordinary federal and state income tax rate, the business must earn $167 of profits to fund a $100 principal payment on the debt.[2]
  - A C corporation structure exacerbates this. If dividends are taxed at a 20% combined federal and state income rate, a $125 dividend generates $100 after tax. To distribute $125 to its shareholders, a C corporation that is subject to taxes on income from operations at a 40% ordinary federal and state income tax rate must generate over $208 of income. Thus, over $208 of business earnings are required to fund a $100 principal payment on the debt.
  - The interest component is easier to finance, assuming the interest is fully deductible.[3] For a partnership or S corporation, only $100 of earnings is necessary to make a $100 interest payment. However, for a C corporation that is subject to taxes on income from operations at a 40% ordinary federal and state income tax rate, earnings of $167 are required to pay a $100 dividend.[4]
- The seller pays tax on the sale. For example, if the seller has a combined 20% federal and state income tax rate, the seller nets $80 on every $100 of purchase price that constitutes capital gain. However, the seller would pay ordinary income tax on any interest component, so that $100 of interest payments would net only $60 to a seller subject to taxes on income from operations at a 40% ordinary federal and state income tax rate.

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[2] However, if the owner is a partner who must pay self-employment tax on the earnings, additional earnings are required to pay the self-employment tax. Holding the partnership interest through an S corporation should avoid this issue.

[3] However, if an electing small business trust borrows to buy stock in an S corporation, interest on that debt is not deductible. Reg. § 1.641(c)-1(d)(4)(ii).

[4] If an individual buyer/shareholder itemizes deductions, the buyer would deduct the interest as investment interest expense. Investment interest expense is deductible to the extent of net investment income. Code § 163(d). Preferably, the buyer would have ordinary interest or nonqualified dividends sufficient to generate this net investment income. Otherwise, the qualified dividends would need to be taxed at ordinary rates to constitute investment income; however, investment interest deducted at ordinary income tax rates generally would offset dividend income taxed at ordinary income tax rates. This comparison is not totally accurate, however, in that the dividend income is included in adjusted gross income (AGI) and can result in reduced itemized deductions and have other adverse AGI-related tax effects. If the buyer is a C corporation, these concerns are not present, and the corporation may also benefit from a dividends-received deduction that can reduce or eliminate the tax on the dividends; however, the buyer's own shareholders would be taxed when the buyer distributes whatever return it receives on its investment.

From these examples, some principles emerge:

- ***Paying Principal***. Principal payments can require from $167[5]-$208[6] of income to be generated to provide the seller with $80[7]-$100[8] after tax. Thus, the tax cost of principal payments represents 40%-62% of the earnings.

- ***Paying Interest***. Interest payments require $100[9]-$167[10] to provide the seller with $60 after tax. Thus, the tax cost of interest payments represents 40%-60% of the earnings.

- ***Efficiency of Entity***. The tax cost is lowest for:

    - Interest or other deductible payments on the sale of a partnership or S corporation, or

    - Principal payments to the extent of the seller's basis.

Consider the portion of the business' equity representing internally generated goodwill, and assume the following tax rates, which might or might not be attained:

Capital Gain	20%	(federal and state income tax)
Ordinary Income	40%	(federal and state income tax)

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

	Capital Gain to Seller	Ordinary Income to Seller
Profit	$ 167	$ 133
Tax to Buyer	- 67	- 0
	$ 100	$ 133
Tax to Seller	- 20	- 53
Net to Seller	$ 80	$ 80

To minimize a sale's tax bite, tax planners seek structures with characteristics similar to interest or other deductible payments on the sale of a partnership or S corporation. Further below is a discussion of special opportunities for partnerships. For now, let's focus on ways to extract value that any entity can try to use.

[5] For a partnership or S corporation.
[6] For a C corporation.
[7] For the gain component of principal payments, net of capital gain tax.
[8] For the portion of principal payments representing a return of basis.
[9] For a partnership or S corporation.
[10] For a C corporation.

Leasing. Some assets used in a business might be held outside of the business and then leased to the business. The buyer continues to lease these assets from the seller. Such lease payments are deductible to the buyer and taxable to the seller, and the seller is not necessarily at risk in that the seller might be able to sell the property to a third party. If a partnership holds the business, the partnership that conducts business operations can save its owners self-employment tax by leasing property instead of owning it.[11]

Generally, real property should not be held in the entity that conducts the business. As discussed above, for self-employment tax purposes it should not be owned by a partnership that has business operations. Because appreciated real estate cannot be distributed from a corporation without triggering either premature (in the case of an S corporation) or double (in the case of a C corporation) taxation under Code § 311,[12] real estate should not be held in a corporation.

Personal Goodwill and Covenants not to Compete. If the business entity does not require its key employees to agree not to compete, the key employees might leave and take their contacts with them. Thus, in such situations the key employees really "own" the business' goodwill. When the business is sold, the buyer would buy goodwill from the person who owns the goodwill, pay key employees not to compete, pay the key employees to work in the business, or a combination of any of these. When goodwill is sold, generally the seller receives favorable capital gain treatment and the buyer deducts over 15 years the sum of the payments.[13] When a covenant not to compete is involved, generally the seller receives ordinary income treatment and the buyer deducts the present value of the payments over 15 years.[14] Thus, compensation for current services, which is deductible in full when paid, is much more beneficial to sellers than either of the above alternatives. Even in the case of goodwill being taxed to the seller at capital gain rates, the benefit of the immediate deduction for compensation for personal services is likely to be of so much benefit to the buyer that the buyer should be willing to pay extra to the seller so that the seller's proceeds after ordinary income tax exceed what the seller would have received for goodwill net of capital gain tax. For example, suppose the seller receives $100 for zero basis goodwill. If the seller's combined federal and state capital gain rate is 20%, the seller receives $80 net of tax. If the buyer pays 40% federal and state tax, the buyer must generate $167 of ordinary income to pay the $100 that it pays the seller. Thus, the seller needs to earn $167 so that the seller receives $80 net of tax. However, if the buyer and seller both have 40% combined federal and state income taxes, then the seller would need just over $133 in ordinary

[11] Lease payments received on a long-term basis are not subject to self-employment tax. Reg. § 1.1402(a)-4(a).

[12] Code § 311 provides that, when a corporation distributes property, the distribution constitutes a sale or exchange by the corporation. Together with the rules governing income taxation of shareholders:

- For an S corporation, generally this means that the shareholders are taxed on the exchange (with favorable capital gain rates often available), receive an increased tax basis in their stock equal to the gain reported, reduce the basis of their stock to the extent of the value of the property that was distributed, and adjust to fair market value the basis of the property that was distributed.

- For a C corporation, generally this means that the corporation pays income tax (with favorable capital gain rates not available) and the shareholders are taxed on the distribution as a dividend, thus generating two layers of tax. However, as with an S corporation, the distributed property's basis is adjusted to fair market value.

[13] Code § 197(a), (d)(1)(A).

[14] Code § 197(a), (d)(1)(E), (f)(3).

income to net the same $80 after taxes. Thus, with a compensation payment of $134-$166, both the seller and buyer are better off (ignoring the deduction the buyer receives for capitalized goodwill in a purchase-of-goodwill scenario).

Deferred Compensation. A common tactic had been to pay the seller compensation for past services rendered. The theory was that, during its formative years, the business did not have the financial ability to compensate the owner for all that the owner did to develop the business into the successful operation it is today. When the business would be sold, finally the business would have sufficient resources to express its gratitude for the owner's past services. The business might pay the owner all at once; or, it might pay this bonus over time to provide the owner with a nice stream of retirement income. This compensation could be paid by the buyer or the seller. If the buyer makes the payments, it deducts them as it makes them and reduces the purchase price to take into account the present value of the payments. If the seller makes the payments, the seller would want to deduct the payments against the sale proceeds or against the interest or income equity component of any deferred sale proceeds.[15]

Under Code § 409A, however, one is required to have a written plan in place as soon as a legally binding right to deferred compensation exists.[16] Thus, if at the time of sale compensating the owner for past services is reasonable and necessary,[17] and the entity can show that a legally binding right to compensation for past services did not exist until that time, then the strategy described in the preceding paragraph may be used.

A more conservative approach would be to have a plan in place when the business is doing well but is not yet sold, which plan vests over time. That strategy is described later.[18] Alternatively, consider paying an immediate lump sum if a plan is not already in place.[19] An immediate lump sum payment often is very unattractive to the buyer (who has cash flow issues and might not need that much deduction in a single year) or seller (who might rather receive payments over time to avoid accelerating income tax if adequate safeguards are in place to protect the payment).

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[15] The seller would not want to liquidate the entity that owned the business until after these payments are made. Otherwise, the payments would constitute an additional capital loss or reduction of capital gain rather than a deduction against ordinary income. *Arrowsmith, Exec. v. Com.*, 344 US 6 (1952).

[16] A plan is any arrangement or agreement providing for a deferral of compensation. Code § 409A(d)(1), (3). If the payment is reasonable because it relates to past services, then it constitutes deferred compensation, and its material terms must be documented in writing to satisfy Code § 409A. Reg. § 1.409A-1(c)(3)(i). The written plan must be in place when the service provider obtains a legally binding right to the compensations. Reg. 1.409A-1(a)(1). One might argue that compensation was earned in a prior year, but there was no legally binding right to payments based on that service, and now it is necessary and reasonable to pay for those past services to retain the employee. Although the author would make such an argument on audit, the author would prefer to have more certainty when planning in light of Code § 409A's expansive reach.

[17] Code § 162 requires any business deduction to be reasonable and necessary. If the future payments relate to compensation earned in the current year, then the taxpayer must prove that (a) the total compensation (current and deferred payments) earned that year is reasonable (to obtain a Code § 162 deduction) and (b) that it was entered into before January 1 of calendar year in which the services were provided (to satisfy Code § 409A(a)(4)(B)(i) and Reg. § 1.409A-2(a)(1)).

[18] See text accompanying footnotes 82-87.

[19] A special exception to Code § 409A applies to payments that occur immediately after the payment becomes vested if the taxpayer can prove that the payment was contingent on continuing to provide services from the date the service had been performed until the date that occurred during the current year. Reg. § 1.409A-1(b)(4)(i).

Conclusion. Other than separating certain assets from the entity that runs the business operations, a tax-efficient way to sell a business is to provide current or deferred compensation to the owners who work in the business. First we will explore other general business income tax concepts that apply to transferring business ownership, then further below we will consider the how Chapter 14 and Code § 409A inform our planning.

B. <u>S Corporation Issues: Surprising Exceptions to the Single-Class-of-Stock Rule</u>

An S corporation cannot have more than one class of stock.[20] The single class of stock rules focus on rights to distribution and liquidation proceeds.[21] However, many techniques allow employees to be compensated in a manner similar to a shareholder without being considered to be a shareholder. Or, employees could hold actual stock whose liquidation rights materially differ from the other stock but is not deemed a second class of stock because of special exceptions that apply only to shareholders who are employees.

Certainly, an employer can give an employee a bonus based on the company's profitability. How far can an employer go in providing compensation that functions like stock ownership without actually being stock?

- An employment agreement is not a binding agreement relating to distribution and liquidation proceeds (and therefore is not a second class of stock) unless a principal purpose of the agreement is to circumvent the single class of stock rules.[22] Even if the IRS finds that one shareholder's compensation is excessive, that finding will not violate the single class of stock rules unless a principal purpose of the agreement is to circumvent those rules.[23]

- If a call option issued to an employee does not constitute excessive compensation, the option is not treated as a second class of stock if it is nontransferable and does not have a readily ascertainable fair market value when issued.[24] However, if the strike price is substantially below the stock's fair market value when the option becomes transferable, it may be treated as a second class of stock if the option is materially modified or transferred to an ineligible shareholder.[25] The safest course of action would be to (1) make the option always be nontransferable without a readily ascertainable fair market value as described above, or (2) start with an option that is transferable only to eligible shareholders and has a strike price that, at inception, is at least 90% of the stock's fair market value.[26]

[20] Code § 1361(b)(1)(D).
[21] Reg. § 1.1361-1(l)(1).
[22] Reg. § 1.1361-1(l)(2)(i).
[23] Reg. § 1.1361-1(l)(2)(v), Example (3). Disparate employee fringe benefits are similarly acceptable. *Id.*, Example (4).
[24] Reg. § 1.1361-1(l)(4)(iii)(B)(2).
[25] Reg. § 1.1361-1(l)(4)(v), Example (2). Such an option would also raise Code § 409A issues that would not be present if the strike price is not less than the stock's fair market value on the date of grant. See text accompanying footnote 118.
[26] Reg. § 1.1361-1(l)(4)(iii)(C). The latter would also raise Code § 409A issues that would not be present if the strike price is not less than the stock's fair market value on the date of grant. See text accompanying footnote 118.

Under certain circumstances, an employer may issue stock to an employee and repurchase it at a bargain price without violating the single class of stock rules.[27]

Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of section 1.83-3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded.

The company can redeem an employee's stock for an amount significantly below its fair market value on the termination of employment or if the company's sales fall below certain levels, when the employee did not receive the stock in connection with his performing services and a principal purpose of the agreement is not to circumvent the single class of stock rules.[28] Could a sale price that is nominal be considered not to be bona fide or be considered to make the stock forfeitable, throwing it into the rules that apply to forfeitable stock? The author has not researched whether this is a legitimate issue, but generally would feel comfortable with a redemption price at book value, because Reg. § 1.1361-1(l)(2)(iii)(A) provides (emphasis added):

> Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless --
>
> (1) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and
>
> (2) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.
>
> ***Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.*** For purposes of this paragraph (l)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

Such a price would prevent the terminated employee from benefiting from valuation methods based on earnings or unrealized appreciation in the company's tangible or intangible assets.

[27] Reg. § 1.1361-1(l)(2)(iii)(B). But see Letter Ruling 200632004, in which the IRS ruled that a bargain repurchase of stock held by a director would constitute a second class of stock.

[28] Reg. § 1.1361-1(l)(2)(vi), Example (9).

C. Partnerships: The Beauty of Profits Interests and the Unadvertised Benefits of Code § 736 Payments to Retiring Partners

When a partnership redeems a partner's interest in full, Code § 736(a) provides that payments may be deductible to the partnership and ordinary income to the selling partner. Or, one may choose to apply Code § 736(b) so that they are nondeductible to the partnership (although possibly depreciated or amortized if the partnership has a Code § 754 election in place) and capital gain to the partner. This brief discussion illustrates why a partner whose interest is being redeemed would generally prefer Code § 736(a) treatment, even though at first glance it would seem that the retiring partner would prefer Code § 736(b) treatment, since capital gains rates are lower than ordinary income rates.

Before explaining this counter-intuitive rule, let's discuss the flexibility allowed. Generally, the redemption agreement can provide that as much or as little of the redemption payments receive treatment under Code § 736(a) or (b).[29] However, capital gain payments:

1. Cannot exceed the fair market value of the withdrawing partner's share of the partnership property.[30]

2. Cannot include certain payments for goodwill, accounts receivable and inventory.[31]

A Code § 736(a) transaction might be structured as follows: The seller receives preferred payments equal to the lesser of the LLC's net operating cash flow or a target amount before any amounts are distributed to the buyer. If the target is not attained, then:

1. The deficiency is added to the following year's target amount.

2. The seller might be given control over certain aspects of running the business. This could be as modest as limiting the buyer's compensation for services rendered or as far-reaching as taking over control of part or all of the business' operations. The partial or total shift on control would be a focal point of negotiations.

These provisions would be built directly into the LLC's operating agreement. So that they know that authority has not been transferred to the seller, third-party lenders would require assurances that the buyer is complying with the agreement with the seller, thus providing an independent check on the buyer's compliance with the deal.

After the seller has received all that has been bargained-for, the seller would no longer be a member of the LLC.

Below is an example, followed by a brief discussion of how, under certain circumstances, an existing corporation can transfer its assets to an LLC to later take advantage of the partnership income tax benefits. If the corporation were a C corporation, it would make an S election after it

[29] Reg. § 1.736-1(b)(5)(iii).
[30] Reg. § 1.736-1(b)(5)(iii).
[31] Code § 736(b)(2).

collects the accounts receivable or other built-in gain assets that are likely to be disposed of by the business.

1. Illustration of Capital Gain vs. Ordinary Income Code § 736(a) Payments

This example assumes that the seller's basis is zero (for example, the portion of the business' equity representing internally generated goodwill) and applies the following tax rates, which might or might not be attained:

Capital Gain	20%	(federal and state income tax)
Ordinary Income	40%	(federal and state income tax)

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

The scenario in the right column below assumes that the partnership/LLC uses pre-tax dollars to redeem the seller's interest in the business. Because the buyer can deduct the payments, the buyer does not have to pay tax on the income generated by operations to fund the payments to the seller. Instead, the seller is being taxed at ordinary income rates on the income from operations using to redeem the seller's interest.

	Capital Gain If Use Section 736(b)	Ordinary Income § 736(a) Payments
Profit	$ 167	$ 133
Tax to Buyer	- 67	- 0
	$ 100	$ 133
Tax to Seller	- 20	- 53
Net to Seller	$ 80	$ 80

Main Points

a. Using a capital gain Code § 736(b) scenario, taxes consume $87 ($167 minus $80), which costs $34 more (compared with $53 tax, the capital gain Code § 736(b) scenario translates into 64% more taxes) to the parties as a whole than would the ordinary income Code § 736(a) scenario in meeting the targeted payments of "principal." Thus, the ordinary income scenario provides more money available to buy out the seller and eases the stress of the buy-out.

The additional $34 cushion would be subject to $14 tax (40% of the buyer's $34 earnings), so the parties really have only $20 more, which is the capital gain tax that the seller would have paid.

Thus, the true net tax savings are only $20, before considering the loss of the deduction for amortized goodwill (goodwill amortization provides less than $3 per year[32] tax savings).

b. In the Code § 736(a) scenario, the seller must receive 33% more ($133 versus $100) to produce this savings. Thus, although the stated sales price would appear to be higher and more burdensome to the buyer, really the buyer is better off as illustrated. Of course, the seller will want to negotiate an increase in payments to capture part or all of these tax benefits; both parties win if the seller receives $134-$166 (again ignoring the loss of the deduction for amortized goodwill).

c. These scenarios ignore self-employment tax. If the seller is tax as a limited partner, that would not be a concern. Otherwise, consider that the buyer would be paying self-employment tax in a sale scenario (increasing the tax from $67 to over $72), so the buyer should be willing to pass these self-employment tax savings to the seller as well.

d. In the § 736(a) scenario, increases in ordinary income tax rates harm the seller disproportionately, although it might be possible for the buyer to agree to pay seller more because the buyer saves more tax by making those additional payments. On the other hand, in a capital gain scenario, an increase in capital gain rates without a corresponding increase in ordinary income rates would not help the buyer save as much tax by paying the seller more.

e. Code § 736(a) requires a complete liquidation in the redeemed partner's interest.[33] However, the complete redemption may be made over time.[34] If the partnership assumes the partner's share of liabilities, it cannot deduct the payment of those liabilities under Code § 736 later than the year in which the partner's relationship with the partnership terminated.[35]

f. The above treatment does not apply to the extent that the LLC is repaying the seller's capital account. In many cases, the seller's capital account would be the LLC's earnings that are allocated to the seller but not distributed. The seller would not be taxed on such distributions, because they were taxed when originally earned.

g. If a more gradual transition is desired, the LLC might be structured with profits interests that shift over time, which might achieve results similar to that of Code § 736(a) without the partner completely retiring. For example, suppose an older member brought in a lot of business, but the agreement would be that the younger members would take over the business after a number of years. The LLC might be structured to give the older member a larger profits interest in early years and a smaller profits interest in later years. The objective would be to structure it not as a sale, but rather as an allocation of profits related to the business each member generates and the services each member performs.

[32] The annual tax deduction is $6.67 ($100 divided by 15), resulting in $2.67 tax savings ($6.67 multiplied by 40%).
[33] Reg § 1.736-1(a)(1)(i).
[34] Rev Rul 75-154.
[35] *Whitman & Ransom*, TC Memo 2005-172.

2. Converting a Corporation to a Partnership to Use Code § 736(a) or Similar Tools

Is goodwill an asset that belongs to the individual owner or to the entity? If a non-compete agreement is not in place, goodwill belongs to the owner personally.[36]

If all of the S corporation's assets were sold to a new entity, tax would be incurred at the corporate level. The sale of goodwill would be taxable, but the new entity's deduction for that payment would be spread over 180 months (15 years).[37] Furthermore, if the IRS were to find that goodwill was transferred to the new entity at a substantial value, without the S corporation retaining a sufficient interest in the new entity, then:

a. The S corporation would have income equal to the goodwill.

b. The shareholders would have immediate dividend income equal to the goodwill, which they then contributed to the new entity without receiving an immediate deduction (the deduction would be spread over 180 months).

If the S corporation transfers its assets to a new LLC taxed as a partnership, retaining a preferred interest at the AFR that distributes only to the extent of operating cash flow, each of Reg. §§1.707-4(a)(2) and 1.707-4(b) separately creates a presumption that a sale has not occurred.[38] If the S corporation is receiving a return whose present value (using the AFR) is equal to the value of the contributed goodwill (if any), the S corporation should not be treated as having distributed such goodwill to its shareholders. It might be advisable to give the corporation a small but significant profits interest in the LLC.

III. Chapter 14

Congress enacted much of Chapter 14 to avoid perceived abuses in valuing transfers of family-controlled business entities. Below this portion considers how retained equity interests are valued (and how to avoid such valuation), and the circumstances under which agreements to require or restrict transfers are considered in determining the value of what is transferred. We

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[36] See *Martin Ice Cream Co.*, 110 TC 189 (1998).

[37] Code § 197 provides for 15 years, and Reg § 1.197-2(f)(1)(i) applies this starting with a particular month.

[38] It is unlikely that the partnership anti-abuse rules would come into play. To minimize the risk that they would under Reg. § 1.701-2(c)(3), the seller cannot be protected from loss. Reg. § 1.701-2(e)(2)(i) says that, if the transaction is contemplated by a particular regulation, then the situation is not considered an abuse of entity treatment; the proposed strategy contemplates a stream of payments clearly approved by the disguised sale regulations. Looking at the larger picture, the anti-abuse rule applies only if the transaction is inconsistent with the intent of Subchapter K. The intent of Subchapter K has three prongs under Reg. § 1.701-2(a):

- <u>The partnership must be bona fide, and each transaction must have a "substantial business purpose."</u> The proposed transaction splits income for generally around 5 years, and it provides the old owner with a way to take control over the business more quickly if the transaction does not work out than in a traditional sale. The new owner benefits by minimizing his risk, in that he is not personally liable. These are substantial, practical business issues.
- <u>The form of each transaction must be respected under substance over form principles.</u> No games are being played here: the parties have every incentive to ensure that the new entity's cash flow is distributed as promised in the transaction.
- <u>Clear reflection of income.</u> All distributions the old owner receives is being taxed. The new owner is not being taxed on income the new owner does not receive.

will focus on how Chapter 14 might affect the beneficial equity structures and deferred compensation techniques described in the "General Income Tax" discussion above. After focusing on this interaction, the portion further below after this one brings the Code §409A overlay into play and tries to find some "sweet spots" which one might seek in structuring businesses.

A. Overview of Chapter 14 Rules Regarding Family-Controlled Business Entities

Generally, Code § 2701 values transfers from older family members to younger family members. Code § 2703 allows the IRS to disregard buy-sell and transfer restrictions in many situations. Code § 2704 allows the IRS to disregard restrictions on liquidating an entity in certain situations.

Does Chapter 14 apply to interests in family-controlled business entities when they are transferred as compensation for services rendered by a family member? The regulations governing transfers in the ordinary course of business are expressly subject to Chapter 14.[39] Furthermore, those regulations generally apply to protect transactions made between unrelated parties from gift tax scrutiny, whereas transactions between related parties are subjected to the usual scrutiny even if the business is an operating business.[40]

B. Code § 2701 Overview

Code § 2701(a)(1) values "transfers" when a transferor or "applicable family member" (the older generation) holds an "applicable retained interest" (a preferential distribution or liquidation right) after making a transfer of an interest in a corporation or partnership to a "member of the transferor's family" (a younger generation). Let's examine the meaning of these quoted terms and consider exceptions to these rules.

[39] See the last sentence of Reg. § 25.2512-8.

[40] See Rev. Ruls. 68-558 (no gift tax on citizens' contributions to company to entice it to invest to create jobs in the community), 72-583 (ignore subjective intent), Rev. Rul. 77-131 (ignore subjective intent), 80-196 (no gift tax when shareholders transferred stock to unrelated key employees; note that Reg. § 1.83-6 treats such transactions for income tax purposes as a contribution to the capital of the corporation followed by compensation paid by the corporation to the employees), and 81-54 (transaction that had legitimate business purpose was done in a manner that constituted a taxable gift to children); *Estate of Cullison*, TC Memo 1998–216 (applying the following standards in holding for the IRS: "Transfers of property in the ordinary course of business … are not subject to gift tax. …. To qualify, the transaction must be bona fide, at arm's length, and free from donative intent. …. As we further noted in Harwood v. Commissioner…: 'Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift.") , *aff'd* 221 F.3d 1347 (9th Cir. 2000); *Estate of Ellie B. Williams*, TC Memo 1998-59 (transfers were gifts, not compensation for services, in light of (a) the fact that decedent did not agree to transfer property to petitioner as part of their business relationship, (b) decedent's personal relationship with petitioner, (c) her history of making gifts to him, and (d) the estate's signing of the gift tax returns); Letter Ruls. 9117035 (ESOP transaction that indirectly benefited son deemed gift), 9253018 (applying Code § 2701 in a different ESOP transaction), and 199928013 (bonuses to son were not gifts because they were part of a larger plan that primarily benefited employees not related to the principal shareholder); and *Blount*, 428 F.3d 1338 (11th Cir. 2005) (when an ESOP and decedent were the only shareholders in the company, the estate had to pay estate taxes for having made a bargain sale to the ESOP), *aff'g in part and rev'g in part* TC Memo 2004–116; ***but see*** *Estate of Pearl I. Amlie*, TC Memo 2006–76 (Code § 2703(b)(1) business purpose was also a business purpose under Reg. § 25.2512–8; business purposes included hedging the holdings of a conservatorship estate and planning for future liquidity needs of the decedent's estate).

"Transfer" generally includes a contribution to capital, a capital structure transaction such as redemption, recapitalization, or other change in the capital structure of a corporation or partnership, or certain terminations of an indirect holding in the entity.[41]

For most purposes of Code § 2701, "applicable family member" means "the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor."[42] "Member of the family" means "the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant."[43]

"Applicable retained interest" includes the following:

- <u>A "distribution right," but only if, immediately before the transfer, the transferor and applicable family members "control" the entity</u>:[44]
  - A "distribution right" is a right to distributions from an entity with respect to stock in a corporation or a partner's interest in a partnership.[45] However, it does not include:[46]
    - a right to distributions with respect to an interest that is of the same class or subordinate to the transferred interest,
    - an extraordinary payment right (a liquidation, put, call, or conversion right), or
    - a right to receive guaranteed payments from a partnership of a fixed amount.
  - "Control" means:
    - In the case of a corporation, at least 50%, by vote or value, of the corporation's stock.[47] To be considered, voting rights must extend beyond the right to vote in liquidation, merger, or a similar event.[48] A person is considered to own a voting right if that person can exercise that right alone or in conjunction with another person.[49] Permissible recipients of income from the equity interest and other beneficiaries, rather than the trustee, are considered to hold voting rights that are in trust.[50] Voting rights subject to a contingency that has not occurred do not count unless the holder of the right can control the contingency.[51]

[41] See Code § 2701(e)(5) and Reg. § 25.2701-1(b)(2)(i).
[42] Code § 2701(e)(2); see Reg. § 25.2701-1(d)(2).
[43] Code § 2701(e)(1); see Reg. § 25.2701-1(d)(1).
[44] Code § 2701(b)(1)(A); Reg. § 25.2701-2(b)(1)(ii).
[45] Code § 2701(c)(1)(A).
[46] Code § 2701(c)(1)(B); Reg. § 25.2701-2(b)(3).
[47] Code § 2701(b)(2)(A).
[48] Reg. § 25.2701-2(b)(5)(ii)(B).
[49] *Id.*
[50] *Id.*
[51] *Id.*

- In the case of a partnership:[52]

  - At least 50% of the capital or profits interests, or

  - In the case of a limited partnership, any interest as a general partner.[53]

  The above excludes any Code § 707(c) guaranteed payment of a fixed amount.[54]

- Solely for purposes of this "control" test, "applicable family member" includes any descendant of any parent of the transferor or the transferor's spouse.[55]

- An extraordinary payment right.[56] Generally, an extraordinary payment right includes a liquidation, put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the transferred interest's value.[57] A "call right" includes any warrant, option, or other right to acquire one or more equity interests.[58]

  Notwithstanding the above, certain rights are not applicable retained interests:[59]

- A mandatory payment right.[60] This is a right to receive a payment at a specific time (including a date certain or the holder's death) for a specific amount.

- A liquidation participation right.[61] This is a right to participate in a liquidating distribution. However, generally the right to ***compel*** liquidation is treated as if it did not exist if the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation.

- A right to a guaranteed payment of a fixed amount under Code § 707(c).[62] The time and amount of payment must be fixed. The amount is considered fixed if determined at a fixed rate, including a rate that bears a fixed relationship to a specified market interest rate.

- A non-lapsing conversion right.[63] This is a non-lapsing right to convert an equity interest:

  - Into a fixed number or fixed percentage of shares in a corporation that are the same class as the transferred interest.

  - Into a specified interest in the partnership (not represented by a fixed dollar amount) that is the same class as the transferred interest.

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[52] Code § 2701(b)(2)(B).
[53] Reg. § 25.2701-2(b)(5)(iii).
[54] Reg. § 25.2701-2(b)(5)(iii). See text accompanying footnote 62.
[55] Code § 2701(b)(2)(C).
[56] Reg. § 25.2701-2(b)(1)(i), (b)(2); see Code § 2701(b)(1)(B).
[57] Reg. § 25.2701-2(b)(1)(i), (b)(2).
[58] Reg. § 25.2701-2(b)(2).
[59] Reg. § 25.2701-2(b)(4).
[60] Reg. § 25.2701-2(b)(4)(i).
[61] Reg. § 25.2701-2(b)(4)(ii).
[62] Reg. § 25.2701-2(b)(4)(iii).
[63] Reg. § 25.2701-2(b)(4)(iv).

In both cases:

- o Differences in voting rights are ignored.

- o The conversion right must be subject to proportionate adjustments:

    - ➢ For a corporation, such adjustments must be made with respect to splits, combinations, reclassifications, and similar changes in capital stock.

    - ➢ For a partnership, the equity interest must be protected from dilution resulting from changes in partnership structure.

C. <u>Code § 2701 Interaction with Income Tax Planning</u>

How does Code § 2701 inform the discussion further above on ways to plan for entity transfers? Below is a qualitative analysis; quantifying these amounts using the complicated subtraction method set forth under Reg. § 25.2701-3(b) is beyond the scope of these materials.

- <u>Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer</u>. Suppose a parent transfers a profits interest to a child and retains the parent's capital account. The parent's capital account generally would be an applicable retained interest, valued at significantly less than its face amount, so that the transfer to the child will be treated as a transfer of much of the parent's capital account as well.[64] However:

- o This rule will not apply if the following, added together, are less than 50% of the partnership's income and less than 50% of the partnership's capital:

    - ➢ The parent's and child's interests, and

    - ➢ Interests of any combination of:

        - ❖ Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor), and

        - ❖ Descendants of the parents of the parent or the parent's spouse (in other words, the parent's and parent's spouse's siblings and the descendants of the parent, of the parent's spouse, or of such siblings).

- o The parent may reduce the gift based on the discounted present value of the right to receive the capital account if either:

    - ➢ The partnership must pay the capital account to the parent at a "specific time," such as a specific date or the parent's death, or

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[64] Presumably this would be the discounted present value of the payment of the capital account upon liquidation, ignoring the family's right to compel liquidation. See text accompanying footnote 62.

- Liquidation (at which time the capital account would be paid to the parent) cannot be compelled by any combination of:
    - The parent,
    - Members of the parent's family (the parent's spouse, a descendant of the parent or the parent's spouse, and the spouse of any such descendant), and
    - Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor).

The parent can enhance the retained capital account's present value by retaining a cumulative distribution right with respect to the capital account. For example, if the partnership were required to pay the parent annually 7% of the parent's capital account and that right either was not contingent on profits[65] or was cumulative,[66] then the parent could also reduce the gift on account of the present value of that payment right.

The value of a junior equity interest cannot be valued at less than 10% of the sum of the total value of all equity interests in the partnership and the total amount of the partnership's indebtedness to the parent and other applicable family members.[67] In a partnership, "junior equity interest" means any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests.[68] Although a profits interest typically would be junior with respect to capital, generally it would not be junior with respect to income.[69] Thus, generally the 10% minimum value rule would not apply to profits interests. However, as a practical matter, often appraisers of qualified retained interests require junior interests to be worth at least 20% of the entity to give full valuation effect to the stated payments, so avoiding the 10% minimum value rule would not necessarily be helpful.

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[65] Thereby constituting a guaranteed payment right under Reg. § 25.2701-2(b)(4)(iii). Instead of using 7% (arbitrarily selected for this example), one could use the prime rate or some other market rate.

[66] Thereby constituting a qualified payment under Code § 2701(c)(3)(C)(i) (first sentence) and Reg. § 25.2701-2(b)(6)(ii). The transferor or an applicable family member who holds a distribution right that does not qualify may nevertheless treat the right as a qualified payment if he or she makes a special election under Code § 2701(c)(3)(C)(i) (second sentence) and Reg. § 25.2701-2(c)(4). Finally, additional gift tax may be imposed under Code § 2701(d) if the qualified payment is not made within the four-year grace period allowed under Code § 2701(d)(2)(C).

[67] Code § 2701(a)(4); Reg. § 25.2701-3(c). Such indebtedness does not include short-term indebtedness incurred with respect to the current conduct of the entity's trade or business (such as amounts payable for current services); indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member; amounts permanently set aside in a qualified deferred compensation arrangement, to the extent the amounts are unavailable for use by the entity; or a qualified lease. Reg. § 25.2701-3(c)(3). A lease of property is not indebtedness, without regard to the length of the lease term, if the lease payments represent full and adequate consideration for use of the property. Lease payments are considered full and adequate consideration if a good faith effort is made to determine the fair rental value under the lease and the terms of the lease conform to the value so determined. Arrearages with respect to a lease are indebtedness.

[68] Code § 2701(a)(4)(B); Reg. § 25.2701-3(c)(2).

[69] However, if the parent retained a cumulative distribution as recommended above, then the profits interest would be junior as to income, and presumably the 10% minimum value rule would apply.

On the other hand, if one needs to go through all of this complexity, one might consider abandoning the profits interest idea and instead using a GRAT.[70] If the parent wants to transfer only a small portion, the parent could transfer a vertical slice (described further below) of what the parent owns and place a ceiling on the amount that is ultimately transferred to the child. If the parent's goal in transferring a profits interest is to incentivize the child, the GRAT's ceiling could be based on objective business performance measures.

- The issuance of a pure profits interest[71] does not have Code § 409A implications.[72] The Code § 409A analysis is not affected by whether the profits interest is junior to another interest.

- Suppose the partnership issues the interest to the child, instead of the parent transferring the interest. Code § 2701 applies to a "change in the capital structure" of a partnership or corporation in certain situations.[73] However, Code § 2701 applies to a change in capital structure only if:[74]

  (1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

  (2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a "subordinate interest") and receives property other than an applicable retained interest; or

  (3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased.

  In this variation, the parent does not hold an applicable retained interest before the transaction. Thus, we look to paragraph (1) and not to paragraphs (2) or (3). Because the parent has retained the capital account that he had before the transaction, rather than receiving a capital account,[75] has the parent "received" an applicable retained interest in the transaction?

- Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest. Suppose a parent is buying a partnership owned by an unrelated third party. The unrelated third party retains all of his capital interest and receives preferred payments of income in liquidation of the value of his interest in excess of his capital account. The parent is entitled to 100% of the profits in excess of the preferred payments. As discussion further above, preferred payments of income to the third party can be very beneficial to the parent who is buying the business, if the preferred payments are

[70] The author thanks Mil Hatcher for his creativity in suggesting the GRAT alternatives described here.
[71] By "pure profits interest" the author means a partnership interest that would be allocated nothing if liquidation were to occur at the time of transfer of such interest.
[72] See text accompanying footnote 109.
[73] Code § 2701(e)(5).
[74] Reg. § 25.2701-1(b)(2)(i)(B).
[75] This approach cannot be taken if done in conjunction with a contribution to capital. Reg. § 25.2701-1(b)(2)(i)(A).

taxed to the third party as a distributive share of income under Code § 736(a) so that the parent is using pre-tax dollars to buy out the third party.

- Initially establishing this capital/income structure will not have Code § 2701 implications, because the parent is not a member of the third party's family.

- The partnership's capital/income structure could have Code § 2701 implications if the parent transfers an interest to his child or any other member of the parent's family.

  - Does the parent own at least "50% of the profits interests" that would be required for Code § 2701 to be considered (since the parent has no capital account yet) if the partnership is a general partnership? The statute and regulations do not clearly answer the question.[76] If the partnership is a limited partnership and the parent is a general partner, then Code § 2701 must be considered no matter what the parent's economic interests are.[77] If the partnership is a manager-managed limited liability company, and the parent is a manager, would that be the same as being a general partner in a limited partnership?

  - Even if one assumes that the parent's partnership interest is sufficient to make one consider Code § 2701, if the parent transfers a vertical slice of the parent's right to income and the same vertical slice of the parent's right to capital to his child, Code § 2701 should not apply to that transfer.[78] Suppose, for example, that the parent owns 60% of the income and 10% of the capital and wants to give a vertical slice of 1/10 of his interest to his child.[79] In that case, the parent would give the child a 6% income (60% multiplied by 1/10) and 1% capital interest (10% multiplied by 1/10) and would retain a 54% income and 9% capital interest. The vertical slice should be structured so that the child succeeds to 1/10 of every item of the parent's rights to distributions and financial obligations. For example, if the parent is obligated to leave a portion of his share of income in the partnership, the child should have a proportionate obligation to leave income in the partnership; the parent's leaving profits in the partnership might[80] constitute a contribution to capital, triggering Code § 2701,[81] in which case one needs to find an exception to Code § 2701, such as transactions involving proportionate vertical slices.

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[76] Code § 2701(b)(2)(B)(i); Reg. § 25.2701-2(b)(5)(iii).

[77] Code § 2701(b)(2)(B)(ii); Reg. § 25.2701-2(b)(5)(iii).

[78] See Reg. § 25.2701-1(c)(3), (4). The vertical slice (proportionate transfer) exception under Reg. § 25.2701-1(c)(4) applies because no applicable family member of the parent owns an interest in the entity.

[79] In the example, the parent starts with a pure profits interest and no capital. However, the parent is likely to leave some income in the partnership, especially since the reinvested income might be used to buy the third party's capital account. The cumulative effect would be to decrease the third party's capital account and increase the parent's capital account until the third party's capital account and income interest have decreased to zero.

[80] The next paragraph of text suggests a difference between the parent transferring a partnership interest and the partnership issuing a partnership interest. Therefore, the author's concern about leaving profits in the partnership could be creating an issue where there is none, because the parent is not transferring property to the child. Thus, this recommendation is an attempt to be very conservative.

[81] Reg. § 25.2701-1(b)(2)(i)(A).

- Deferred Compensation.[82] Suppose a parent is 55 years old and wants to retire in 10 years. The business entity (same analysis whether partnership or corporation) agrees to make the following series of payments:

  - Retirement Payment. $100,000 per year for life,[83] but only if the parent continues to work for the entity until the parent attains age 65.[84] This should not violate Code § 409A; of course, to satisfy other tax issues, the retirement payment must, when combined with other compensation, constitute reasonable compensation for future services.[85] Similarly, as a payment that is fixed in amount at a specific time, it is not subject to Code § 2701,[86] whether or not the IRS attempts to classify it as equity.

  - Disability Payment. The parent receives $100,000 for life if the parent becomes disabled before attaining age 65. If disability is defined consistent with Code § 409A(a)(2)(A)(ii) & (a)(2)(C) and the pronouncements thereunder, the payment would not violate Code § 409A. Unfortunately, this definition is more stringent than most good disability policies, and one might consider paying a bonus to the parent so that the parent can buy disability insurance instead.[87]

  - Death Benefit. A death benefit to replace the disability and retirement payments would not violate Code § 409A.

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[82] Although this is not equity, it reduces the entity's value for many purposes and makes it easier to sell. It is realistically available only if the entity earns sufficient income.

[83] If instead the payment were for a fixed period of years instead of for life, more planning opportunities are available if the arrangement provides at all times that the right to the series of installment payments is to be treated as a right to a series of separate payments. Reg. § 1.409A-2(b)(2)(iii).

[84] When the parent reaches 65, the present value of the retirement payments vests for FICA purposes, and a lump-sum FICA tax payment is due. Although this might sound onerous, it is actually quite beneficial. FICA tax (for employer and employee combined, or for self-employment tax purposes) is 15.3% on annual income up to the taxable wage base (TWB) and 2.9% on all annual income above the TWB. See http://www.ssa.gov/OACT/COLA/cbb.html for the current TWB ($102,000 in 2008). Most of the FICA tax on the present value will be at the lower 2.9% rate. When payments are made in future years, they will not be subject to FICA tax. This could save $12,648 of FICA tax each year ($102,000 TWB multiplied by the 12.4% spread between 15.3% and 2.9%).

[85] In this example, the requirement that the parent work for 10 years is an attempt to spread the period of "earning" the compensation for the purposes of determining reasonable compensation.

[86] Reg. § 25.2701-2(b)(4)(i)(in the case of a corporation) or (iii) (in the case of a partnership).

[87] A good disability policy will provide benefits if the disabled person cannot work in his or her ***own occupation***. Contrast this with Code § 409A(a)(2)(C), which provides (emphasis added):

> For purposes of subparagraph (A)(ii), a participant shall be considered disabled if the participant—
>
> (i) is unable to engage in ***any substantial gainful activity*** by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or
>
> (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

The discussion below of creative bonus arrangements convinces the author that none of the above would constitute an equity interest. Therefore, such arrangements would not constitute an "applicable retained interest" that would taint a transfer by the parent to a child.[88]

- Stock Options. Stock options exercisable at a price that is at least the underlying stock's value on the date of grant generally are not subject to Code § 409A. Similar rules apply to partnerships. For purposes of Code § 2701, the IRS tends to view options as compensation, not equity:[89]

  > Until the options are exercised, the holder of the option has no right to receive dividends and no right to vote shares of the corporation. The holder has only the right to purchase an equity interest (i.e., shares of stock). In purchasing the shares of stock, the holder would then obtain an equity interest in which he would have these rights. The holder of the options, thus, does not hold an equity interest in the corporation and a transfer of the options is not subject to section 2701 of the Code.

  Income tax cases have held than an option to acquire a partnership interest does not constitute an equity interest in the partnership.[90] The author has not discovered Code § 2701 cases addressing that question.

  However, options are subject to Code § 2703, which deals primarily with buy-sell agreements.[91]

- Creative Bonus Arrangements. Suppose an employee who is a family member is entitled to receive a bonus based on the entity's profitability. If the bonus is required to be paid on March 15 following the calendar year the results of which are being measured, the bonus plan generally would not be subject to Code § 409A. If this bonus is based on the entity's income, would the bonus plan constitute an equity interest?

  The author is not aware of Code § 2701 cases addressing this issue, so the author has summarized selected income tax cases.

  As in other areas, state law determines rights, but tax law determines the effect of those rights; whether a partnership exists depends on a weighting of several factors.[92] The most commonly cited factors, none of which is conclusive, are:[93]

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[88] Code § 2701 applies only when the parent or a member of the parent's family holds an applicable retained interest. An applicable retained interest includes only a right to equity. See Code § 2701(b), (c)(1), (c)(2).

[89] Letter Ruling 199952012 and CCA 199927002; see Letter Ruling 9616035. The IRS also compares the stock with respect to which the option is granted with the stock that the transferor retained. See Letter Ruling 9725032 (option related to publicly traded stock, and such stock is not subject to Code § 2701) and 9722022 (stock subject to option was same class as stock the transferor retained, so Code § 2701 did not apply).

[90] *Dorman v. US*, 296 F2d 27 (9th Cir. 1961) (option was a capital asset but not a partnership interest); *Vestal v. US*, 498 F2d 487 (8th Cir. 1974) (option was neither a capital asset [because its value was too speculative] nor a partnership interest); *Mayhew*, TC Memo 1992-68 (option and right to bonus did not constitute a profits interest).

[91] See text accompanying footnotes 101-105.

[92] *Commissioner v. Culbertson*, 337 US 733 (1949), clarifying *Commissioner v. Tower*, 327 US 280 (1946).

- [t]he agreement of the parties and their conduct in executing its terms;
- the contributions, if any, which each party has made to the venture;
- the parties' control over income and capital and the right of each to make withdrawals;
- whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
- whether business was conducted in the joint names of the parties;
- whether the parties filed Federal partnership returns or otherwise represented to [the IRS] or to persons with whom they dealt that they were joint venturers;
- whether separate books of account were maintained for the venture; and
- whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Some very entrepreneurial taxpayers have been treated as employees and not as owners when they:

- Received salary plus 50% of the profits.[94]
- Developed a new product line, not only thinking of the idea but also reducing it to practical application and sales to the general public, receiving a percentage of sales.[95]

The above tests all assume that the service provider is an employee. In a corporate setting, a shareholder who works in the business has two different capacities: an owner and an employee. The author is aware of only one situation in which the IRS combined the two concepts, and that was a clearly abusive situation.[96] The discussion further above about S corporations compensating employees with stock options provide insight about when, for income tax purposes, an option constitutes equity in the corporation. Absent guidance in a Code § 2701 setting, the author suggests relying on the income tax principles, possibly requesting a private letter ruling in appropriate situations.

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[93] *Luna*, 42 TC 1077-78 (1964). Although this case dealt with an insurance agent, it has been cited in many other situations.

[94] *Friednash v. Commissioner*, 209 F2d 601 (9th Cir 1954); *Duley*, TC Memo 1981-246.

[95] *Luna*, 42 TC 1067 (1964). This is one of many cases in which insurance agents unsuccessfully attempted to treat as the sale of a capital asset payments commuting their future commissions or similar contract rights.

[96] In TAM 9352001, son-in-law was given an employment contract that paid him cash of at least three or four times the market value of his services, for a management position for which he was not qualified, as well as issuing him a control block of voting stock as part of his compensation. The IRS ruled that the stock was cumulative preferred stock, with the excess compensation constituting the preference.

Contrast that with a partnership setting: For income tax purposes, all partner compensation is considered in conjunction with the partner's equity interest. Although Code § 707(a) provides that a partner may be considered as dealing with a partnership other than in his/her capacity as a partner, under Code § 707(c) fixed payments to a partner for services constitute guaranteed payments. Such payments are reported on the Schedule K-1 that the partnership issues to the partner; issuing Form W-2 that applies to employees violates the regulations governing FICA. Whether a particular compensation arrangement is a guaranteed payment or a distributive share of profits is a fluid concept.[97]

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[97] Reg. § 1.707-1(c) provides:

> Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of §1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:
>
> *Example (1).* Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).
>
> *Example (2).* Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.
>
> *Example (3).* Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.
>
> *Example (4).* Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's

Generally, a payment based on gross income constitutes a guaranteed payment (such as a fixed percentage of gross rent), whereas a payment based on net income constitutes a distributive share (such as rental income net of all allocable expenses).[98] The author suggests the following guidelines for partnerships:

- If the service provider has a clearly-defined equity interest in the partnership, any additional compensation constituting a guaranteed payment will be reported on the service provider's Schedule K-1.[99] If the IRS audits an applicable family member's estate tax return and obtains partnership income tax returns, an agent is likely to argue that the service provider's guaranteed payments are part of the service provider's total equity interest and might argue that a testamentary or prior transfer of equity to the service provider should have been valued considering this additional compensation. One should carefully consider the extent to which the service provider has the <u>right</u> as a partner to make these payments to himself/herself.

- Contrast this to a corporate setting, where these incentive payments are reported on Forms W-2. The IRS' main inquiry is likely to be whether the incentive payments constituted reasonable compensation. Although the IRS might argue that the payments were part of the service provider's rights as a shareholder, in most corporate settings the shareholder would need to elect a director to protect his/her interest, and then prove that the director would have conspired with the other directors to order the corporation's president to pay such compensation.[100]

D. <u>Code § 2703 Overview</u>

Before discussing Code § 2703, one must understand the overlay provided by Reg. § 20.2031-2(h):

> **(h) Securities subject to an option or contract to purchase.** Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his

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30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

[98] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶13.03: "Partners Acting in Their Capacities as Partners: Section 707(c) Guaranteed Payments," discusses that the Tax Court held that a management fee equal to 3% of gross rents constituted a distributive share rather than a guaranteed payment. The treatise states that the IRS disagreed with the Tax Court's ruling, both citing the Revenue Ruling and providing details in footnote 144:

> Rev. Rul. 81-300, 1981-2 CB 143. The legislative history of the Deficit Reduction Act of 1984, however, states that the transaction described in Rev. Rul. 81-300 should be governed by § 707(a), not § 707(c) . Moreover, it seems that § 707(a) treatment is dictated by the fact that the services rendered (real estate management) are traditionally compensated by fees that are a percentage of gross income, thus triggering § 707(a)(2)(A). 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S. Prt. No. 169, at 229, 230 (Comm. Print 1984). See supra ¶ 13.02[4].

[99] See footnote 97.

[100] Many states have statutory close corporation provisions allowing a corporation to abolish such formalities. Furthermore, a shareholders' agreement can purport to lock-in such arrangements; however, the general rule is that no agreement can legally bind future directors to a particular course of action.

> death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at §25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement.[101]

For purposes of gift, estate and GST tax, Code § 2703(a) provides that the value of any property shall be determined without regard to:

> (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use such property.

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the parent is deemed to make a taxable transfer to the extent that the equity interest's value exceeds the payment under that agreement. These rules extend to all sorts of arrangements:[102]

> A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

However, Code § 2703(b) provides that the above rules shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

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[101] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, TC Memo 2004-116, *aff'd* 428 F.3d 1338 (11th Cir. 2005).

[102] Reg. § 25.2703-1(a)(3).

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles:[103]

> A right or restriction is considered to meet each of the three requirements … if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of [Reg.] § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to [Reg.] § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles:[104]

(i) In general. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

(ii) Evidence of general business practice. Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test in *Estate of Amlie*:[105]

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[103] Reg. § 25.2703-1(b)(3).
[104] Reg. § 25.2703-1(b)(4).
[105] TC Memo 2006-76.

> For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

E. Code § 2704 Overview

In a family-controlled business, Code § 2704(a) treats as a transfer the lapse of any voting or liquidation right in a corporation or partnership. Code § 2704(b) disregards restrictions on liquidation that are not commercially reasonable and are more restrictive than state law defaults.

In the context of an affirmative transfer of an equity interest, regulations do not apply these rules regarding liquidation restrictions to the ability to liquidate one's equity interest.[106] Thus, Code § 2704 generally will not be significant in most cases involving incentive compensation or the transfer of an equity interest.

If the entity is not family-controlled (using a combination of Code § 2701 and 2704 principles), then Code § 2704 does not apply.

IV. Code § 409A Implications of Structuring Closely-Held Businesses

Enacted by the American Jobs Creation Act of 2004, Code § 409A imprints a new layer of rules that supplements existing rules (constructive receipt, Code § 83, Code § 457(f), etc.) on taxing compensation.[107] It punishes service providers (employees and independent contractors) who receive deferred compensation without complying with its terms. The service provider must pay a penalty of 20% of the deferred compensation when it is includible in gross income. At the same time, the service provider must also pay interest to the IRS on the deferred tax, measured from the taxable year that is the later of when compensation was earned or when it was not subject to a substantial risk of forfeiture. Permissible triggering events for payments under Code § 409A include separation from service, disability, death, a specified time or fixed schedule, a change in control of the service recipient, or an unforeseeable emergency.[108] These materials are not intended to provide a thorough knowledge of Code § 409A. The discussion below focuses on satisfying exceptions to Code § 409A with respect to equity and substitutes for equity.

As described above, the issuance of a profits interest is, from an income tax perspective, an excellent way to transition a closely-held business to the next owners. However, profits interests have Code § 2701 consequences for family-controlled businesses, so the transferor either

[106] *Kerr*, 292 F.3d 490 (5th Cir. 2002); *compare* Reg. § 25.2704-2(b) (for a transferred interest, an "applicable restriction" is a limitation on the ability to liquidate the entity") *with* Reg. § 25.2704-1(a)(2)(v) (for a lapse, liquidation right means fight to compel the entity to redeem the interest).

[107] Although the statute became effective January 1, 2005, existing plans do not need to be modified until December 31, 2008. Notice 2007-86. However, all plans should comply as soon as possible.

[108] The regulations and various IRS pronouncements provide very detailed rules on how to apply these concepts. The author always works with employee benefits practitioners in his firm who know these rules better than he does.

prepares to be treated as making a gift of the capital account that would ordinarily be associated with the profits interest or retains preferred payments that help reduce the impact of Code § 2701. Until further guidance is issued, Code § 409A does not apply to profits interests.[109]

Performance bonuses that are due March 15 after a calendar year-end can have excellent motivational effects and comply with all of the various rules discussed in these materials. The main obstacle to overcome is to make sure that, when the performance bonus is added to other compensation, the service provider's total compensation must be reasonable. Performance bonuses based on profits should not constitute an equity interest under Code § 2701 if the service provider does not have any other equity interest, the service provider is not identified to the IRS or third parties as being an owner, and the service provider does not share in any losses. Finally, because the date is fixed no later than 2.5 months after yearend, paying compensation after that fixed date would not cause the payment to violate Code § 409A if the payment is made during the calendar year including the fixed date.[110]

Further above, we discussed that a fixed payment upon attaining a particular age would satisfy Code § 409A without causing Code § 2701 or other income or estate tax problems, coupling that with a disability and death benefits.[111] Suppose, for example, that $100,000 payments begin when the parent attains age 65, and the parent currently makes $150,000 per year. If the parent is not ready to retire at age 65, then:

- The parent receives the $100,000 deferred compensation each year, even though the parent has not retired.

- ***Before*** the beginning of any calendar year with respect to which the parent would earn $150,000 for working, the parent elects to defer the compensation the parent would have received. For example, the parent might elect to take $50,000 of what the parent earns currently (for a total of $150,000, including the deferred compensation) and postpone payment of the remaining $100,000 to a later date. Another alternative might be for the parent's annual compensation to be cut back to $50,000 per year, keeping the parent's total package at $150,000 ($100,000 deferred compensation plus $50,000 current earnings). These alternatives provide nice flexibility, with the parent deciding each year how to treat what he or she will earn the following year.

Change in the entity's control is an event that can trigger payment of deferred compensation without the harsh consequences of Code § 409A.[112] Generally, such a change in control in a corporation occurs when any one person, or more than one person acting as a group, acquires

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[109] Notice 2005-1, Q&A-7. This continues to apply under section III.G of the Preamble to the final regulations.
[110] Reg. §§ 1.409A-1(b)(4)(i), 1.409A-3(b), (d).
[111] See text accompanying footnotes 82-88.
[112] In order to cover earn-out provisions where the acquirer in a change of control contracts to make an immediate payment at the closing of the transaction with additional amounts payable at a later date, delayed payments may meet the requirements for a payment at a specified time or pursuant to a fixed schedule if they are paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to the change in control event to the extent paid not later than five years after the change in control event. Reg. § 1.409A-3(i)(5)(iv)(A).

ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the stock of such corporation.[113] Similar rules apply to partnerships.[114] Using principles that apply to other forms of performance-based compensation, Code § 2701 should not apply to compensation awarded upon change of control.

Finally, options to acquire equity do not constitute an equity interest in a corporate setting and, if the service provider is not a partner, do not constitute an equity interest in a partnership interest.[115] Thus, they should not be subject to Code § 2701. However, they are subject to Code § 2703 in a family-controlled business, so they must be binding during life and after death and must satisfy the comparability test. The rest of these materials focus on the requirements to exclude stock options from Code § 409A; satisfying these tests is likely to bring a taxpayer into compliance (or least close to compliance) under the Code § 2703(b) comparability test under the *Amlie* case.[116]

The Treasury and IRS have not issued guidance on options to acquire partnership interests, other than to provide that such options are subject to rules similar to those governing corporate stock options.[117] If the stock option's exercise price is never less than the underlying stock's fair market value on the date the option is granted, then generally the stock option does not constitute deferred compensation.[118] Thus, the key to a successful stock option is determining the value on the date that the option is granted.

For stock options issued on or after January 1, 2005 and before the effective date of final regulations, taxpayers have two ways to determine fair market value:[119]

- <u>Notice 2005-1, Q&A-4(d)(ii)</u> provides that for purposes of determining the value of the underlying stock upon the grant of a nonstatutory stock option, "any reasonable valuation method may be used." This includes estate tax valuation under Reg. § 20.2031-2. Taxpayers may rely on Notice 2005-1 for stock rights issued on or after January 1, 2005 but before January 1, 2008.[120]

- <u>Prop Reg. § 1.409A-1(b)(5)(iv)(B)</u> provides additional details in response to commentators' assertions that the above Notice is too vague. Taxpayers may rely on

[113] Reg. § 1.409A-3(i)(5)(v)(A). This applies to a change in the ownership of the corporation, a change in effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation. Reg. § 1.409A-3(i)(5)(i).
[114] Third paragraph of Part VI.E. to the Preamble to the Prop. Regs., allowing taxpayers to rely on similar rules until further guidance is issued for a partnership setting. This continues to apply under section III.G of the Preamble to the final regulations.
[115] A partner's option to acquire a partnership interest might or might not constitute an equity interest. See text accompanying footnotes 97-100.
[116] The *Amlie* case is described in the text accompanying footnote 105.
[117] Notice 2005-1, Q&A-7. This continues to be the case under section III.G. of the preamble to the final regulations.
[118] Reg. § 1.409A-1(b)(5)(i)(A).
[119] Notice 2006-4.
[120] Section XII.C. of the Preamble to the final regulations.

either the proposed regulations or the final regulations for stock rights issued any date before January 1, 2008. [121]

- Reg. § 1.409A-1(b)(5)(iv)(B) provides:

(B) Stock not readily tradable on an established securities market.

(1) In general. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of anticipated future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), recent arm's length transactions involving the sale or transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders, or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

(2) Presumption of reasonableness. For purposes of this paragraph (b)(5)(iv)(B), the use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

[121] Section XII.C. of the Preamble to the final regulations.

(i) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option).

(ii) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in §1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to §1.83-5, provided that such stock is valued in the same manner for purposes of any nonlapse restriction applicable to the transfer of any shares of such class of stock (or any substantially similar class of stock) to the issuer or any person that owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the issuer (applying the stock attribution rules of §1.424-1(d)), other than an arm's length transaction involving the sale of all or substantially all of the outstanding stock of the issuer, and such valuation method is used consistently for all such purposes, and provided further that this paragraph (b)(5)(iv)(B)(2)(ii) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(iii) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(1) of this section, of illiquid stock of a start-up corporation. For this purpose, illiquid stock of a start-up corporation means service recipient stock of a corporation that has no material trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put, call, or other right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in §1.83-3(i)), and provided that this paragraph (b)(5)(iv)(B)(2)(iii) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in §1.409A-3(i)(5)(v) or §1.409A-3(i)(5)(vii) within the 90 days following the action to which the valuation is applied, or make a public offering of securities within the 180 days following the action to which the valuation is applied. For purposes of this paragraph (b)(5)(iv)(B)(2)(iii), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons that the corporation reasonably determines is qualified to perform such a valuation based on the person's or persons' significant knowledge, experience, education, or training. Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

(3) Use of alternative methods. For purposes of this paragraph (b)(5), a different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered. For example, one valuation method may be used to establish the exercise price of a stock option, and a different valuation method may be used to determine the value at the date of the repurchase of stock pursuant to a put or call right. However, once an exercise price or amount to be paid has been established, the exercise price or amount to be paid may not be changed through the retroactive use of another valuation method. In addition, notwithstanding the foregoing, where after the date of grant, but before the date of exercise or transfer, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes of determining the payment at the date of exercise or the purchase of the stock, as applicable.

A form of compensation similar to stock options is a stock appreciation right (SAR). A SAR is like a stock option, except that the employee never buys the stock. In many cases involving stock options, an employee borrows to exercise the stock option, repays the exercise price by selling the shares, and then keeps the remaining stock. A SAR gives the employee the same cash the employee would have received if the employee had borrowed to exercise the option, sold all of the stock immediately, and repaid the loan, without making the employee go through all of those steps and without the employee ever owning any of the underlying stock. If properly structured, a SAR would receive Code § 409A treatment similar to an option.[122] A SAR is likely have few, if any, Chapter 14 implications because the employee never receives any equity in the company.

Finally, awards of restricted stock could work well. Code § 409A does not apply merely because property is not includable income in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture under Code § 83 or is includable in income solely due to a valid election under Code § 83(b).[123] The service provider should receive

[122] Reg. § 1.409A-1(b)(5)(i)(B).

[123] Reg. §§ 1.409A-1(b)(6)(i), 1.83-3(b). If an important goal is to convert nonvested restricted stock to deductible compensation upon the transfer of an interest in the business to the holder, a Section 83(b) election should not be made.

actual shares of stock subject to forfeiture; a promise to transfer stock in the future may be subject to Code § 409A,[124] although it could be excluded from Code § 409A for other reasons. However, the IRS takes the position that a gift of a stock option is an incomplete gift until exercise of the option is no longer conditioned on the performance of services by the transferor;[125] presumably, this attitude would also apply to restricted stock. The author disagrees with the IRS' position regarding incomplete gifts but cautions planners to consider whatever litigation risks the IRS' position might entail when making transfers of property conditioned on the performance of services by the transferor.

[124] Reg. § 1.409A-1(b)(6)(ii).
[125] Rev. Rul. 98-21, reversing the IRS' prior private letter ruling position.