

IRS Examinations of Restaurants

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Introduction

- Restaurants can be full service food operations, where one is seated and orders from a wait person, paying at the end of the meal, with an average check of \$15 and above.
- Restaurants can be limited service food operations, such as fast food or casual dining, where one orders, pays for, and picks up their own food and may clear their own table, with an average check of less than \$10.

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Introduction

- One fact that is consistent is that all restaurants have numerous sales transactions with small dollar amounts, taking place in a short time frame, such as during lunch or dinner.
- Many restaurants, especially smaller or closely held ones, are cash intensive and employees and/or owners handle large volumes of cash transactions every day.

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What Does an Auditor Focus On?

- Internal controls
- Unreported income by the restaurant,
- Cost of sales, and
- Unreported tip income by the employees.

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Indirect Methods of Proof

The Markup Method

- The Markup Method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination in order to make the actual determination of tax liability.
- It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's gross receipts.
- By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit, or even net profit.
- By using some known base and the typical applicable percentage, individual items of income or expenses may be determined.
- These percentages can be obtained from analysis of Bureau of Labor Statistics data or industry publications. If known, use of the taxpayer's actual markup is required.
- This method is most effective when applied to businesses whose inventory is regulated or purchases can be readily broken down in groups with the same percentage of markup.

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Unit and Volume Method

- In many instances gross receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer.
- The number of units or volume of business done by the taxpayer might be determined from the taxpayer's books as the records under examination may be adequate as to cost of goods sold or expenses.
- In other cases, the determination of units or volume handled may come from third party sources.

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When to Use the Unit and Volume Method

- The Unit and Volume Method is recommended for making the actual determination of tax liability when:
 - The examiner can determine the number of units handled by the taxpayer and also know the price charged per unit.
 - The business has only a few types of products which are sold or there is little variation in the types of services performed, and the charges made by the taxpayer (sales price) for merchandise or services are relatively the same throughout the tax period.

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Bar Income

- As in any income tax examination, the auditing techniques used depend on the quality and quantity of the taxpayer's books and records. If the taxpayer is a large bar that maintains inventory records which detail the daily and/or monthly purchases and sales of liquor, then the liquor cost percentage can be computed and applied to total purchases to determine the gross receipts and gross profit of the taxpayer.
- If the taxpayer is a small "Mom and Pop" bar that does not maintain detailed purchase and sale records, it may be difficult and time consuming to compute the purchases for one day or one month. In this case, it may be preferable to rely (at least in part) on third-party information to verify purchases and compute the mark-up on cost.
- The mark-up may then be applied to total purchases of similar items to approximate the business gross receipts and gross profit .

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Liquor Cost Percentage to Compute Gross Receipts

- To compute gross receipts using the liquor cost percentage, the following steps should be taken:
 - Determine the cost of some of the more popular brands of liquor;
 - Determine the sales values of the bottle if all liquor out of these bottles were sold;
 - Divide the sales value into the cost to get the potential pouring cost.

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Example 1

Computing the liquor cost percentage:

- Determine the cost of liquor:
The taxpayer's records and verification from third-party sources indicate that the cost per quart is \$4.48.
- Determine the sales value of the bottle:
A quart has 32 ounces in it. If the taxpayer poured 1-1/4 ounces per drink, there would be 25.60 drinks per bottle. $(32 / 1.25 = 25.60)$

If the taxpayer sold the drinks for \$1.10, then the sales value per bottle less sales tax of \$1.97 would be \$26.19. $(25.60 \times \$1.10 = \$28.16 - \$1.97 = \$26.19)$

- Determine the pouring cost percent:

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Example 1, Cont.

Cost per bottle/Sales value = Pouring cost %

This gives you the potential pouring cost percent.

$$\frac{\text{Cost } \$4.48}{\text{Sales value } \$26.19} = 17.1\%$$

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Determine The Gross Sales

Purchases/Pouring cost % = Gross sales

If 17.1 percent is applied to total purchases of \$5,000, the gross receipts should be \$29,239.77 or $(\$5,000/17.1\% = \$29,239.77)$.

Gross Receipts (100%)	\$29,239.77
Less: Purchases (17.1%)	<u>(\$ 5,000.00)</u>
Gross Profit (82.9%)	\$24,239.77

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Using the Mark-up on Cost Method to compute the Gross Receipts

- If it is difficult to determine a taxpayer's daily and/or monthly purchases, the Mark-up on Cost Method may be used to compute gross receipts and gross profit. This method works closely with the liquor cost percentage method; however, different percentages are being determined.
- As with the cost percentage method, the cost and sales value of the various items needs to be computed. Then, the mark-up on cost can be computed. Mark-up on cost is the amount of the sales price over the cost of an item.

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Example 2

Simplified
Sales Price 10.00
Cost 5.00
Goss Profit 5.00

Mark-Up on Cost = Sales price/Cost

$\$10.00/\$5.00 = 200\%$

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Example 2, Cont.

- The following steps should be taken to compute gross receipts based on mark-up on cost:
 - Determine the mark-up of the various alcoholic items the taxpayer sells. The mark-up should be determined, if possible, in the initial interview. If the taxpayer does not know the mark-up of the bar items, you must compute it based on the sales price of drinks and the cost of the drinks.
 - Determine the purchases made by the taxpayer. You can obtain this information from the invoices provided by the taxpayer, if available and accurate. If accurate records are not available, you should request the names of all of the vendors from the taxpayer in the initial interview. Following third-party contact procedures, send letters to the vendors requesting all records of purchases made by the taxpayer in the years under examination or contact other available sources.
 - Apply the mark-up to the purchases of the various types of alcohol.

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Cost per drink = Bottle price / Number of drinks in bottle

- *Draft Beer*
- Draft beer is sold by the one quarter keg and one half keg. A one quarter keg contains 992 ounces of beer. A one half keg contains 1,984 ounces of beer. The beer distributors calculate that there are approximately 190 glass servings per one half keg and 93 servings from a one quarter keg. This calculation accounts for foam and spillage, which is common with draft beer.
- Sales price is based on the price of the beer as listed on the menu and confirmed during the initial interview. Divide the sales price by the size of the drink to get the sales price per ounce. It is important to determine the size of beers served, ounces in each glass, pitcher, etc.

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- *Bottled/ Canned Beer*
- Sales price of the bottled/canned beer is based on the price for the bottle according to the menu and the taxpayer's statements in the initial interview.
- Cost of the beer is an average cost of beers available for sale by the taxpayer. Bottles and cans are usually sold by 12-pack or case (24); therefore, divide the cost by 12 or 24.

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- *Wine*
- Sales price per glass is based on the price listed in the menu. Divide the sales price by the size of the glass to get sales price per ounce. It is important to determine in initial interview the ounces in each serving.
- Cost of the wine is an average cost of wine available for sale by the taxpayer. Wine can be sold by the bottle, box, or keg, therefore, take the cost of the unit divided by the number of ounces to get a cost per ounce.



Employee Tip Income Reconstruction Using Indirect Methods

- Employee tip income is income under IRC section 61 and Treas. Reg. section 1.61-2(a) (1) and can be reconstructed using indirect methods.
- The percentage markup method is one of the most often used methods to reconstruct unreported tips, although the cash expenditures method is also used.
- The McQuatters formula is also a common method to determine the tips as an hourly amount, a percentage of gross sales or receipts, or a percentage of the taxpayer's wages.



McQuarters Formula

- (1) total sales of food and beverages reduced by 10 percent to allow for low or no tips and tip-sharing;
- (2) this amount (that is, sales subject to tips) was divided by the total number of hours worked by all waitresses during the year to arrive at sales-per-waitress-per-hour average;
- (3) this average was multiplied by the number of hours in each year that Ms. McQuatters worked to determine her yearly sales; and
- (4) her yearly sales were multiplied by 12 percent to compute her yearly tip income.
 - The Tax Court reduced the tip income percentage from 12 to 10%.



Income from Coin-Operated Activities

- If the machines are leased, the general rule is that the income generated from the machines is split based on some percentage determined by the owner of the machine.

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Rebates From Supplies

- It is common practice in the restaurant industry for suppliers to enter into supplier arrangements with restaurants. Typically, these arrangements extend beyond the taxable year.
 - For example, suppose that Supplier A enters into an agreement with a restaurant chain to supply soft drink concentrate.
 - The contract states that the supplier will advance \$5,000,000 to the restaurant chain immediately and in return the restaurant agrees to purchase all of its soft drinks from Supplier A for the next 5 years.
- The Service's position is that upfront payments received under supplier agreements are income upon receipt.

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Cost of Goods Sold

- The use of statistical and ratio analyses is a useful pre-audit tool for an examiner.
- This can tell the examiner if the Cost of Goods Sold is overstated or out of balance in comparison with reported Gross Receipts.
- This could occur when the inventory amounts are 'estimated', when there is theft or personal use of inventory, or when gross receipts are under-reported.
- Statistical and ratio analyses are not tests of the reliability of reported income or expenses and cannot be substituted for an income probe audit step. Rather, the use of statistics and ratio analysis in pre-audit may indicate that additional audit steps are warranted.

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$$\frac{\text{Gross Sales} - \text{Cost of Goods Sold}}{\text{Gross Sales}} = \text{Gross Profit Percentage}$$

- This ratio shows how much of the sales represent gross profit.
- Compare the gross profit percentage (GPP) with the ratios of similar businesses. You can use BizStats.com or Restaurant.org for this information. The GPP should be consistent with industry standards and be sufficient to produce a net profit.
- Compare the GPP of the current year to the prior and subsequent years' GPP. The GPP should be consistent in a business from year to year. A low GPP may indicate a problem with inventory valuation.

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Example of GPP Calculation

Gross Sales	\$100,000	100%
Cost of Goods Sold	\$70,000	70%
Gross Profit	\$30,000	30%
$\frac{\$100,000 - \$70,000}{\$100,000} = 30\% \text{ GPP}$		

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$$\frac{\text{Cost of Goods Sold}}{(\text{Beg Inventory} + \text{End Inventory}) / 2} = \text{Inventory Turnover Rate}$$

- This ratio computes the number of times the inventory 'turned over' or was sold during the year. It is an indicator of a business's profitability because when inventory turnover decreases, sales and net profit decrease. Conversely, when inventory turnover increases, sales and profits increase. This is because the goal of all retailers is to sell the inventory at a profit and buy more.
- Compare the inventory turnover rate with the ratios of similar businesses. You can use BizStats.com or Restaurant.org for this information. The inventory turnover should be consistent with industry standards.

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Example of Inventory Turnover Rate

Beginning Inventory \$156,000
Ending Inventory 178,000
Cost of Goods Sold 700,000

$$\frac{\$700,000}{(\$156,000 + \$178,000) / 2} = 4.19 \text{ times during the year}$$

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Percentage of Increase or Decrease in Ending Inventory (for at least three years)

$$\frac{\text{End Inventory} - \text{Beg Inventory}}{\text{Beg Inventory}} = \% \text{ Change in Inventory}$$

- This ratio shows any significant variations from year to year. It can indicate an overstatement in Cost of Goods Sold.
- Compare the % change in ending inventory balances of the current year to the prior and subsequent years' amounts. Any significant increase or decrease in ending inventory should be questioned.

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Other Ratios

- Prime Cost % = Prime Cost (cost of food and beverage sold plus Labor cost)/Total Sales
- Food Cost % = Food Cost /Food Sales *
- Labor Cost % = Total Labor Cost/Total Sales
- Liquor Cost % = Liquor Cost/Liquor Sales
- Wine Cost % = Wine Cost/Wine Sales
- Beer Cost % = Beer Cost/Beer Sales
- General and Administrative % = General Administrative Cost/Total Sales
- Sales per Seat = Total Sales/Number of Restaurant Seats
- Sales per Square Foot = Total Sales/Restaurant Square Footage
- Sales per Labor Hour = Sales/Full Time Employees
- Inventory Turnover = Cost of Goods Sold/Average Inventory

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Ratio Patterns

- Ratio patterns can indicate unreported income and suggest a need for additional income probes. For example, an analysis of a restaurant return indicates that the restaurant has suffered losses for 3 consecutive years or longer and has a high ratio of cost of goods sold to sales. It is reasonable to question the source of the cash necessary for the restaurant to continue operating under these circumstances.
- Inspecting the cash flow statement may pinpoint potential sources and assist in preparing a Source and Application of Funds.

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Charitable Contributions of Food Inventory

- Congressional intent is to encourage charitable contributions of excess food that would otherwise go to waste.
- IRC Section 170(e) (3) allows an enhanced deduction for qualifying contributions of food inventory. This deduction is equal to the basis of the property contributed plus one half of the appreciation, not to exceed twice the basis. This amount would be treated as a contribution and cost of goods sold would be reduced by the basis of the property contributed.

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IRS Form 1099K

IRS Form 1099-K

- Starting in 2012, IRS requires credit-card companies and other third party payment processors to issue IRS Form 1099-K to vendors who receive gross payments that exceed \$20,000 and process more than 200 sales transactions.
- The form reports the gross amount for these transactions on a monthly basis.

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VOID CORRECTED

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		FILER'S federal identification no.	OMB No. 1545-2205	2017 Form 1099-K Payment Card and Third Party Network Transactions
		PAYEE'S taxpayer identification no.		
1a Gross amount of payment card/third party network transactions	1b Card Not Present transactions	2 Merchant category code	Copy 1 For State Tax Department	
\$	\$	\$		
Check to indicate if FILER is a (an): Payment settlement entity (PSE) <input type="checkbox"/> Electronic Payment Facilitator (EPF)/Other third party <input type="checkbox"/>	Check to indicate transactions reported are: Payment card <input type="checkbox"/> Third party network <input type="checkbox"/>	3 Number of payment transactions	4 Federal income tax withheld	
PAYEE'S name		5a January	5b February	
Street address (including apt. no.)		\$	\$	
		5c March	5d April	
City or town, state or province, country, and ZIP or foreign postal code		\$	\$	
		5e May	5f June	
PSE'S name and telephone number		\$	\$	
		5g July	5h August	
Account number (see instructions)		\$	\$	
		5i September	5j October	
Form 1099-K		\$	\$	
		5k November	5l December	
www.irs.gov/form1099k		\$	\$	
		6 State	7 State identification no.	8 State income tax withheld
Department of the Treasury - Internal Revenue Service		\$	\$	\$
		\$	\$	\$

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Income Verification Request

- In certain circumstances, the IRS will issue Letter 5035, 5039 or 5043 to request that the taxpayer verify its reported income.
- The taxpayer is given 30 days to complete Form 14420 "Verification of Reported Income."

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IRS Form 5039

Income Reporting Verification Notice

Why you are receiving this letter

In reviewing your tax return, we compared your reported gross receipts to the payments reported to us on Forms 1099-K, *Payment Card and Third Party Network Transactions*. This comparison showed an unusually high portion of gross receipts from card payments and other Form 1099-K reportable transactions. As a result, your gross receipts may be underreported.

Most similar businesses have between [redacted] % and [redacted] % of gross receipts from card payments and other Form 1099-K reportable transactions. Applying these percentages to the amount reported on your Forms 1099-K would result in gross receipts between [redacted] and [redacted]. Comparing this range to your reported gross receipts, we identified a difference of [redacted] to [redacted], which is potentially underreported. This amount may be attributable to unreported non-card sources, including cash and checks.

The following information is used in the calculation above:

- The amount of gross receipts you reported on your income tax return [redacted]
- The amount of payment card receipts reported to us on Forms 1099-K [redacted]

While there may be reasons the portion of gross receipts from card payments for your business is higher than that of most similar businesses, it is important to review your records to confirm that your gross receipts are fully reported.

What you need to do

- Review all information used in preparing your tax return to make sure you are fully reporting receipts from all sources, including payment card and non-card sources such as cash and checks.
- Complete the enclosed Form 14420, *Verification of Reported Income*. This form provides additional information to explain why the portion of your gross receipts from non-card payments appears unusually low for your type of business.
- Return the completed Form 14420, requested information, and a copy of this letter in the enclosed envelope within 30 days from the date of this letter. If you find any inaccuracies on your tax return, address them in your response. You may also choose to include an amended return with your response. Failure to furnish a complete and accurate response may result in further compliance action.

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Letter 5039 (Rev. 12-2014)
Catalog Number 58964V

IRS Form 14420 "Verification of Reported Income"

Form 14420 (October 2015)	Department of the Treasury - Internal Revenue Service Verification of Reported Income		OMB Number 1545-2236		
Taxpayer name		Taxpayer Identification Number	For tax period ending		
<p>Instructions: Complete this form and provide the requested information to explain why the portion of your gross receipts from non-card payments (e.g., cash or checks) appears to be lower than most similar businesses.</p> <p>Step 1 – Review the Form 1099-K information below for accuracy. You can get your Forms 1099-K from our website at www.irs.gov by searching the keywords, "Get transcript." Note: If more than five Forms 1099-K were filed, then line 5 shows the combined amounts of the remaining Forms 1099-K not listed in the table below.</p>					
Filer's Name	Filer's Federal ID Number	Gross amount from Form 1099-K (Box 1a)	Card not present transactions (Box 1b)	Merchant Category Code and industry (Box 2)	Number of payment transactions (Box 3)
1.		\$	\$		
2.		\$	\$		
3.		\$	\$		
4.		\$	\$		
5.		\$	\$		
<p>1a. Does the Form(s) 1099-K listed above belong to you? If no, identify which Form(s) 1099-K does not belong to you and provide an explanation with the correct information <input type="checkbox"/> Yes <input type="checkbox"/> No</p>					
<p>1b. Are the amounts correct on each Form 1099-K listed? If no, identify which Form(s) 1099-K does not show the correct amount and provide an explanation with the correct amount <input type="checkbox"/> Yes <input type="checkbox"/> No</p>					

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Income Verification – Example

- XYZ Corp receives Letter 5039-N which states:
 - Forms 1099-K issued to XYZ report \$106,316 of credit card sales.
 - According to the IRS, similar business have between 41% and 57% of receipts from credit card sales.
 - Consequently, the IRS asked XYZ to verify why its gross receipts should not be between \$157,040 and \$253,737.

Income Verification – Example

- IRS Statistical Analysis does not account for:
 - Credit Card payments for tips
 - Industries where the percentage use of credit cards has increased compared to the use of cash payments.

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Income Verification

- Failure to respond can result in a proposed assessment or a field audit.
- A taxpayer's response could result in the waiver of his Fifth Amendment rights against self-incrimination.

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Tax Procedure: IRS Methods of Obtaining Information From and About Taxpayers

SHARON L. MCCARTHY, ESQ.
KOSTELANETZ & FINK, LLP

Selected Provisions of Internal Revenue Manual (IRM)

- 4.10.2.10: Requesting Information: Overview
- 4.10.2.10.1: Determining the Type of Books and Records Available
- 4.10.2.10.2: Requesting Information or Documents from the Taxpayer
- 4.10.2.10.3: Authority to Request Books, Records, and Accountant's Workpapers
- 4.46.4.5: Information Document Request Process
- 4.46.4.5.1: General IDR Procedures
- 4.46.4.5.2: IDR Enforcement Process
- 4.23.4.5.3: Mandatory Requirements for Information Document Requests (IDRs)

Types of Income Tax Examinations

Correspondence examinations

- Generally conducted by Campus operations
- Conducted by mail and fax
- Tax Examiners and Tax Compliance Officers

Office examination

- Generally individual returns
- Limited number of issues
- Conducted in IRS offices
- Tax Compliance Officers

Types of Income Tax Examinations

Field examinations

- Conducted at place of business, home, representatives office, where books and records are kept
- All business returns, some individual returns
- Includes Large Business and International
- All types and sizes of issue
- Revenue Agents

Information Document Requests

Written request for Information and Documents from the IRS to the taxpayer in the audit.

IRS has expansive power to collect information and from taxpayers.

The IDR is not self-enforcing.

IRS can use summons authority to obtain the information and documents if the taxpayer does not comply with the IDR.

IRS Summons Authority

I.R.C. § 7602 authorizes the IRS to issue a summons to taxpayers and third parties to:

- Examine books and records;
- Obtain testimony from the taxpayer; and
- Obtain testimony from third parties who can provide information that may be relevant to determining a taxpayer's liability or ascertaining the correctness of a return.

IRS Summons Authority

Very Broad: **I.R.C. § 7602(a)** provides that a summons may be issued to:

- Ascertain the correctness of any return;
- Make a return where none has been made;
- Determine the liability of any person for any tax; or
- Collect any such liability.

The IRS also may issue a summons to inquire into any offense. **I.R.C. § 7602(b)**.

The IRS cannot issue a summons if a Department of Justice referral is in effect. **I.R.C. § 7602(d)**.

Reach of IRS Summons Authority

- Can reach foreign based taxpayers doing business in the United States. *United States v. Toyota Motor Corp.*, 561 F Supp 354 (C.D. Cal. 1983).
- Can be used in aid of determining or collecting another country's taxes. *United States v. A.L. Burbank & Co., Ltd.*, 525 F.2d 9 (2d Cir. 1975).

Improper Purpose Doctrine

“An abuse [of process] would take place if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute or for any other purpose reflecting on the good faith of the particular investigation.”

United States v. Powell, 379 U.S. 48, 58 (1964).

Service of Summons

The IRS may serve a summons by:

- Delivery in hand to the person; or
- By leaving the summons at the person's last place of abode.

The IRS may serve a summons on a third-party recordkeeper by registered or certified mail.

- Third-party recordkeepers include banks, consumer reporting agencies, any person extending credit through the use of credit cards, brokers, attorneys, accountants, barter exchanges, regulated investment companies, enrolled agents, and owners or developers of a computer software source code.
- **I.R.C. § 7603.**

Time and Place for Examination

I.R.C. § 7605 provides that the time and place for responding to a summons must be reasonable and may not be less than ten days after the summons was issued.

Failure to Obey Summons

“Any person who, being duly summoned to appear to testify, or to appear and produce books, accounts, records, memoranda, or other papers, as required under sections . . . 7602, 7603, and 7604(b), neglects to appear or to produce such books, accounts, records, memoranda, or other papers, shall, upon conviction thereof, be fined not more than \$1,000, or imprisoned not more than 1 year, or both, together with costs of prosecution.”

I.R.C. § 7210.

Summons Enforcement

A summons is not self-enforcing.

- The IRS may bring an action in district court compelling a taxpayer or third party to comply with a summons. **I.R.C. § 7604(b).**
- Note that a taxpayer recipient of a summons issued in connection with that taxpayer's own tax liability may not bring a petition to quash the summons because the United States government has not waived its sovereign immunity to allow such petitions. *Abraham v. United States*, 740 F.2d 2 (2d Cir. 1984).
- The IRS must bring suit to enforce the summons, and the individual taxpayer may raise his, her, or its arguments in that proceeding.

Summons Enforcement – The *Powell* Factors

Congress intended for the summons-enforcement proceedings to be “summary in nature.” The purpose of a summons is “not to accuse,” but only “to inquire.”

In order to enforce a contested summons, the IRS must demonstrate that:

1. “The investigation will be conducted pursuant to a legitimate purpose;”
2. “The inquiry may be relevant to the purpose;”
3. “The information sought is not already within the Commissioner’s possession;” and
4. “The administrative steps required by the [Internal Revenue] Code have been followed.”

This is not a difficult standard to meet and is usually achieved through an examiner’s affidavit. *United States v. Powell*, 379 U.S. 48, 57-58 (1964).

Summons Enforcement – Good Faith

- The government generally satisfies its initial burden of demonstrating that the summons was issued in good faith by filing an affidavit from the investigating agent attesting to the four “Powell factors.”
- The court may quash an IRS summons “on any appropriate ground”— including improper purpose.
- The party objecting to the summons, however, is not automatically entitled to an evidentiary hearing.
- The taxpayer has a right to conduct an examination of an IRS official regarding the purpose for issuing a summons if the taxpayer can “point to specific facts or circumstances plausibly raising an inference of bad faith.” *United States v. Clarke*, 573 U.S. 248 (2014).

Relevancy Standard

“As the language of § 7602 clearly indicates, an IRS summons is not to be judged by the relevance standards used in deciding whether to admit evidence in federal court. *Cf.* Fed. Rule Evid. 401. The language ‘may be’ reflects Congress’ express intention to allow the IRS to obtain items of even potential relevance to an ongoing investigation, without reference to its admissibility.”

United States v. Arthur Young & Co., 465 U.S. 805, 814 (1984).

Special Rules for Third Party Summons – Right to Notice of Third-Party Contacts

- **IRC § 7602(c)** provides that an IRS agent may not contact any person other than the taxpayer with respect to the determination of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with anyone other than the taxpayer may be made.
- The IRS shall periodically provide the taxpayer a record of persons contacted and shall provide such record on request to the taxpayer.
- The IRS may provide notice in advance that third parties may be contacted.

Notice of Third Party Contacts – Taxpayer First Act of 2019

(1) General notice. An officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer unless such contact occurs during a period (not greater than 1 year) which is specified in a notice which--

- (A) informs the taxpayer that contacts with persons other than the taxpayer are intended to be made during such period, and
- (B) except as otherwise provided by the Secretary, is provided to the taxpayer not later than 45 days before the beginning of such period.

“Nothing in the preceding sentence shall prevent the issuance of notices to the same taxpayer with respect to the same tax liability with periods specified therein that, in the aggregate, exceed 1 year. A notice shall not be issued under this paragraph unless there is an intent at the time such notice is issued to contact persons other than the taxpayer during the period specified in such notice. The preceding sentence shall not prevent the issuance of a notice if the requirement of such sentence is met on the basis of the assumption that the information sought to be obtained by such contact will not be obtained by other means before such contact.”

(2) Notice of specific contacts. The Secretary shall periodically provide to a taxpayer a record of persons contacted during such period by the Secretary with respect to the determination or collection of the tax liability of such taxpayer. Such record shall also be provided upon request of the taxpayer.

I.R.C. § 7602(c).

Notice of Third Party Contacts – Taxpayer First Act of 2019

- (c)(3) Exceptions.** This subsection shall not apply--
 - (A) to any contact which the taxpayer has authorized;
 - (B) if the Secretary determines for good cause shown that such notice would jeopardize collection of any tax or such notice may involve reprisal against any person; or
 - (C) with respect to any pending criminal investigation.

Right to Privacy During Third Party Contacts and Interviews

The taxpayer's right to privacy will be protected when contacting third parties for information.

- Information will be collected, to the greatest extent practicable, directly from the taxpayer to whom it relates.
- Third party contacts will be made when the taxpayer is unable to provide necessary information or when the examiner needs to verify information provided.
- Information about taxpayers collected from third parties will be verified to the extent practicable with the taxpayer before action is taken.

Internal Revenue Manual 4.10.3.3.1.4, 4.11.57.3

IRS employees may make investigative disclosures to the extent necessary in obtaining information, which is not otherwise reasonably available, with respect to the correct determination of tax, liability for tax, or the amount to be collected. **I.R.C. § 6103(k)(6).**

Right to Move to Quash Third-Party Summons

- Taxpayer may move to quash a summons issued to a third-party under **I.R.C. § 7609**.
- An action to quash must be brought within 20 days after notice of the summons is given to the identified party, and a copy of the moving party's petition must be sent both to the summoned party and to the Service by registered or certified mail. **I.R.C. § 7609(b)(2)(B).**

Potential Defenses to Enforcement of a Summons

- The summons was issued for an improper purpose.
- The summoned information is not relevant to the audit of the taxpayer.
- The IRS already has the information summoned.
- The IRS did not follow the necessary administrative steps for issuing and enforcing a summons.
- The documents sought do not exist.
- The summonsed party does not have possession, custody, or control of the documents or information sought.
- The summoned information is privileged.
- There is a Department of Justice referral in effect. **I.R.C. § 7602(d).**

Possession, Custody, or Control

- A legal or physical inability to produce the documents is a complete defense justifying noncompliance with an IRS summons.
- One must, however, make an exhaustive search for missing documents and must make sincere attempts to regain possession over documents taken by third parties. *United States v. Bryan*, 339 U.S. 323, 330-331 (1950); *United States v. O'Henry's Film Works*, 598 F.2d 313 (2d Cir. 1979).

Potential Privileges

- Attorney client privilege, including the *Kovel* privilege.
- Tax practitioner privilege under **I.R.C. § 7525**.
- Work product doctrine.
- 5th Amendment privilege.
- Spousal Privilege.

Attorney-Client Privilege

- Where legal advice of any kind is sought
- From a professional legal advisor in his capacity
- The communication relating to that purpose
- Made in confidence
- By the client
- Are at his instance permanently protected
- From disclosure by himself or by the legal advisor
- Except if the protection be waived

Waiver of Attorney-Client Privilege

- Express Waiver
 - Caused by intentionally (or inadvertently) revealing privileged communications to a third party.
- Implied Waiver
- Caused by putting otherwise-privileged topics into controversy –
 - Reliance on advice of counsel.
 - Reasonable cause and good faith (e.g., **I.R.C. § 6664(c)(1)**).
 - *AD Investment 2000 Fund LLC v. Comm’r*, 142 T.C. No. 13 (2014) (“by placing the partnerships’ legal knowledge and understanding into issue in an attempt to establish the partnerships’ reasonable legal beliefs in good faith arrived at (a good-faith and state-of-mind defense), petitioners forfeit the partnerships’ privilege protecting attorney-client communications relevant to the content and the formation of their legal knowledge, understanding, and beliefs”).

Attorney-Client Privilege: *Kovel*

- Extension of attorney-client privilege to an accountant (or other agent of the attorney).
- The key is that the “the presence of the accountant is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit.”
United States v. Kovel, 296 F.2d 918 (2d Cir. 1961).

Federally-Authorized Tax Practitioner Privilege

- **I.R.C. § 7525**: “[C]ommunication between a taxpayer and any federally authorized tax practitioner [is privileged] to the extent the communication would be ... privileged ... if it were between a taxpayer and an attorney.”
- Limited to noncriminal tax matters where the U.S. is a party (i.e., not recognized in state courts or non-tax controversies).
- Limited to tax advice.
- Does not apply to tax shelter advice.

Work Product Privilege

Fed. R. Civ. P. 26(b)(3)

(A) *Documents and Tangible Things*. Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:

- (i) they are otherwise discoverable under Rule 26(b)(1); and
- (ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.

(B) *Protection Against Disclosure*. If the court orders discovery of those materials, it must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation.

Work Product Privilege, Cont.

- Meaning of “in anticipation of litigation:”
 - “[D]ocuments should be deemed prepared ‘in anticipation of litigation,’ . . . if ‘in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared *because of the prospect of litigation.*”
 - “Where a document is created because of the prospect of litigation, analyzing the likely outcome of that litigation, it does not lose protection under this formulation merely because it is created in order to assist with a business decision.”

United States v. Adlman, 134 F.3d 1194, 1202 (2d Cir. 1998).

Fifth Amendment Privilege

“No person shall be compelled in any criminal case to be a witness against himself.”

U.S. Const., Amend. V.

- Privilege can be invoked in civil and criminal proceedings (but can give rise to adverse inference in civil case).
- A communication is incriminating under the Fifth Amendment not only when it directly yields evidence to support a criminal conviction, but when it “includes information which would furnish a link in the chain of evidence that could lead to prosecution, as well as evidence which an individual reasonably believes could be used against him in a criminal prosecution.” *Maness v. Meyers*, 419 U.S. 449 (1975).

Spousal Privileges

- **Marital Communications Privilege**
 - Information privately disclosed between husband and wife in the confidence of the marital relationship.
 - Either spouse may invoke (witness or non-witness spouse).
 - Applies even after the marriage has dissolved.
 - Applies in all kinds of proceedings.
- **Spousal Testimonial Privilege**
 - Applies to any adverse testimony, not just confidential communications.
 - Limited to criminal cases.
 - Applies only during the marriage.
 - Only the witness-spouse can invoke.

John Doe Summons

The government must obtain a court order (*ex parte*) after establishing that:

1. The summons relates to the investigation of a particular person or ascertainable group or class of persons;
2. There is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law; and
3. The information sought to be obtained from the examination of the records or testimony (and the identity of the person or persons with respect to whose liability the summons is issued) is not readily available from other sources.

This procedure is *ex parte* and based “solely on the petition and supporting affidavits” of the government.

I.R.C. § 7609(f).

John Doe Summons, Cont.

The Taxpayer First Act provides a new requirement in **I.R.C. § 7609(f)**:

- “The Secretary shall not issue any summons described in the preceding sentence unless the information sought to be obtained is narrowly tailored to information that pertains to the failure (or potential failure) of the person or group or class of persons referred to in paragraph (2) to comply with one or more provisions of the internal revenue law which have been identified for purposes of such paragraph.”

Dual Purpose Summons

- The IRS does not have to use the John Doe summons procedure when it serves a summons on a particular taxpayer with the “dual purpose” of investigating that taxpayer’s tax liability and unidentified parties’ tax liabilities.
- A dual-purpose summons does not constitute a John Doe summons and the IRS does not have to comply with Code Sec. 7609(f) “as long as all the information sought is relevant to a legitimate investigation of the summoned taxpayer.” The IRS, however, cannot issue a summons to a specific taxpayer as a pretext for avoiding the John Doe summons requirements.

Tiffany Fine Arts v. United States, 469 U.S. 310 (1985).

Challenging John Doe Summons

- The government’s application for judicial authorization to issue a John Doe summons is made *ex parte*, and the summoned party cannot intervene in the proceeding or move to quash a John Doe summons.
- The remedy for a party who has been served with a John Doe summons is to raise any challenges after the government has brought an action against that party for enforcement of the John Doe Summons. However, in that enforcement proceeding, the summoned party cannot challenge the summons on the ground that the government failed to comply with the requirements of I.R.C. § 7609(f).
- Rather, the summoned party is limited to challenging the summons based on either the government’s failure to comply with the *Powell* requirements, bad faith, or abuse of process.

See, e.g., *United States v. Coinbase, Inc.*, 2017 WL 5890052 (N.D. Cal. 2017).

John Doe Summonses – Statute of Limitations

- The statute of limitations on civil assessment of tax and criminal prosecution for tax offenses for the person whose tax liability is at issue is suspended if the summoned party does not timely comply with the John Doe summons. **I.R.C. § 7609(e)(2)** provides as follows:
 - “In the absence of the resolution of the summoned party’s response to the summons, the running of any period of limitations under section 6501 or under section 6531 with respect to any person with respect to whose liability the summons is issued (other than a person taking action as provided in subsection (b)) shall be suspended for the period — (A) beginning on the date which is 6 months after the service of such summons, and (B) ending with the final resolution of such response.”

Formal Document Requests ("FDR's")

During an exam, if foreign-based documentation requested by an IDR is not sufficiently provided, the IRS can issue an FDR.

If the FDR is not substantially complied with and the taxpayer did not have reasonable cause for failure to comply, the taxpayer shall be prohibited from introducing into evidence foreign-based documentation relevant to the tax treatment of the examined item at issue.

I.R.C. § 982.

Other IRS Methods of Gathering Offshore Information

- DHS Treasury Enforcement and Communication System ("T.E.C.S."), provides revenue officers with the following tools:
 - the ability to access taxpayer information from multiple law enforcement agencies.
 - a method for revenue officers to communicate messages to federal and state law enforcement.
 - the ability to research a taxpayer's historical travel information. *See* I.R.M. Sec. 5.1.18.14.7.
 - access to various treasury filings (e.g., FinCEN Form 104 (currency transaction reports) and Form TD F 90-22.47 (suspicious activity reports). *See* I.R.M. Sec. 9.4.2.4.2.
- See generally* I.R.M. Sec. 5.1.18.

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Other IRS Methods of Gathering Offshore Information

IRS/DOJ DATA MINING

- OVDP submissions
- FATCA reports
- Data obtained through the DOJ amnesty program for Swiss banks
- Whistleblowers

FinCEN and tax return information

- FBARs filed by taxpayers that identify foreign accounts
- Other information returns regarding foreign assets (e.g., IRS Form 5471 (foreign corporations), IRS Form 3520 (foreign trusts), IRS Form 8938 (foreign-based assets))

Treaty and Tax Information Exchange Agreement ("TIEA") requests. *See* I.R.M. Sec. 5.21.2.5.

- Revenue Officers may request information from foreign tax authorities through the U.S. Competent Authority Office (the Tax Attaché).

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Other IRS Methods of Gathering Offshore Information, Cont.

Questioning at the border

- Once a Revenue Officer enters taxpayer information into T.E.C.S. the taxpayer is placed on the DHS lookout indicator list
- Applies to citizen and non-citizen taxpayers
- Customs officials can question taxpayers at the border about their tax liability, their assets, the purpose/duration of travel, etc.

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Circular 230 Requirements for Practitioners – Information to Be Furnished to the IRS - 31 C.F.R. 10.20(a)

1. A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.
2. Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information. The practitioner must make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons.

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Circular 230 Requirements for Practitioners – Information to Be Furnished to the IRS - 31 C.F.R. 10.20(a), Cont.

3. When a proper and lawful request is made by a duly authorized officer or employee of the Internal Revenue Service, concerning an inquiry into an alleged violation of the regulations in this part, a practitioner must provide any information the practitioner has concerning the alleged violation and testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

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Circular 230 Requirements for Practitioners – Interference with a proper and lawful request for records or information - 31 C.F.R. 10.20(b)

- A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

Grand Jury Subpoena

If a grand jury subpoena is issued, the Department of Justice is involved and the IRS has referred the matter for prosecution.

The government often includes language requesting that the recipient of the grand jury subpoena not disclose the subpoena to anyone because it may “impede an on-going investigation.”

Absent a court order, the government may not instruct the recipient of a grand jury subpoena not to disclose the existence of the subpoena to a third party:

- *In re Grand Jury Proceedings*, 814 F.2d 61 (1st Cir. 1987) (letter from the U.S. Attorney’s office informing witness that disclosure of the existence of grand jury subpoena could impede criminal investigation improperly imposed a perceived obligation of secrecy in violation of Rule 6(e)(2)).
- *US v. Gigliotti*, 15 Cr. 204, slip op. (E.D.N.Y. Dec. 23, 2015) (government conceded it was improper to include instruction on grand jury subpoena that witness is “hereby directed not to disclose the existence of this subpoena, as it may impede an ongoing investigation”).
- *US v. Kilpatrick*, 575 F. Supp 325, 332 (D. Colo. 1983) (prosecutor committed prosecutorial misconduct by instructing witnesses that they were obligated to keep testimony secret).

Thank you

Break!



IRS REPRESENTATION
Conference

6th Annual NE IRS Representation Conference 88

IRS REPRESENTATION
Conference

November 21 & 22, 2019

The IRS and Insolvency Issues

Moderator: Noelle Geiger, Esq., Green & Sklarz LLC, New York, NY
Panelists: Barry A. Fischman, CPA, Marcum, LLP, New Haven, CT
William H. Kea, Jr., Director, Specialty Collection – Insolvency;
Acting Director, Field Collection Operations, IRS, Atlanta, GA
Jeffrey M. Sklarz, Esq., Green & Sklarz LLC, New Haven, CT



Small Business/Self-Employed Division

Bankruptcy and the IRS

Hank Kea
Director, Specialty Collection – Insolvency

- Insolvency is responsible for **administering** both the tax and bankruptcy law for **collecting** tax debts through the bankruptcy court
- Complying with both sets of law requires **coordination**

- **Field Insolvency (FI):**
 - Consists of four territories throughout the country
- **Centralized Insolvency Operation (CIO):**
 - Located in the Philadelphia Campus

- Mailing address for providing IRS notice of all bankruptcy filings
- Correspondence from debtors and trustees should be mailed to:

Internal Revenue Service
P.O. Box 7346
Philadelphia, PA 19101-7346

- **Prepares and files** all proofs of claim
- **Works** all chapters of bankruptcy – except for some Chapter 7 No Asset cases
- **Reviews** bankruptcy documents, as appropriate
- **Refers** cases to the U.S. Attorney, Department of Justice (DOJ) or Area Counsel, as necessary

- **Appears** in court as expert witnesses
- **Attends** first meeting of creditors, as necessary
- **Makes** collection determinations
- **Negotiates** with debtors or their representatives
- **Works** all complex issues CIO identifies

- **Handles** incoming telephone calls via a toll-free line:
 - External **800-973-0424**
(for debtors and their representatives)
- **Loads** all cases to the Automated Insolvency System (AIS)

- **Performs** actions on Chapter 7 No Asset cases
- **Monitors** Chapter 13 cases
- **Receives** all Chapter 7 and Chapter 13 payments
- **Initiates** closing actions on Chapter 7 and Chapter 13 cases

Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA)

- All tax returns must be filed
- File prior four years of pre-petition returns
- Unfiled returns can:
 - Prevent confirmation
 - Result in dismissal or conversion
- File all post-petition returns

Department of the Treasury
Internal Revenue Service
[IRS.gov](https://www.irs.gov)

Cancellation of Debt (COD) Issues

- Calculating COD
- COD in and out of bankruptcy
- Real world examples

Cancellation of Debt Income

- Gross Income includes income from COD
- COD is a taxable event.
- COD income is eligible for exclusion under I.R.C. § 108, subject to possible tax attribution reduction.
- COD income exclusions include (i) discharge but still insolvent after the discharge and (ii) discharge in bankruptcy.

Cancellation of Debt Income

Debt Relief from Sale or Exchange.

- AB (adjusted basis) includes debt, so the person who pays by borrowing is on an equal footing with the person who pays in cash
- AR (amount realized) includes debt relief.
- Debt relief from sale or exchange does not qualify for the I.R.C. § 108 exclusions.

Cancellation of Debt Income

Sale of property with recourse debt.

Treas. Reg. § 1.1001-2(c), Example 8.

- Step 1. Compute sale or exchange gain, which generally is FMV of property less AB.
- Step 2. Compute COD income, which is generally amount of debt less FMV of property.

Cancellation of Debt Income

Recourse Debt Example: Debt = \$100; FMV = \$70; AB = \$80.

Step 1. \$70 AR (FMV of property)

(\$80) AB

(\$10) Sale or exchange loss; exclusion rules of § 108 do not apply

Step 2. Difference between discharged debt of \$100 and FMV of \$70 is \$30, which is COD income and eligible for § 108 exclusions

Cancellation of Debt Income

Sale of property with nonrecourse debt.

- Treas. Reg. § 1.1001-2(c), Example 7; and Tufts v. Comm., 461 U.S. 300 (1983)
- AR includes full amount of debt, even if FMV of property is less than amount of debt.
- All gain on disposition is sale or exchange gain/loss, and, the exclusions of § 108 do not apply.

Cancellation of Debt Income

Nonrecourse Debt Example: Debt = \$100; FMV = \$70; AB = \$80.

\$100 AR (amount of debt on property)

(\$ 80) AB

\$20 Sale or exchange gain; exclusion rules of § 108 do not apply

Its sale and exchange income!

War Story 1: Bankrupt Partnership and Solvent Owners

- Chompers LLC files for bankruptcy
- Under Chompers' proposed plan of reorganization, it will shed \$10x of secured debt, which was personally guaranteed by Bob Chompers (the owners of Chompers LLC, who everyone calls "BC") and \$100x of unsecured trade debt, which was not guaranteed.
- BC owns a home worth \$50x and his only debt is the PG on the \$10x credit line.

War Story 2: Getting the Deal Done

- Ted and Tammy Taxpayer have to file bankruptcy because the \$100x credit line they guaranteed on their friend's business defaulted
- Ted and Tammy also owe \$50x in non-dischargeable tax debt, \$30x of which is subject to a properly perfected NFTL on all of their assets
- Ted and Tammy own
 - Commercial real estate valued at \$30x, subject to a \$25x mortgage
 - An IRA with \$50x in it
 - Misc. exempt assets worth \$5x

THE TAX FALLOUT OF BUSINESS BREAKUPS

<i>Moderator</i>	<i>Panelist</i>	<i>Panelist</i>	<i>Panelist</i>	<i>Panelist</i>
SHELBY L. WILSON, ESQ.	ANTHONY F. VITIELLO, ESQ.	ROBERT M. FINKEL, ESQ.	BARRY FISCHMAN, CPA	JEFFREY M. SKLARZ, ESQ.
GREEN & SKLARZ LLC	CONNELL FOLEY LLP	MORITT HOCK & HAMROFF LLP	MARCUM LLP	GREEN & SKLARZ LLC

IRS REPRESENTATION CONFERENCE | NOVEMBER 22, 2019 | MOHEGAN SUN CASINO & RESORT

OVERVIEW

- BUSINESS DIVORCE ISSUES
- BASIC LLC ISSUES
- TAX IMPLICATIONS OF VARIOUS BREAK-UPS
- REAL WORLD APPLICATION
- QUESTIONS AND OVERFLOW

NON-TAX CONSIDERATIONS

- **Is business capable of being divided?**
 - Desire of parties
 - Employees
 - Intellectual property
 - Equipment
 - Real estate
 - Lender consent
 - Customer notification
 - Non-compete
 - Confidentiality agreement

TAX ISSUES IN SPLITTING UP

- Tax Issues involved in the splitting up of a company revolve around two major factors:
 - Type of entity involved
 - Form of the transaction contemplated
- Tax consequences are significantly different for corporations and partnerships.

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REDEMPTION OF STOCK—SECTION 302

- General Rule under Section 302 – payments made for redemption of stock treated as a distribution under Section 301.
- Five Exceptions the General Rule:
 - Distribution not essentially equivalent to a dividend. § 302(b)(1)
 - Distribution is substantially disproportionate. § 302(b)(2)
 - Distribution completely terminates shareholder's interest. § 302(b)(3)
 - Distribution in partial liquidation. § 302(b)(4)
 - Distribution made post-death for payment of estate taxes and other administrative expenses. § 303

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REDEMPTION OF STOCK—SECTION 302

- Distribution is not essentially equivalent to a dividend. § 302(b)(1)
 - Point – whether the distribution results in a “meaningful reduction of the shareholder’s proportionate interests in the corporation”
 - Subjective standard, based on facts and circumstances of the case
 - Factors to be considered revolve around changes in the voting power of the shareholder – pro rata distributions typically will not fall under this exception
 - Davis v. United States, 397 U.S. 301, is the major precedent for this exception

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REDEMPTION OF STOCK—SECTION 302

- **Distribution is substantially disproportionate. § 302(b)(2)**
- **This is a mathematical test and is much less subjective.**
- **Test as follows:**
 - The shareholder owns less than 80% of the total voting stock of the corporation that he or she had owned before the redemption after the redemption is complete;
 - The shareholder owns less than 80% of the percentage of total value of the common stock that he or she had owned before the redemption;
 - The shareholder owns less than 50% of the total combined voting power of the shares; and
 - The redemption is not part of a series of planned redemptions

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REDEMPTION OF STOCK—SECTION 302

- **Distribution completely terminates shareholder's interest. § 302(b)(3)**
 - Main exception under Section 302, due to allowance of waiver of family attribution rules under Section 318
 - Requires complete termination of shareholder interest in the corporation
 - Regulations, rulings and cases focus on family attribution and on "continued interest" of shareholder in corporation, as officer, director, creditor, etc... IRS takes more expansive view on this issue than courts

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REDEMPTION OF STOCK—SECTION 302

- **Waiver of family attribution requires as follows:**
 - Immediately after the distribution, the shareholder has no interest in the corporation other than as a creditor;
 - The shareholder does not acquire any interest other than stock required by bequest or inheritance within ten years from the date of the distribution (i.e., "the look forward rule") and notifies the IRS if they do acquire any such interest during this period;
 - The shareholder has not transferred any stock or received any stock in ten years prior to the distribution from anyone from whom the stock would have been attributed to the shareholder (i.e., "the look back rule"); and
 - The shareholder elects to waive the attribution rules

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REDEMPTION OF STOCK—SECTION 302

- **Distribution in partial liquidation. § 302(b)(4)**
 - Little used exception under Section 302, due to complexity
 - Requires the following elements:
 - (A) the distribution is not essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level), and
 - (B) the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year

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REDEMPTION OF STOCK—SECTION 302

- **Distribution made post-death for payment of estate taxes and other administrative expenses. § 303**
 - Stock redeemed from a shareholders which has been inherited from a decedent entitled to sale or exchange treatment to the extent of estate's total amount of estate taxes and certain administrative expenses
 - To qualify, value of the stock has to constitute at least 35% of decedent's adjusted gross estate
 - Redemption transaction must occur within four years following date of decedent
 - Can be for part or all of the stock of the decedent

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REDEMPTION OF STOCK—SECTION 302

- **Why is it important to fit the transaction within one of the exceptions to Section 302?**
 - Where treated as a sale or exchange, less than the full amount of the payment is taxable – only the amount in excess of basis
 - Can cause problems with use of installment method under Section 6166 if redemption not characterized as a sale or exchange
 - Tax rates are constantly changing for dividends

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REDEMPTION OF STOCK—SECTION 302

- **S Corporations**

- Entity Purchase – calculations for an S corporation are different.
- [§ 1368](#) provides allocation formula
- Advantage for purchase by non-selling shareholders—basis. SH can receive tax free distributions and can deduct net corporate losses up to amount of basis [§§ 1368\(b\) and 1366\(d\)\(1\)](#)
- One class of stock requirement [Reg. 1.1361-1\(l\)\(2\)\(iii\)\(A\)](#)
- Closing the Books [Section 1377\(a\)\(2\)](#)

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REDEMPTION OF STOCK—SECTION 302

- **Funding with Life Insurance**

- Typical arrangement for a buy sell agreement for small businesses with few shareholders
- Can be used for entity redemptions or cross purchase arrangements
- Provides liquidity for purchase, and if structured correctly will be with tax free proceeds
- Cross purchase advantage – basis step up (which is very important for S Corporations)
- Possible AMT issues for C Corporations for redemptions [§ 56\(g\)](#)

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DISTRIBUTION OF PROPERTY FROM CORPORATIONS

- **Code Section 311(b)**

- Corporation will recognize gain on distribution of appreciated property measured by the excess of fair market value over basis
- If S corporation, gain will flow through to shareholders and will increase basis
- May be able to offset gain if S corporation is liquidated in the same year as the distribution of appreciated property
- Mismatch problem if distribution of appreciated property triggers recapture of previous deductions (ordinary income) since liquidation will generate capital loss
- If assets are used in the business and the taxpayer is actively involved, then taxpayer should not be subject to 3.8% Medicare tax

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DISTRIBUTION OF PROPERTY FROM CORPORATIONS

- **Code Section 311(b)**

- If C Corporation, corporate level gain is paid by corporation
- Distribution to shareholders will be a dividend under Code Section 301

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DISTRIBUTION OF PROPERTY FROM CORPORATIONS

- **Code Section 1239**

- Re-characterizes gain from the sale of depreciable or amortizable property between related parties as ordinary income
- A related party with respect to a person includes a “controlled entity” which includes any corporation in which the person owns more than 50% of the outstanding stock

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TAX-FREE CORPORATE DIVISIONS

- **Code Section 355** Allows for tax-free divisions of corporations. There are seven requirements for Section 355 to apply
- **Distribution is made to a shareholder with respect to the shareholder’s stock of the distributing corporation**
 - Spin-off
 - Split-off
 - Split-up
- **Distributing corporation must distribute stock of “controlled corporation” which controls immediately prior to distribution**
 - Must own at least 80% of voting stock and 80% of all other classes prior to distribution
 - If distributing corporation retains any stock in controlled corporation must demonstrate retention is not for tax avoidance purposes

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TAX-FREE CORPORATE DIVISIONS

- **Code Section 355**
- **Transaction cannot be principally as a device to distribute earnings and profits**
 - IRS will look at number of device and non-device factors post-distribution.
- **Active business test**
 - Active conduct of trade or business by distributing corporation or a controlled corporation
 - Active trade or business is defined as certain activities which excludes holding certain investment assets unless owner performs substantial personal services
 - Active business must have been conducted for 5 year period prior to distribution
 - Control of corporation engaged in active business cannot have been acquired in taxable transaction within 5 year period

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TAX-FREE CORPORATE DIVISIONS

- **Code Section 355**
- **Transaction must have a business purpose**
 - Must be a real and substantial non-federal tax purpose
 - Requirement stems from case law, specifically [Gregory v. Helvering, 293 U.S. 465 \(1935\)](#), and now contained in regulations.
 - As of 2003, IRS will not issue PLR's on business purposes
 - However, PLR's prior to 2003 are instructive
 - A shareholder purpose is not same as corporate purpose, but shareholder dispute may qualify
 - Dispute must involve shareholders actively involved in running of business
 - Disputes among passive shareholders will not qualify

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TAX-FREE CORPORATE DIVISIONS

- **Code Section 355**
- **Continuity of interest**
 - One or more shareholders of distributing corporation should own continuing interest in distributing corporation and controlled corporation after distribution
 - 50% should be enough [Reg. § 1.355-2\(c\)\(2\)](#)
- **Active trade or business which existed five years before the spin-off must exist after the spin-off**

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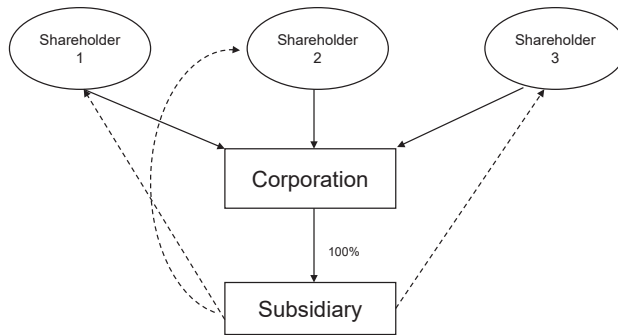
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SPIN-OFF

A spin-off usually involves the distributing corporation making a pro-rata distribution of the stock of an existing or newly-formed subsidiary to its shareholders



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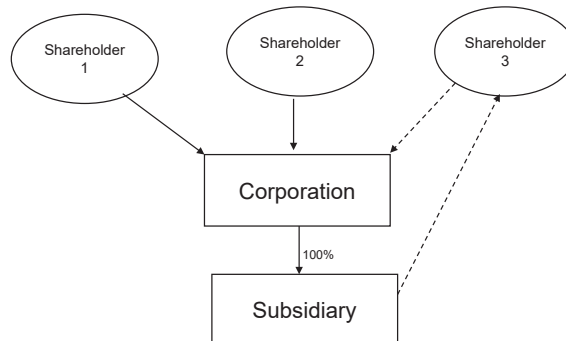
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SPLIT-OFF

A split-off usually involves the distributing corporation making a non-pro-rata distribution of the stock of an existing or newly-formed subsidiary to some of distributing corporation's shareholders in exchange for their stock



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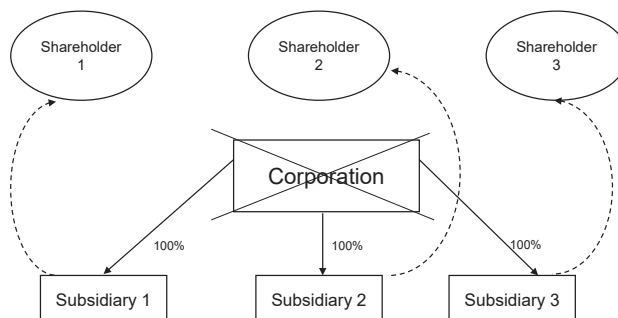
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SPLIT-UP

A split-up usually involves the distributing corporation making a non-pro-rata distribution of the stock of two or more existing or newly-formed subsidiaries to its shareholders in exchange for all of their stock in the distributing corporation



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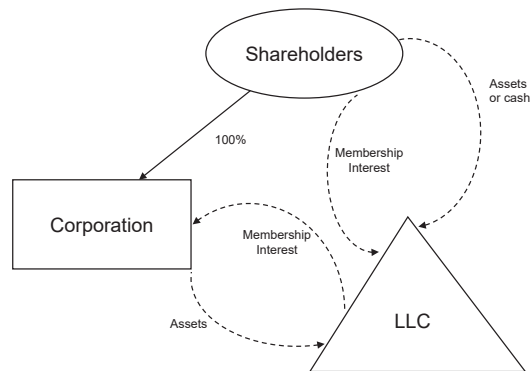
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PARTNERSHIP DROP DOWN

Corporation can contribute appreciated assets into an LLC in exchange for membership interest with shareholders of corporation or other parties contributing cash or other assets



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PARTNERSHIP DROP DOWN

■ Code Section 311(b) Issues

- Risk that IRS may argue corporation's receipt of LLC interest did not constitute full and adequate consideration for the appreciated property it contributed and, therefore, "disappearing value" constitutes a distribution to the shareholders
 - [Cox Enterprises](#)
- If corporation makes a distribution of its LLC membership interest to its shareholders and takes valuation discounts to reduce gain under Code Section 311(b), IRS will likely attempt to deny
 - [Pope & Talbot](#)

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DISTRIBUTIONS – GENERAL RULES

- Treatment to Distributee. [Section 731\(a\)](#)
- A distribution from a partnership to a partner is not taxable to the partner except to the extent that:
 - Section [704\(c\)\(1\)\(B\)](#) applies;
 - The amount of "money" distributed exceeds the partner's basis in the partnership; or
 - Section [737](#) applies

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DISTRIBUTIONS – GENERAL RULES

- **Nonliquidating Distributions. Section 732(a)**
 - **Basis of property received will be the lesser of:**
 - the partnership's basis in the property distributed or
 - the partner's basis in the partnership in his or her partnership interest, adjusted for any money distributed or deemed distribution under [Section 752](#)
- **Liquidating Distributions. Section 732(b)**
 - Basis of property received is equal to partner's basis in partnership less any money received

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DISTRIBUTIONS – GENERAL RULES

- **Partnership Basis Adjustment. Section 734(b)**
- **The partnership can adjust its basis in the assets remaining after a distribution of property to a partner if:**
 - the partnership makes an election under [Section 754](#) and
 - the distributee partner recognizes gain or loss on the distribution or
 - the distributee partner's basis of the property differs from the partnership's basis in the property

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DISTRIBUTIONS – SECTION 731(C)

- **Section 731(c)**
 - Marketable securities treated as money
 - Results in gain recognition if FMV of marketable securities distributed exceeds basis of distributee partner's partnership interest
 - Gain reduced by partner's share of the partnership's net appreciation in the property distributed
 - Does not require any other partner to recognize gain

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DISTRIBUTIONS OF MARKETABLE SECURITIES - EXCEPTIONS

- **Exceptions to § 731(c)**
 - Distributee partner previously contributed the marketable securities being distributed
 - Securities were non-marketable at time of acquisition (e.g. invest in company prior to it becoming publicly-traded)
 - Partnership is an “investment partnership”
 - Partnership has never engaged in a trade or business; and
 - Substantially all of the assets owned by the partnership are money and marketable securities and certain other assets
 - Pro rata distribution of appreciated marketable securities to the partners

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DISTRIBUTIONS – SECTION 704(C)(I)(B)

- Distribution of appreciated property (at the time of contribution to the partnership) to a non-contributing partner within seven years of contribution will trigger gain to contributing partner
- Counterpart to allocation of gain on sale of appreciated property to contributing partner
- Example – Father contributes real estate to partnership worth \$100 with cost basis of \$60 and three children each contribute \$100 in cash
- If real estate is distributed out to a child two years later in redemption of his partnership interest, then father recognizes \$40 of taxable income
- If real estate is distributed to father in redemption of his partnership interest, then no gain recognized because of exception for distribution to contributing partner

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DISTRIBUTIONS – SECTION 704(C)(I)(B)

- **Impact of Gifts of Partnership Interests**
 - For purposes of [Section 704\(c\)](#), donee steps into shoes of donor with respect to built-in gain
 - Example – Father contributes real estate to partnership worth \$100 with cost basis of \$60 and three children each contribute \$100 in cash, so father and each child owns a 25% partnership interest
 - If father gifts a 5% interest to each child, then father will own a 10% partnership interest and each child will own a 30% interest
 - If real estate is sold for \$100, then gain of \$40 (\$100 less \$60 basis) is allocated as follows:
 - Father...\$16
 - Child #1...\$ 8
 - Child #2...\$ 8
 - Child #3...\$ 8

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DISTRIBUTIONS – SECTION 737

- **General Rules**
- **Triggered by contribution of appreciated property, followed by distribution of other property, other than cash or marketable securities, to contributing partner within seven years of contribution**
- **Gain is the lesser of Net Pre-Contribution Gain or Excess Distribution.**
 - Net Pre-Contribution Gain is amount of gain which distributee partner would recognize if all appreciated property contributed by distributee partner within seven years of contribution was distributed to another partner.
 - Excess Distribution is excess of the fair market value of the property distributed to the distributee partner over the basis in his partnership interest.

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DISTRIBUTIONS – SECTION 737

- **Example – Father contributes real estate to partnership worth \$100 with cost basis of \$60 and three children each contribute \$100 of mineral royalties**
- **If \$100 of mineral royalties are distributed out the Father:**
 - Net Pre-Contribution Gain is \$40 (\$100 less \$60).
 - Excess Distribution is \$40 (\$100 less \$60).
 - If the value of the mineral royalties distributed to Father is \$130, then Excess Distribution is \$70 (\$130 less \$60).

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DISTRIBUTIONS – SECTION 737

- **Previously Contributed Property Exception**
- **If any of the appreciated property was contributed by the distributee partner, then such property is excluded from the computation of Net Pre-Contribution Gain and Excess Distribution**
- **Impact of Gifts of Partnership Interests**
 - For purposes of [Section 737](#), donee steps into shoes of donor with respect to Net Pre-Contribution Gain, unclear for previously contributed property exception

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DISTRIBUTIONS – SUMMARY

- **Ordering Rules**
 - [Section 704\(c\)\(1\)\(B\)](#)
 - [Section 731\(c\)](#)
 - [Section 737](#)
- **Practice Points**
 - If partner contributes appreciated property to a partnership, the pre-contribution gain will be taxed to that partner when the gain is recognized by the partner.
 - A donee “steps into the shoes” of the donor with respect to allocation of pre-contribution gain, with possible exception of [Section 737](#)
 - If appreciated property is distributed to someone other than the contributing partner (within seven years of contribution), then contributing partner will recognize taxable income on amount of pre-contribution gain
 - Exception for distribution of appreciated property back to contributing partner will be impacted by gifts of partnership interests

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REDEMPTION OF PARTNERSHIP INTEREST

- **Code Section 736**
 - Governs treatment of payments to retiring or deceased partner.
 - [Code Section 736\(a\)](#) payments are either treated as guaranteed payments (if fixed in amount) or as a distributive share of partnership income
 - Will produce ordinary income to recipient partner, but generate income tax deduction for remaining partners or deflect income from remaining partners to retiring partner
 - Fixed payments to a retiring partner are not subject to self-employment tax

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REDEMPTION OF PARTNERSHIP INTEREST

- **[Section 736\(b\)](#) payments are treated as distributions by the partnership in exchange for partnership property.**
 - Will produce mix of ordinary income and capital gain to recipient partner
 - Gain or loss is generally capital under [Code Section 741](#), except to extent of [Code Section 751](#) hot assets
 - Payments for unrealized receivables cannot be treated as [Code Section 736\(b\)](#) payments
 - The partnership agreement must specifically state that a payment is being made for goodwill under [Section 736\(b\)](#), or the payment will be reclassified as a [Code Section 736\(a\)](#) distribution
 - If partnership agreement is silent on the issue and a [Code Section 754](#) election is in place, then likely result is that payment will be a [Code Section 736\(b\)](#) distribution even if parties want [Code Section 736\(a\)](#) to apply

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REDEMPTION OF PARTNERSHIP INTEREST

- **Code Section 736 payments involve various income tax deferrals**
 - Retiring partner recovers basis before recognizing gain in contrast to installment sale in which each payment will likely have gain recognition
 - Retiring partner is not required to recognize interest of the deferred payments as is case with installment sale
 - Amortization of goodwill indirectly acquired begins with each separate annual gain recognized under Code Section 736 in contrast with a direct installment sale of goodwill, in which case all amortization of goodwill begins when the promissory note is delivered

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REDEMPTION OF PARTNERSHIP INTEREST

- **Impact to Partnership**
 - Allocation of Taxable Income. [Section 706](#) requires that transferring partner be allocated share of income or loss be allocated to transferring partner through the date of the sale (or death)
 - Pro-rata method. Allocate pro-rata share of income or losses for the year based upon number of days (default method)
 - Closing of the books. Can elect to close the books as of date of transfer to allocate income or loss for taxable
- **754 Election**
 - Can make an election under [Section 754](#) to adjust the income tax basis of the partnership assets up or down to reflect the gain or loss recognized by the transferring partner
 - Election is mandatory if the partnership has assets with a loss of at least \$250,000

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THANK YOU!

