Bloethe Tax School

Presented by the ISBA Tax Section

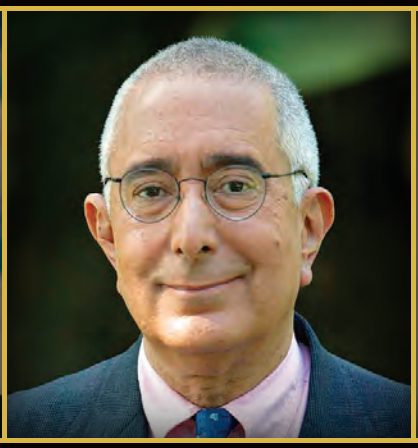
December 7-9, 2016
Downtown Des Moines Marriott
Des Moines, Iowa

10TH ANNUAL LAND INVESTMENT EXPO

Peoples Company's Land Investment Expo, the nation's premier agriculture real estate conference.

February 3, 2017 | Sheraton West Des Moines Hotel

ROBERT SAIK
CEO, Agri-Trend Group of Companies



BEN STEIN
Pop-Icon, Economist & Humorist

MARK TERCEK
CEO & President, The Nature Conservancy

STEVE EISMAN
Subject of Michael Lewis' book "The Big Short"

PEOPLES™ COMPANY
INNOVATIVE. REAL ESTATE. SOLUTIONS.

LandInvestmentExpo.com

SCHEDULE-WEDNESDAY, DECEMBER 7

8:00 – 12:45 - **Registration and Exhibit Hall Opens**
12:30 – 12:45 – **Opening Remarks and Welcome** – Speakers: Skip Kenyon, ISBA President and Tamara Borland, Bloethe Tax School Chair
12:45 – 1:00 – **ACA Special Provisions: Exemptions and Special Enrollments** – Speaker: Tamara Borland, Iowa Legal Aid
1:00 – 2:00 – **Iowa Department of Revenue (IDOR) Updates and Revisions to Form 100** – Speakers: Patty Fulton and Matt Bishop, Iowa Department of Revenue
2:00 – 3:30 – **Forms and Examples** – Speakers: James Goodman, Moore McKibben Goodman & Lorenz LLP and Maureen Kenney, Bradley & Riley See the Form Book
3:30 - 3:45 – **Break**
3:45 – 4:15 – **Income Averaging** – Speaker: Adam Ullrich, Reimer, Lohman, Reitz, Sailer & Ullrich
4:15 – 5:30 – **Like Kind Exchanges** – Speaker: David Brown, IPE 1031 See the Tax Manual
5:00 – 5:30 – **New Farmer Credits** – Speaker: Steve Ferguson, Iowa Agricultural Development Authority
5:30 – 7:00 – **Complimentary Reception Sponsored by the Dickinson Law Firm**

SCHEDULE-THURSDAY, DECEMBER 8

7:00 – 8:00 – **Registration and Exhibit Hall Opens**
8:00 – 10:15 – **Tax Manual** – Speakers: David Bibler, Buchanan Bibler Gabor & Meis; Lee Wilmarth, Anderson Wilmarth Van Der Maaten Belay & Fretheim and Dan Fretheim, Anderson Wilmarth Van Der Maaten Belay & Fretheim See the Tax Manual
10:15 – 10:30 – **Break** (sponsored by Peoples Company)
10:30 – 11:25 – **Succession Planning-Ethics** – Speaker: Jenna Lain, The Law Office of Jenna Lain, PLLC
11:25 – 12:15 – **Avoiding Pitfalls - Employee v. Independent Contractor, Choice of Entity** – Speakers: Daniel Fischer, Hall and Hudson P.C. and James Hinchliff, Finneseth Dalen & Powell, PLC
12:15 – 1:30 – **Lunch** (not provided with registration)
1:30 – 2:15 - **Iowa Department of Revenue and Audits** – Speakers: Alana Stamas and Theresa Dvorak, Iowa Department of Revenue Policy Division No outline provided
2:15 – 3:00 - **Healthcare Reform Implications for Small Businesses** – Speaker: Kristine Tidgren, Center for Agricultural Law and Taxation (CALT) See the Tax Manual
3:00 – 3:15 – **Break** (sponsored by Peoples Company)
3:15 – 4:15 - **Employee Benefits- Flexible Spending, High Deductible Insurance Plans and Health Savings Accounts** – Speaker: Dustin Petty, Base
4:15 – 5:00 - **Ethics: Cybersecurity and Cloud-based Databases** – Speaker: Todd Scott, Minnesota Lawyers Mutual Insurance Co.
5:00 – 6:30
Drake University Law School Happy Hour Hosted by Drake University Law School (Located in the Sioux City Room - 3rd Floor)

University of Iowa College of Law Happy Hour Hosted by the University of Iowa College of Law (Located in the Waterloo Room - 3rd Floor)

SCHEDULE-FRIDAY, DECEMBER 9

Track One

7:00 – 8:00 - **Registration and Exhibit Hall Opens**
8:00 – 9:00 - **Probate and Tax-Deceased Farmer Owner/Operator Issues** – Speaker: Alyssa Stewart See the Tax Manual
9:00 – 9:45 - **Charitable Trusts and Foundations** - Endow Iowa – Speaker: Sheila Kinman, Community Foundation of Greater Des Moines
9:45 – 10:00 – **Break**
10:00 – 11:00 - **2704 Discount Regulation Developments** – Speaker: Gary Streit, Shuttleworth & Ingersoll PLC
11:00 – 12:15 – **Blue Ribbon Panel** – Panelists: Kenton Vriezelaar, Vriezelaar Tigges Edgington Bottaro Boden & Ross LLP and Thomas Houser, Davis Brown Law Firm, Darrel Morf, Simmons Perrine Moyer Bergman PLC; and Brad Nelson, Norelius & Nelson PC No materials provided

Track Two

7:00 – 8:00 - **Registration and Exhibit Hall Opens**
8:00 – 8:45 – **S Corporation Set Ups and Pitfalls** – Speaker: Frank Carroll, Davis Brown Law Firm and Michael Gilmer, McEnroe Gotsdiner Brewer Steinbach & Rothman PC No Materials provided
8:45 – 9:45 – **C to S Corporations** – Speaker: David Bibler, Buchanan Bibler Gabor & Meis
9:45 - 10:00 – Break
10:00 – 10:50 – **Profit Interests in Partnerships** – Speaker: David Repp, Dickinson Mackaman Tyler & Hagen PC No materials provided at this time
10:50 – 11:40 – **Sales or Redemptions of Partnership Transactions** – Speaker: David Repp, Dickinson Mackaman Tyler & Hagen PC
11:40 – 12:30 – **New Audit Rules for Partnerships Post Tax Equity and Fiscal Responsibility Act** - Speaker: Joe Kristan, Roth & Company, P.C.

Caveat

The printed materials contained in this book and the oral presentations of the speakers are not intended to be a definitive analysis of the subjects discussed. The reader is cautioned that neither the program participants nor The Iowa State Bar Association intends that reliance be placed upon these materials in advising your clients without confirming independent research.

Bloethe Tax School

Presented by the ISBA Tax Section

WEDNESDAY, DECEMBER 7
Downtown Des Moines Marriott
Des Moines, Iowa

Bloethe Tax School

ACA Special Provisions: Exemptions and Special Enrollments

12:45 p.m.-1:00 p.m.

Presented by
Tamara Borland
Low-Income Taxpayer Clinic
Iowa Legal Aid
1700 S. 1st Avenue, Suite 10
Iowa City, IA 52240
Phone: 319-351-6570

WEDNESDAY, DECEMBER 7, 2016

AFFORDABLE CARE ACT

Premium Tax Credits

Exemptions

Shared Responsibility Payments

NEW PREMIUM TAX CREDIT (PTC)

Who Qualifies?

Households with Modified Adjusted Gross Income of up to 400% of Poverty

Who <u>are not</u>?

- Eligible for *affordable* workplace coverage or government coverage such as
  - Medicaid,
  - CHIP,
  - Medicare, or
  - Tricare
- Immigrants without documentation or authorization
- Incarcerated persons (after final disposition)
- Married persons using Married Filing Separately status

MARRIED FILING SEPARATELY EXCEPTION

TEMPORARY REGULATION §§1.36B-2T,2(A)-(B)1.

- Living separately from spouse at the time that a return is filed because the taxpayer is either:
  - Abandoned- TP has made reasonable attempts to locate other spouse and has been unable to, or
  - A Victim of Domestic Abuse- the definition includes:
    - Financial Control,
    - Psychological,
    - Physical, and
    - Sexual Abuse.
- Can only use this exception for three consecutive years
- If Head of Household filing status is available it must be used instead.

HOUSEHOLD INCOME AND MAGI FOR PTC

- Household =tax filer plus dependents
- Modified Adjusted Income=
  - US 1040 Line 37 plus
  - Any Social Security not included on Line 20b
  - Foreign Income
  - Tax-Exempt Interest

How Much is the Premium Tax Credit(PTC)

- Exchange identifies Second Lowest Cost Silver Plan (SLCSP) that covers the household.
- Family is expected to pay a set percentage of income towards premiums.
  - This is based upon % of poverty
- Family Selects the desired plan Platinum thru Bronze.
- Cap on PTC. The cost can not be greater than the actual premium cost.
  - Plan cost is < less than SLCSP minus the Expected Contribution (EC)

  The **plan cost** is the maximum APTC.
  - Plan cost is > greater than the SLCSP minus EC

  The result of SLCSP-EC is the maximum APTC.

Family Robinson

Expected Contribution is $3,000

SLCSP is $5,500

Maximum Premium Tax Credit is
$5,500-$3,000=$2,500

Assume the family takes the maximum Advanced Premium Tax Credit (APTC)

Possible Premium Cost For the Family

- Scenario 1: Family picks a Silver Plan with a total premium cost (without credit) for the year of $4,500.
  - APTC is $2,500 and is paid to insurer directly.
  - $4,500-$2,500= $2,000 or 166.66 a month paid in premiums by family to health insurer.
- Scenario 2: Family picks Gold Plan costing $6,000.
  - APTC is $2,500
  - Premium paid by family is $3,500 or $291.66 a month

A third Option

- Scenario 3: Family picks Bronze Plan costing $2,200.
  - APTC is $2,200.
  - $0 in premium paid by family per month.
  - Family will pay higher out of pocket costs.

Things to Keep in Mind

- Expected Contribution is less than the SLCSP for your area then your PTC is Zero.
  - John is at 316% of poverty with an income of $37,310. He is 26 years old and lives in Polk County.
  - His expected contribution to insurance is 9.5% or $3,544.
  - The SLCSP that will cover him is $2,196.
  - If John selects this plan, his cost for insurance will be $183 per month.
- Insurers can charge 50% more for premiums for smokers.
- The PTC calculation does not factor in that additional cost.

Debbie, Joe and Jeff

- Debbie and Joe are a married couple with one son.
- Debbie has Schedule C income of $34,000
- Joe has Social Security Disability income of $11,500
- The only adjustment to income is $2,400 in self-employment tax. Self-employed health insurance premiums can be deducted but assume the taxpayer does not use this adjustment.
- They have a son who is 21 years old and a junior in college as of January 1, 2015. He has $7,000 in net self-employment income.

Premium Tax Credit Calculations- 26 USC § 36B

- Total Household Income is $50,100
  - MAGI includes non-taxable Social Security Income and Dependent's income if Dependent has a filing obligation.
- % of Poverty= 249%
- Expected premium contribution: Approx. 8.02% or $4,018.
- Premium for Second Lowest Cost Plan for wife and child: Approx. $10,872.
- Total Premium Tax Credit: $6,854.

Levels of Plans

- Platinum- Highest premiums lowest out of pocket costs
- Gold
- Silver- Second lowest cost silver plan is used for calculation of premium tax credit
- Bronze- Lowest cost plan with higher out of pocket costs.

  Used in affordability determinations and

  Used in "shared responsibility" penalty calculations.

ADDITIONAL ASSISTANCE

Households at up to 250% of poverty

- Must enroll in a **Silver** plan to receive the additional assistance.
- Silver plans have
  - Higher premiums, but
  - Lower out of pocket costs such as deductibles, out of pocket maximums, fees for hospitalizations, and office visits.
- Additional Assistance covers between 73% and 94% of out of pocket expenses
  - The lower the percentage of poverty, the higher the coverage of expenses
  - Compare this with an average silver plan which covers approximately 70% of out of pocket costs.

2015 Poverty Guidelines

House-hold Size	100%	133%	150%	200%	250%	300%	400%
1	$11,880	$15,800	$17,820	$23,760	$29,700	$35,640	$47,520
2	$16,020	$21,307	$24,030	$32,040	$40,050	$48,060	$64,080
3	$20,160	$26,813	$30,240	$40,320	$50,400	$60,480	$80,640
4	$24,300	$32,319	$36,450	$ 48,600	$60,750	$72,900	$97,200

ADVANCED PREMIUM TAX CREDIT

- Taxpayers applying for insurance through the exchange will estimate income for 2015.
- Based upon this estimate, the exchange calculated maximum allowable advance premium tax credit, if eligible.
- Taxpayer could take all of it, a portion, or none in advance.
- Advance Premium Tax Credit was payable directly to the insurance company.

AVOIDING REPAYING THE APTC

- Taxpayers need to update the exchange regarding:
  - Changes in income
  - Changes in household composition
    - Marriages, Divorces, Deaths, Births and Adoptions
- If taxpayer receives too much APTC, the taxpayer will have to repay at least a portion
  - Cap on repayment for taxpayers below 400% of poverty.
  - A Couple filing jointly at 221% of poverty will be limited to a repayment of $1,500.

SHARED RESPONSIBILITY

Play or Pay

- Individuals
- Imposition of the penalty
  - Individuals- starts January 1, 2014
    - 2016 penalty paid with Tax Return filed in 2017
    - Determined on a month by month basis

INDIVIDUAL SHARED RESPONSIBILITY PAYMENT

Regulations:
26 CFR 1.5000A 1-5

A non-exempt individual must:

- Have minimum essential coverage or
- Pay a Individual Shared Responsibility payment (tax penalty)

EXEMPT INDIVIDUALS 1.5000A-3

The following charts are adapted from an IRS chart found at: https://www.irs.gov/affordable-care-act/individuals-and-families/aca-individual-shared-responsibility-provision-exemptions#Exemptions%20and%20Who%20Grants%20Them

NOTE: Exempt individuals may still have a requirement to provide MEC or pay the individual shared responsibility payment for someone they can claim as a dependent who is considered non-exempt.

Exemptions	May only be granted by Marketplace	May only be claimed on tax return
Coverage is considered unaffordable (Required Contribution is more than 8.13% of income).		**X**
Short coverage gap - You went without coverage for less than three consecutive months during the year.		**X**
Income below the return filing threshold		**X**
Citizens or resident alien living abroad (see IRS chart)		**X**
Not lawfully present in the U.S.and not a U.S. citizen, or U.S. national (for this purpose, an immigrant with Deferred Action for Childhood Arrivals (DACA) status is not considered lawfully present and therefore is eligible for this exemption.)		**X**
Members of a health care sharing ministry		**X**

Exemptions	May only be granted by Marketplace	May only be claimed on tax return
Members of Indian Tribes		**X**
Incarceration - You are in a jail, prison, or similar penal institution or correctional facility after the disposition of charges.*		**X**
Members of certain religious sects - You are a member of a religious sect in existence since December 31, 1950, that is recognized by the Social Security Administration (SSA) as conscientiously opposed to accepting any insurance benefits, including Medicare and Social Security.	**X**	
Coverage considered unaffordable based on projected income - You do not have access to coverage that is considered affordable based on your projected household income.	**X**	

Exemptions	May only be granted by Marketplace	May only be claimed on tax return
General hardship - You experienced circumstances that prevented you from obtaining coverage under a qualified health plan, including, but not limited to, homelessness, eviction, foreclosure, domestic violence, death of a close family member, and unpaid medical bills. Learn more about the criteria for this exemption.	X	
Aggregate self-only coverage considered unaffordable - Two or more family members' aggregate cost of self-only employer-sponsored coverage is more than a certain percentage (8.05 percent for 2015) of your actual household income, as does the cost of any available employer-sponsored coverage for the entire family.	X	

Exemptions	May only be granted by Marketplace	May only be claimed on tax return
Determined ineligible for Medicaid in a state that did not expand Medicaid coverage - You are determined ineligible for Medicaid solely because the State in which you live does not participate in Medicaid expansion under the Affordable Care Act.	X	
Resident of a state that did not expand Medicaid - Your household income is below 138 percent of the federal poverty line for your family size and at any time during the year you reside in		X
**** States that did not expand Medicaid for all of 2016:** Alabama, Florida, Georgia, Idaho, Kansas, Louisiana, Maine, Mississippi, Missouri, Nebraska, North Carolina, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Wisconsin, and Wyoming.		

Exemptions	May only be granted by Marketplace	May only be claimed on tax return
Unable to renew existing coverage You were notified that your health insurance policy was not renewable and you consider the other plans available unaffordable. This exemption is available only until October 16, 2016. See HHS guidance and HHS Question and Answer for more information.	X	
AmeriCorps coverage - You are engaged in service in the AmeriCorps State and National, VISTA, or NCCC programs and are covered by short-term duration coverage or self-funded coverage provided by these programs.	X	

Minimum Essential Coverage (MEC)

MEC includes:

- Certain Government Sponsored Coverage
- Eligible Employer Sponsored Plan
- A plan purchased in the individual marketplace
- A grandfathered in Health Plan

Coverage: One day of one month=coverage for the whole month

Non-Exempt Dependents Defined

- Taxpayer is entitled to claim under IRC 152
  - Whether you claim the dependent or not
- Qualifying Child or
- Qualifying Relative

Individual Shared Responsibility Payment

Lesser of

- The sum of monthly penalty amounts for each individual in the shared responsibility family or
- The sum of the monthly average bronze plan premiums for the share responsibility family.

Monthly Penalty Amounts

1/12 multiplied by
the **greater** of
Flat Dollar amount
or
Excess Income Amount

FLAT DOLLAR AMOUNT

Flat Dollar Amount is the **lesser** of

- The sum of the *Applicable* D*ollar* A*mount* for all members of the household subject to a shared responsibility payment , or
- 300 percent of the Applicable Dollar Amount

WHAT IS THE APPLICABLE DOLLAR AMOUNT?

- Applicable Dollar Amount
  - 2014: $95
  - 2015: $325
  - 2016:$695
  - After 2016 this amount is indexed.
- Applicable Dollar Amounts for persons who have not attained 18 before the first day of the month is one-half the amount listed above.

EXCESS INCOME AMOUNT

Household Income

Minus

Applicable Filing Threshold for Taxpayer's Filing Status

(Married Filing Jointly, Married Filing Separately, Head of Household, Single, Qualifying Widower)

Multiplied by the *Income Percentage*

Income Percentage

Taxable years beginning 2013: 1%

2014: 1%

2015: 2 %

Years after 2015: 2.5%

CALCULATING SHARED RESPONSIBILITY PAYMENT

We Need to Know

- Number of non-exempt taxpayers
- Number and age of non-exempt Dependents
- Number of months for each non-exempt member of the household without MEC
- Household Income
- Filing Threshold

These are used to calculate the

- Monthly Penalty amount

You will also need to know the

Average National Bronze Premium for the year

NON-EXEMPT DEPENDENT

Scotty

- Moves in with your client in December 2014 and moves out January 2016
- He doesn't work but helps cook and clean.
- Scotty turned 26 on May 31, 2015 and is no longer on his parent's health insurance.
- Scotty is client's qualifying relative for 2015.
- Your client earned $27,000 in 2015

CALCULATING THE FLAT DOLLAR AMOUNT

Flat Dollar Amount for Scotty
Lesser of
1/12 of $695 x 7 (months without coverage)
=
$407.35
Or
300% of the Flat Dollar Amount
(limits amount paid by families)

So lesser amount of the above two is **$407.35**

Excess Income

Filing Threshold 2016 for Taxpayer: $10,350
Penalty calculation for full year:
MAGI- Filing Threshold for Single Person=
Excess Income

$27,000-$10,350= $16,650 X 2.5% or $416.25

Total Monthly Penalty Amount

Compare
Flat Dollar Calculation ($407.35)
With
Excess Income Calculation ($416.25)
And
Select the larger of the two sums.

$416.25

PENALTY REPORTED ON 1040

Compare Monthly Penalty Total
$416.25
with
Cost of Average National Bronze Premium
($2,676- 1 person)
For uncovered months
$223 per month
Months without MEC=Seven (7)
$223 x 7= $1,561
Choose the Lesser Amount:
PENALTY REPORTED: **$416.25**

COLLECTION OF PENALTIES AND OVERPAYMENTS?

Shared Responsibility

Offset of refunds and certain administrative procedures

vs.

Advanced Premium Tax Credit

Subject to all regular collection procedures.

However…

Cap on recapture for those households below 400% of poverty.

CONTACT INFORMATION

Tamara Borland
LITC Clinic Director
Iowa Legal Aid
1700 S. 1st Avenue Suite 10
Iowa City IA 52240
319-351-6570

tborland@iowalaw.org

Bloethe Tax School

Iowa Department of Revenue (IDOR) Updates and Revisions to Form 100

1:00 p.m.-2:00 p.m.

Presented by
Patty Fulton
Iowa Department of Revenue
Hoover State Office Building - 4th Floor
1305 E. Walnut
Des Moines, IA 50319

Matt Bishop
Iowa Department of Revenue
Hoover State Office Building - 4th Floor
1305 E. Walnut
Des Moines, IA 50319

WEDNESDAY, DECEMBER 7, 2016

Bloethe Tax School – Iowa State Bar Association

Iowa Department of Revenue Presentation – December 7, 2016

- Legislative Update
  - Income Tax
  - Tax Credits & Incentives
  - Sales & Use Tax
  - Environmental Protection Charge (EPC)
- Other Information
  - Deduction & Credit Amounts
  - Income Tax Checkoffs
  - Interest Rate
  - eFiling Statistics
  - 2D Barcode
  - New W-2 & 1099 Reporting Requirements
  - File Schedule C?
  - Common Taxable Services – Sales Tax
- Iowa Capital Gain Deduction
  - IA 100 Stakeholder Group
  - IA 100 Form Changes
  - IA 100 Form Series (IA 100A through IA100F)
- Information Resources
  - Iowa Tax Research Library
  - Iowa Department of Revenue Website
  - Automatic E-mail Updates
  - Social Media

Iowa Department of REVENUE

Bloethe Tax School
Iowa State Bar Association

Patty Fulton

Matt Bishop

Iowa Department of REVENUE

2016 Legislative Update
Income Taxes

Internal Revenue Code (IRC) Coupling Bill

- House File 2433 updated references to January 1, 2016 for tax year 2015 ONLY
- Iowa remains decoupled from federal bonus depreciation

Facilitating Rapid Response to State-Declared & Presidential-Declared Disasters

- Out-of-state businesses and individuals performing disaster or emergency-related work in Iowa are not subject to Iowa income tax or withholding
- The disaster response period starts ten days before the state-declared or presidential-declared disaster and ends sixty days after the end of the declared state disaster or emergency
- Effective for tax years beginning on or after January 1, 2016

529 Plan Changes

- Tax-exempt, nonprofit organizations under IRC section 501(c)(3) were added to the list of entities that can open and contribute to an individual's Iowa College Savings 529 Plan on behalf of that individual

- An individual can take an itemized deduction for the contribution to the 501(c)(3) if the individual did not designate the contribution be used for the direct benefit of any dependent of the individual or the individual did not designate any single beneficiary

- Effective for tax years beginning on or after January 1, 2016

Iowa Department of REVENUE

2016 Legislative Update
Tax Credits & Incentives

Solar Energy System Tax Credit

- **2014 and 2015 Installations:** Applications received after May 1 following the year of the installation will be considered on a first-come, first-served basis for the next available year's allocation
- **2016 and After Installations:** Applications received after the May 1 deadline will be denied
- The application must be completed online and can be accessed on the Department's website

Renewable Energy Tax Credit

- Facilities placed in service before January 1, 2018 may now be eligible for the credit
- A solar facility qualifies for part of the 10 megawatts of generating capacity reserved for solar facilities as long as it is located within this state; has a generating capacity of 1 ½ megawatts or less (but not less than ¾ megawatts if all or part of the energy is for on-site consumption); is owned in whole or in part, directly or indirectly by one of the electric cooperatives described in the statute; and is placed in service between July 1, 2005 and January 1, 2018

Geothermal Tax Credit

- Iowa credit is currently 20% of the federal residential energy efficient property tax credit allowed for geothermal heat pumps in residential property located in Iowa – the federal credit is set to expire December 31, 2016
- If the federal credit is not extended, effective for tax year 2017, the Iowa credit will be 10 % of the taxpayer's qualified expenditures on equipment that uses the ground or groundwater as a thermal energy source to heat the taxpayer's dwelling, or as a thermal energy sink to cool the dwelling

Adoption Tax Credit

- The Iowa adoption tax credit is increased from $2,500 per adoption to $5,000 per adoption
- The credit is equal to the amount of qualified adoption expenses paid or incurred by the taxpayer during the tax year in connection with the adoption of a child
- Effective for tax years beginning on or after January 1, 2017

Iowa Adoption Tax Credit Form (IA 177)

Iowa Department of REVENUE

2016 IA 177
Iowa Adoption Tax Credit
https://tax.iowa.gov

Name(s)_____ SSN_____

Part I – Information about your eligible adopted child

1. Child's full name_____
2. Child's identifying number_____
3. Was the adopted child placed in Iowa?

   Yes ☐ ..... Continue to Part I, line 4
   No ☐ ..... Stop. You are not eligible to take this credit.
4. Year the adoption became final_____
5. Child's age at adoption_____
6. Name of other adoptive parent if not included on the IA 1040_____
7. Social Security Number of other adoptive parent_____

Iowa Adoption Tax Credit Form (IA 177)

Part II – Iowa Adoption Tax Credit Calculation

1. Adoption expenses paid or incurred during 2016 for this child. (If filing claims separately, see instructions) ..... 1. _____
2. Adoption expenses paid or incurred during 2016 for this child that were reimbursed by an employer or other entity ..... 2. _____
3. Qualified adoption expenses paid or incurred during 2016 for this child. Subtract line 2 from line 1 ..... 3. _____
4. Maximum Iowa Adoption Tax Credit 4. $2,500
5. Iowa Adoption Tax Credits claimed for the adoption of this child by the taxpayer in other tax years ..... 5. _____
6. Iowa Adoption Tax Credits claimed for the adoption of this child by other taxpayers in this or other tax years not included on line 5 ..... 6. _____
7. Other credits claimed. Add line 5 and line 6 ..... 7. _____
8. Subtract line 7 from line 4 ..... 8. _____
9. Iowa Adoption Tax Credit. Enter the smaller of line 3 or 8. Also enter in column K of Part II on the IA148 Tax Credit Schedule ..... 9. _____

IA 148 Tax Credits Schedule must be completed.

Renewable Chemical Production Tax Credit

- New refundable tax credit with an annual cap of $10 million
- Available to an eligible business that produces a renewable chemical in this state from biomass feedstock
- Applies to renewable chemicals produced in the state from biomass feedstock on or after January 1, 2017

Renewable Fuels Tax Credits

Expiration dates extended to January 1, 2021:

- E-15 Plus Gasoline Promotion Tax Credit
- E-85 Gasoline Promotion Tax Credit
- Biodiesel Blended Fuel Tax Credit
- Sales and use tax refund for biodiesel production

Ethanol Promotion Tax Credit is still scheduled to expire on January 1, 2021

Biodiesel Blended Fuel Tax Credit

Credit amount changes:

- Diesel fuel rated B-5 or higher, but less than B-11 receives a credit of 3.5 cents per gallon
- Diesel fuel rated B-11 or higher receives a credit of 5.5 cents per gallon
- Effective for tax years beginning on or after January 1, 2018

Iowa Department of REVENUE

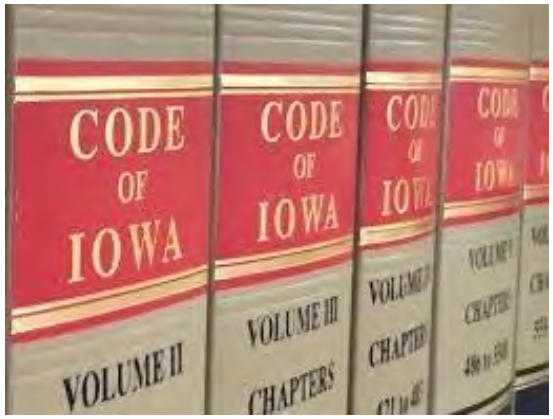
2016 Legislative Update
Sales & Use Tax

Machinery, Equipment, & Computers

- **Beginning July 1, 2016** the sales and use tax exemption for certain computers, machinery, equipment, and replacement parts is expanded
- House File 2433 expands the exemption to include supplies, and it provides definitions of replacement parts and supplies

Background Information

- **Prior to July 1, 2016**
  - Replacement parts were exempt
  - Supplies were taxable
  - “Replacement parts” and “supplies” were not defined in the statute



Exempt Replacement Parts & Supplies (Beginning July 1, 2016)

- "Computers, machinery, equipment, replacement parts, supplies, and materials used to construct or self-construct computers, machinery, equipment, replacement parts, and supplies" are exempt when used for an exempt purpose.

Replacement Parts (Prior to July 1, 2016)

- Prior to July 1, 2016:
  - Replacement parts were not defined in the statute.
  - Replacement parts were presumed to have a useful life of at least 12 months.

Definition of Exempt Replacement Parts (Beginning July 1, 2016)

- "Replacement part" means tangible personal property other than computers, machinery, equipment, or supplies, regardless of the cost or useful life of the tangible personal property, that meets all of the following conditions:
  - The item replaces a component of a computer, machinery, or equipment, which component is capable of being separated from the computer, machinery, or equipment
  - The item performs the same or similar function as the component it replaced
  - The item restores the computer, machinery, or equipment to an operational condition, or upgrades or improves the efficiency of the computer, machinery, or equipment

Definition of Exempt Supplies (Beginning July 1, 2016)

- "Supplies" means tangible personal property, other than computers, machinery, equipment, or replacement parts, that meets one of the following conditions:
  - The item is connected to a computer, machinery, or equipment and requires regular replacement because the property is consumed or deteriorates during use
  - The item is used in conjunction with a computer, machinery, or equipment and is specially designed for use in manufacturing specific products and may be used interchangeably and intermittently on a particular computer, machine, or piece of equipment
  - The item comes into physical contact with other tangible personal property used in processing and is used to assist with or maintain conditions necessary for processing
  - The item is directly and primarily used in an exempt activity

Exempt Supplies (Beginning July 1, 2016)

- Examples of exempt supplies:
  - Saw blades
  - Drill bits
  - Filters
  - Jigs
  - Dies
  - Tools (but not hand tools)
  - Cutting fluids
  - Oils
  - Coolants
  - Lubricants
  - Prototype materials
  - Testing materials

Exempt Replacement Parts & Supplies (Beginning July 1, 2016)

- Bottom line: Many, but not all, items used in manufacturing are exempt
- Exempt items must be used in an exempt activity (e.g., directly and primarily used in processing by a manufacturer)

Iowa Department of REVENUE

Exempt Replacement Parts & Supplies (Beginning July 1, 2016)

Publication on our website:

https://tax.iowa.gov/sites/files/idr/documents/HF2433publication.pdf

Iowa Department of REVENUE

2016 Legislative Update
Environmental Protection Charge

Environmental Protection Charge (EPC)

- The 1 cent per gallon EPC on fuel deposited into certain, primarily underground, storage tanks expires effective December 31, 2016
- Originally set to expire on June 30, 2016

Iowa Department of REVENUE

Other Information

Standard Deduction Amounts

2016:

- Filing status 1 - $1,970
- Filing status 3 or 4 - $1,970 for each spouse
- Filing status 2, 5, or 6 - $4,860

2017:

- Filing status 1 - $2,000
- Filing status 3 or 4 - $2,000 for each spouse
- Filing status 2, 5, or 6 - $4,920

College Savings Iowa 529 Plan

- $3,188 per beneficiary for 2016

Taxpayers Trust Fund Credit Amount

- $54 for 2013
- $15 for 2014
- $0 for 2015
- $0 for 2016

Individual Income Tax Checkoffs

Same four checkoffs for 2016, 2017, & 2018:

- Fish & Wildlife Fund (Chickadee Checkoff)
- Iowa State Fair Foundation (Corn Dog Checkoff)
- Joint Fire Fighter Preparedness Fund / Veterans Trust Fund
- Child Abuse Prevention

Interest Rate

- 0.4% per month during 2016
- 0.4% per month during 2017

eFiling Statistics for Current Processing Year

- 90% of individual income tax returns
- 70% of corporation income tax returns
- 22% of fiduciary tax returns

2D Barcode

- 46% of paper returns used 2D barcode
- The fillable IA 1040 on our website automatically creates a computer generated barcode on the return. The barcode allows the return to process faster than a handwritten paper return.
- Because the computer generates the barcode, all entries on the fillable IA 1040 must be made on the computer before the return is printed.
- **If you need to make changes to the return**, update the fillable form and reprint. All information you keyed into the form is reflected in the barcode.
- Handwritten information is not captured. Any information written on the return after it is printed will not be reflected in the barcode.

New W-2 & 1099 Reporting Requirements

W-2s, W-2Gs, & 1099s

- Beginning in 2017 for tax year 2016:
  - Withholding agents with 50 or more employees must electronically file W-2 forms with the Department by the last day of January following the tax year.
  - Withholding agents with less than 50 employees may, but are not required to, electronically file W-2 forms with the Department by January 31, 2017.
  - Withholding agents may, but are not required to, electronically file W-2G and 1099 forms with the Department by January 31, 2017.

- Beginning in 2018 for tax year 2017:
  - All are required to electronically file W-2, W-2G, and 1099 forms with the Department by the last day of January following the tax year.

Verified Summary of Payments Report (VSP)

- All withholding agents are required to submit a completed VSP by January 31.

New W-2 & 1099 Reporting Requirements

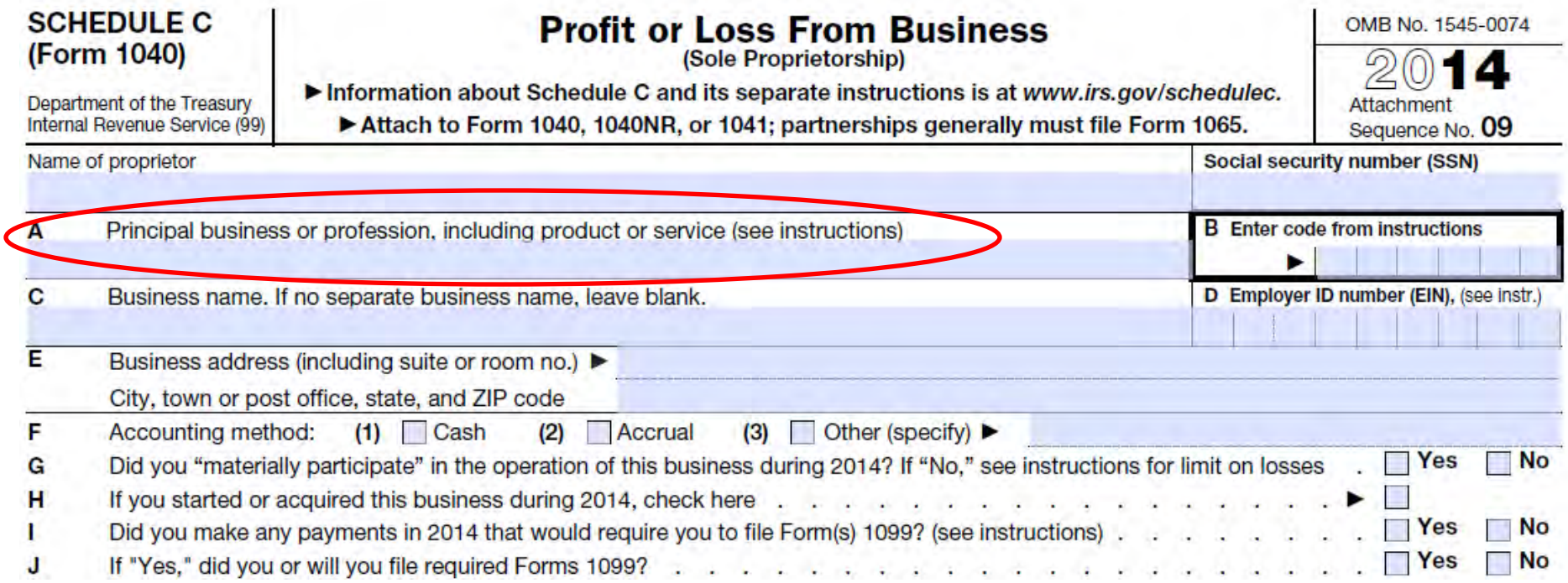
- Publication 44-082, Iowa Department of Revenue Electronic Reporting of Wage Statements and Information Returns is now available on the Department's website. This publication contains specifications and instructions for this electronic reporting.

- For immediate notification when more details are available, please subscribe to our GovDelivery e-mail distribution list for W-2/1099 filers. Here is the link to subscribe:
  - https://public.govdelivery.com/accounts/IACIO/subscriber/topics?qsp=IACIO_1

When subscribing, the *IDR_W2/1099 Filers* option will be found under the *Electronic Filing* heading.

Iowa Department of REVENUE

File Schedule C?



SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)

▶ Information about Schedule C and its separate instructions is at *www.irs.gov/schedulec.*
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2014

Attachment Sequence No. **09**

Name of proprietor

Social security number (SSN)

A Principal business or profession, including product or service (see instructions)

B Enter code from instructions ▶

C Business name. If no separate business name, leave blank.

D Employer ID number (EIN), (see instr.)

E Business address (including suite or room no.) ▶

City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2014? If "No," see instructions for limit on losses . ☐ Yes ☐ No

H If you started or acquired this business during 2014, check here . . . . . ▶ ☐

I Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) . . . . . ☐ Yes ☐ No

J If "Yes," did you or will you file required Forms 1099? . . . . . ☐ Yes ☐ No

Taxable Service?

Iowa Department of REVENUE

Common Taxable Services

- Appliance / Machine Repair
- Barber / Beauty / Cosmetology
- Carpentry
- Electrical Repair / Installation
- Janitorial / Cleaning / Building Maintenance
- Lawn Care / Landscaping / Tree Trimming & Removal
- Painting / Papering / Interior Decorating
- Pet Grooming
- Photography (sale of tangible personal property)
- Plumbing
- Vehicle Repair

Which Services are Taxable?

List of taxable services on our website:

https://tax.iowa.gov/iowa-sales-and-use-tax-taxable-services-0

Iowa Department of REVENUE

Iowa Capital Gain Deduction

Questions About Specific Scenarios

- The following slides will present information regarding updates to the IA 100 Capital Gain Deduction Form.
- The information presented here is general in nature and is not intended to address specific scenarios.
- We cannot discuss specific scenarios during this presentation.
- If you have questions about a specific scenario, please e-mail idr@iowa.gov

Iowa had under 2 million individual income taxpayers annually during this time

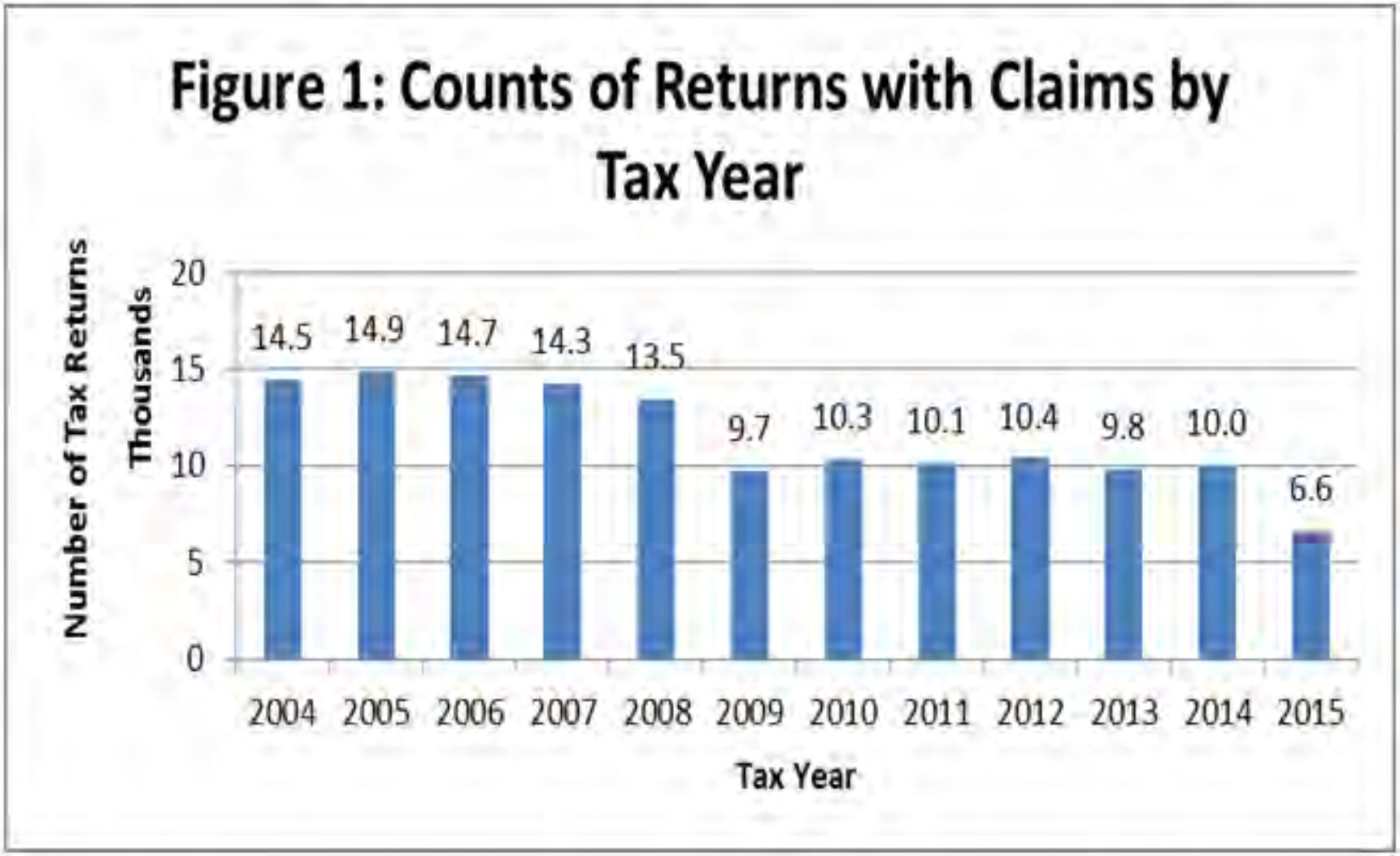
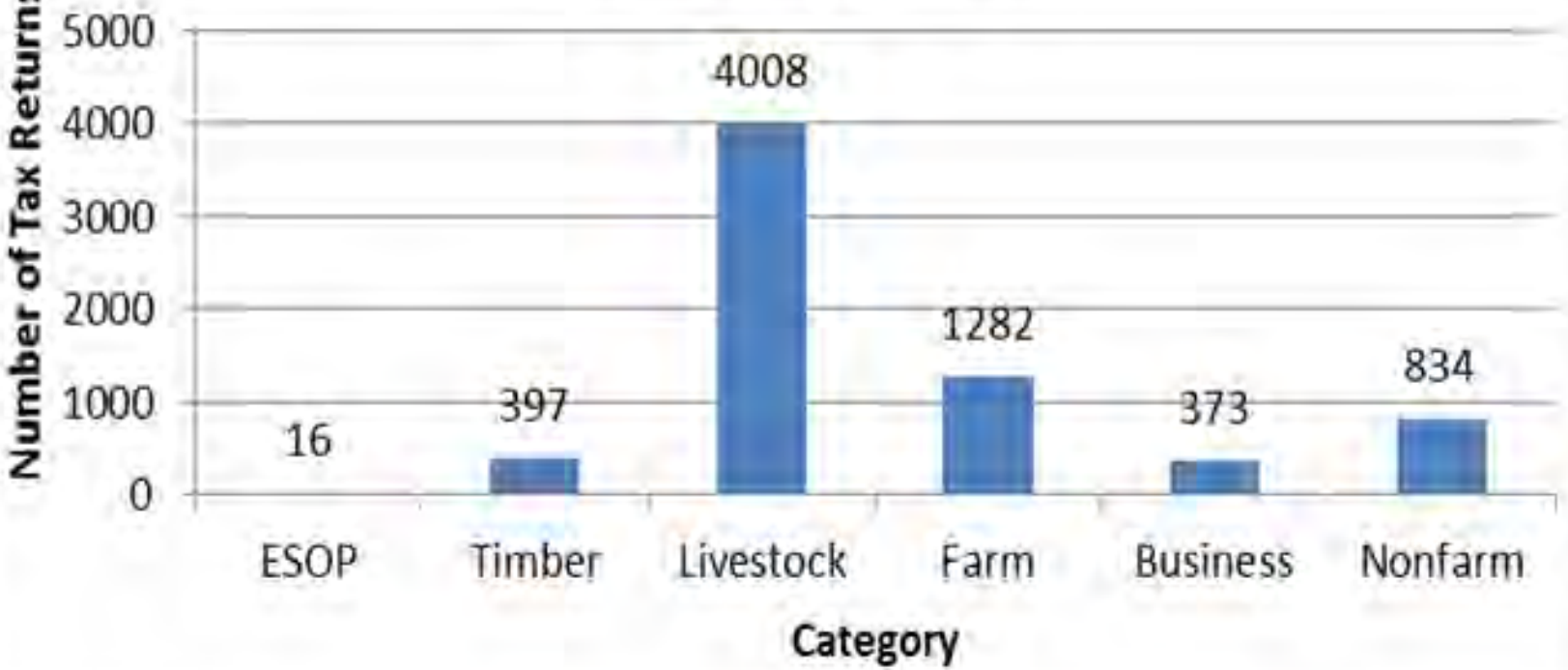


Figure 8: Number of Tax Returns by Category 2015



IA 100 Stakeholder Group

- Earlier this year, a stakeholder group was formed to review issues related to the IA 100.
- The group consisted of tax preparers, software developers, and the Iowa Department of Revenue.
- Revisions to the IA 100 were made to address many of the concerns expressed by the stakeholder group, legislators, and taxpayers.

IA 100 Form Changes

- The goal of the IA 100 is to request information up-front, rather than months or years after the return is filed.
- The revised 2016 IA 100 series generally requires less information than the 2015 form.
- Certain Information that required much effort for taxpayers to collect up-front is no longer requested.

IA 100 Form Changes

Installment Sales

- The IA 100 will be required each year for installment sales; however, less information is required to be provided than was the case for tax year 2015.

IA 100 Form Changes

For tax year 2016, the IA 100 has been broken up into the following series of forms:

- IA 100A – Cattle, Horses, or Breeding Livestock
- IA 100B – Real Property Used in a Farm Business
- IA 100C – Real Property Used in a Non-Farm Business
- IA 100D – Timber
- IA 100E – Business
- IA 100F – Employer Securities to a Qualified Iowa Employee Stock Ownership Plan

Form IA 100A – Cattle, Horses, or Breeding Livestock

Iowa Department of REVENUE

2016 IA 100A

Iowa Capital Gain Deduction – Cattle, Horses, or Breeding Livestock

https://tax.iowa.gov

Name(s)_____ SSN_____

Part I: Sale of Cattle, Horses, or Breeding Livestock

1. Was the gain from the sale of livestock reported under IRC section 1231?
   No ☐ ..... Sale is not eligible for Iowa capital gain deduction. Stop.
   Yes ☐ .... Continue to line 2.

2. Report information on each livestock sale (see instructions)

Type of Livestock (for example Cattle, Horse, Swine)	Livestock Use (Breeding, Dairy, Draft, or Sporting)	Documented Sale Date	Meet Minimum Holding Period?	Purchaser Name if Lineal Descendent	Purchaser Relation if Lineal Descendent

Form IA 100B – Real Property Used in a Farm Business

Iowa Department of REVENUE

2016 IA 100B

Iowa Capital Gain Deduction – Real Property Used in a Farm Business

https://tax.iowa.gov

Name(s)_____ SSN_____

Part I: Sale of Real Property Used in a Farm Business

1. Farmland address or legal description (include county)_____

   _____

   _____

   _____

2. Total number of acres sold_____
3. Ownership period
   a. Date acquired ..... 3a._____
   b. Date sold..... 3b._____
4. Length of holding period ..... Years 4a._____ Months 4b._____
5. If the taxpayer did not own the property for at least ten years, explain how the taxpayer held the property for at least ten years under IRC section 1223.

   _____

   _____

Form IA 100C – Real Property Used in a Non-Farm Business

Iowa Department of REVENUE

2016 IA 100C

Iowa Capital Gain Deduction – Real Property Used in a Non-Farm Business

https://tax.iowa.gov

Name(s)_____ SSN_____

Part I: Sale of Real Property Used in a Non-Farm Business

1. Business name_____
2. Activity of the business_____

   _____
3. Check the business organization type (check only one)

   Partnership ☐ S Corporation ☐

   Sole Proprietorship ☐ C Corporation ☐

   LLC ☐ Other ☐ (Explain:_____)
4. Real property address or legal description_____

   _____

   _____

Form IA 100D – Timber

Iowa Department of REVENUE

2016 IA 100D
Iowa Capital Gain Deduction - Timber
https://tax.iowa.gov

Name(s)_____ SSN_____

Part I: Sale of Timber

1. Timber address_____
2. Ownership period
   a. Date acquired ..... 2a._____
   b. Date sold..... 2b._____
3. Length of holding period. ..... Years 3a._____ Months 3b._____
4. Explain how the purchaser intends to use the timber_____

   _____
5. Was the gain from the sale of timber reported under IRC section 1231?
   No ☐..... Sale is not eligible for Iowa capital gain deduction. Stop.
   Yes ☐.... Continue to Part II, line 1.

Form IA 100E – Business

Iowa Department of REVENUE

2016 IA 100E

Iowa Capital Gain Deduction - Business

https://tax.iowa.gov

Name(s)_____ SSN_____

Part I: Sale of a Business

1. Business name_____
2. Business address_____
3. Activity of the business_____

   _____
4. Check the business organization type (check only one)

   Partnership ☐ S Corporation ☐

   Sole Proprietorship ☐ C Corporation ☐

   LLC ☐ Other ☐ (Explain_____)
5. Is the capital gain from the sale of capital stock or an ownership interest in the business?

   No ☐..... Continue to Part I, line 7.

   Yes ☐.... Continue to Part I, line 6.
6. Was the sale treated as a sale or acquisition of assets for federal income tax purposes?

   No ☐..... Sale is not eligible for Iowa capital gain deduction. Stop.

   Yes ☐.... Continue to Part I, line 7.

Form IA 100F – ESOP

Iowa Department of REVENUE

2016 IA 100F
Iowa Capital Gain Deduction – ESOP
https://tax.iowa.gov

Name(s)_____ SSN_____

Part I: Sale of Employer Securities to a Qualified Iowa Employee Stock Ownership Plan (ESOP)

1. Name of Iowa corporation_____
2. Does the ESOP own at least 30% of all outstanding employer securities issued by the Iowa corporation?
   No ☐ ..... Sale is not eligible for Iowa capital gain deduction. Stop.
   Yes ☐ .... Continue to Part II, line 1.

Part II: Details of Property Sold

1. Was the property sold owned by a C corporation?
   No ☐ ..... Continue to Part II, line 2.
   Yes ☐ .... Sale is not eligible for Iowa capital gain deduction. Stop.
2. List all owner name(s) _____
   _____
3. Enter taxpayer's ownership share of the total property sold to three decimal places (for example 65.2%) ..... 3. _____ %

Iowa Department of REVENUE

Resources

Iowa Department of REVENUE

Home | Search | Contact Us | Help

IOWA Tax Research Library

Welcome!

This research library contains Court Decisions, Rulings, and other information from the Iowa Department of Revenue archives. Statutes and rules referenced in library documents are no longer contained in this online library. Please refer to the statutes and rules of Iowa, including past versions of statutes and rules, available on the Iowa General Assembly Website. The Iowa Tax Research Library search function allows you to search by key word(s) or phrase with the ability to refine your selection to narrow your search.

Click here to begin your search.

Disclaimer

It is the Department's intent to maintain this online library with current and accurate information, along with some historical information. However, please be aware that the conclusions reached in policy letters, letters of findings, orders, and court decisions contained in the library may have been superseded by more recent determinations. Policy letters are only applicable to the factual situation referenced and to the statutes in existence at the time of issuance. Any written advice or opinion provided by Department personnel that is not pursuant to a Petition for Declaratory Order under 701 IAC 7.24 is not binding upon the Department. Some of the documents in this tax research library have certain information, such as names and addresses, shaded to protect taxpayer privacy.

https://tax.iowa.gov

Receive Automatic Updates

Email Updates

To sign up for updates or to access your subscriber preferences, please enter your contact information below.

Subscription Type Email

***Email Address**

Submit **Cancel**

Your contact information is used to deliver requested updates or to access your subscriber preferences.

Privacy Policy - Help

Iowa Department of REVENUE

Subscribe to the Following Topics

- Newsroom
- Tax Information
- eFile & Pay Information
- Sign-up for Due Date Reminders
- Economic, Fiscal, & Statistical Information
- Electronic Filing

NOTE: These replace the eLists formerly used

Iowa Department of REVENUE

Follow Us on Twitter

@IDRBusinessTax

@IDRIncomeTax

@IDRTaxPros

Iowa Department of REVENUE

Like Us on Facebook

www.facebook.com/iowadepartmentofrevenue

Iowa Department of REVENUE

Purpose of this Presentation

This presentation is intended for general educational purposes only.

Anyone involved in an audit or protest must contact the Department representative they are working with on that issue.

What Questions Do You Have?

Iowa Department of
REVENUE

THANK YOU!!

Iowa Department of
REVENUE

Iowa Department of REVENUE

Bloethe Tax School
Iowa State Bar Association

Patty Fulton
Matt Bishop

Iowa Department of REVENUE

2016 Legislative Update
Income Taxes

Internal Revenue Code (IRC) Coupling Bill

- House File 2433 updated references to January 1, 2016 for tax year 2015 ONLY
- Iowa remains decoupled from federal bonus depreciation

Facilitating Rapid Response to State-Declared & Presidential-Declared Disasters

- Out-of-state businesses and individuals performing disaster or emergency-related work in Iowa are not subject to Iowa income tax or withholding
- The disaster response period starts ten days before the state-declared or presidential-declared disaster and ends sixty days after the end of the declared state disaster or emergency
- Effective for tax years beginning on or after January 1, 2016

Iowa Department of REVENUE

529 Plan Changes

- Tax-exempt, nonprofit organizations under IRC section 501(c)(3) were added to the list of entities that can open and contribute to an individual's Iowa College Savings 529 Plan on behalf of that individual
- An individual can take an itemized deduction for the contribution to the 501(c)(3) if the individual did not designate the contribution be used for the direct benefit of any dependent of the individual or the individual did not designate any single beneficiary
- Effective for tax years beginning on or after January 1, 2016

Iowa Department of REVENUE

Iowa Department of REVENUE

2016 Legislative Update
Tax Credits & Incentives

Solar Energy System Tax Credit

- **2014 and 2015 Installations:** Applications received after May 1 following the year of the installation will be considered on a first-come, first-served basis for the next available year's allocation
- **2016 and After Installations:** Applications received after the May 1 deadline will be denied
- The application must be completed online and can be accessed on the Department's website

Iowa Department of Revenue

Renewable Energy Tax Credit

- Facilities placed in service before January 1, 2018 may now be eligible for the credit
- A solar facility qualifies for part of the 10 megawatts of generating capacity reserved for solar facilities as long as it is located within this state; has a generating capacity of 1 ½ megawatts or less (but not less than ¾ megawatts if all or part of the energy is for on-site consumption); is owned in whole or in part, directly or indirectly by one of the electric cooperatives described in the statute; and is placed in service between July 1, 2005 and January 1, 2018

Iowa Department of Revenue

Geothermal Tax Credit

- Iowa credit is currently 20% of the federal residential energy efficient property tax credit allowed for geothermal heat pumps in residential property located in Iowa – the federal credit is set to expire December 31, 2016
- If the federal credit is not extended, effective for tax year 2017, the Iowa credit will be 10 % of the taxpayer's qualified expenditures on equipment that uses the ground or groundwater as a thermal energy source to heat the taxpayer's dwelling, or as a thermal energy sink to cool the dwelling

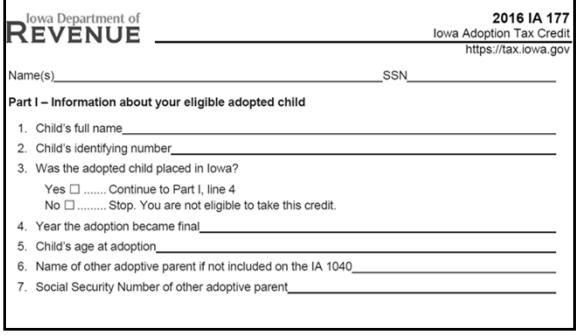
Iowa Department of Revenue

Adoption Tax Credit

- The Iowa adoption tax credit is increased from $2,500 per adoption to $5,000 per adoption
- The credit is equal to the amount of qualified adoption expenses paid or incurred by the taxpayer during the tax year in connection with the adoption of a child
- Effective for tax years beginning on or after January 1, 2017

Iowa Department of REVENUE

Iowa Adoption Tax Credit Form (IA 177)



Iowa Department of REVENUE

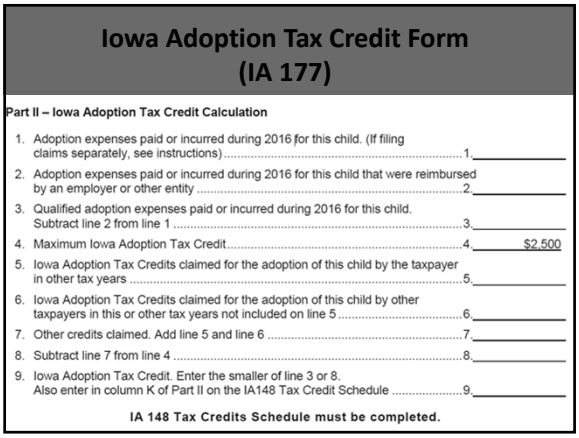
2016 IA 177
Iowa Adoption Tax Credit
https://tax.iowa.gov

Name(s)_____ SSN_____

Part I – Information about your eligible adopted child

1. Child's full name_____
2. Child's identifying number_____
3. Was the adopted child placed in Iowa?
   Yes ☐ ..... Continue to Part I, line 4
   No ☐ ..... Stop. You are not eligible to take this credit.
4. Year the adoption became final_____
5. Child's age at adoption_____
6. Name of other adoptive parent if not included on the IA 1040_____
7. Social Security Number of other adoptive parent_____

Iowa Adoption Tax Credit Form (IA 177)



Part II – Iowa Adoption Tax Credit Calculation

1.	Adoption expenses paid or incurred during 2016 for this child. (If filing claims separately, see instructions) ..... 1.	
2.	Adoption expenses paid or incurred during 2016 for this child that were reimbursed by an employer or other entity ..... 2.	
3.	Qualified adoption expenses paid or incurred during 2016 for this child. Subtract line 2 from line 1 ..... 3.	
4.	Maximum Iowa Adoption Tax Credit ..... 4.	$2,500
5.	Iowa Adoption Tax Credits claimed for the adoption of this child by the taxpayer in other tax years ..... 5.	
6.	Iowa Adoption Tax Credits claimed for the adoption of this child by other taxpayers in this or other tax years not included on line 5 ..... 6.	
7.	Other credits claimed. Add line 5 and line 6 ..... 7.	
8.	Subtract line 7 from line 4 ..... 8.	
9.	Iowa Adoption Tax Credit. Enter the smaller of line 3 or 8. Also enter in column K of Part II on the IA148 Tax Credit Schedule ..... 9.	

IA 148 Tax Credits Schedule must be completed.

Renewable Chemical Production Tax Credit

- New refundable tax credit with an annual cap of $10 million
- Available to an eligible business that produces a renewable chemical in this state from biomass feedstock
- Applies to renewable chemicals produced in the state from biomass feedstock on or after January 1, 2017

Iowa Department of Revenue

Renewable Fuels Tax Credits

Expiration dates extended to January 1, 2021:

- E-15 Plus Gasoline Promotion Tax Credit
- E-85 Gasoline Promotion Tax Credit
- Biodiesel Blended Fuel Tax Credit
- Sales and use tax refund for biodiesel production

Ethanol Promotion Tax Credit is still scheduled to expire on January 1, 2021

Iowa Department of Revenue

Biodiesel Blended Fuel Tax Credit

Credit amount changes:

- Diesel fuel rated B-5 or higher, but less than B-11 receives a credit of 3.5 cents per gallon
- Diesel fuel rated B-11 or higher receives a credit of 5.5 cents per gallon
- Effective for tax years beginning on or after January 1, 2018

Iowa Department of Revenue

Iowa Department of REVENUE

2016 Legislative Update
Sales & Use Tax

Machinery, Equipment, & Computers

- **Beginning July 1, 2016** the sales and use tax exemption for certain computers, machinery, equipment, and replacement parts is expanded
- House File 2433 expands the exemption to include supplies, and it provides definitions of replacement parts and supplies

Iowa Department of REVENUE

Background Information

- **Prior to July 1, 2016**
  - Replacement parts were exempt
  - Supplies were taxable
  - "Replacement parts" and "supplies" were not defined in the statute

Iowa Department of REVENUE

Exempt Replacement Parts & Supplies (Beginning July 1, 2016)

- "Computers, machinery, equipment, replacement parts, supplies, and materials used to construct or self-construct computers, machinery, equipment, replacement parts, and supplies" are exempt when used for an exempt purpose.

Iowa Department of REVENUE

Replacement Parts (Prior to July 1, 2016)

- Prior to July 1, 2016:
  - Replacement parts were not defined in the statute.
  - Replacement parts were presumed to have a useful life of at least 12 months.

Iowa Department of REVENUE

Definition of Exempt Replacement Parts (Beginning July 1, 2016)

- "Replacement part" means tangible personal property other than computers, machinery, equipment, or supplies, regardless of the cost or useful life of the tangible personal property, that meets all of the following conditions:
  - The item replaces a component of a computer, machinery, or equipment, which component is capable of being separated from the computer, machinery, or equipment
  - The item performs the same or similar function as the component it replaced
  - The item restores the computer, machinery, or equipment to an operational condition, or upgrades or improves the efficiency of the computer, machinery, or equipment

Iowa Department of REVENUE

Definition of Exempt Supplies (Beginning July 1, 2016)

- "Supplies" means tangible personal property, other than computers, machinery, equipment, or replacement parts, that meets one of the following conditions:
  - The item is connected to a computer, machinery, or equipment and requires regular replacement because the property is consumed or deteriorates during use
  - The item is used in conjunction with a computer, machinery, or equipment and is specially designed for use in manufacturing specific products and may be used interchangeably and intermittently on a particular computer, machine, or piece of equipment
  - The item comes into physical contact with other tangible personal property used in processing and is used to assist with or maintain conditions necessary for processing
  - The item is directly and primarily used in an exempt activity

Iowa Department of Revenue

Exempt Supplies (Beginning July 1, 2016)

- Examples of exempt supplies:
  - Saw blades
  - Drill bits
  - Filters
  - Jigs
  - Dies
  - Tools (but not hand tools)
  - Cutting fluids
  - Oils
  - Coolants
  - Lubricants
  - Prototype materials
  - Testing materials

Iowa Department of Revenue

Exempt Replacement Parts & Supplies (Beginning July 1, 2016)

- Bottom line: Many, but not all, items used in manufacturing are exempt
- Exempt items must be used in an exempt activity (e.g., directly and primarily used in processing by a manufacturer)

Iowa Department of Revenue

Exempt Replacement Parts & Supplies (Beginning July 1, 2016)

Publication on our website:
https://tax.iowa.gov/sites/files/idr/documents/HF2433publication.pdf

Iowa Department of REVENUE

2016 Legislative Update Environmental Protection Charge

Environmental Protection Charge (EPC)

- The 1 cent per gallon EPC on fuel deposited into certain, primarily underground, storage tanks expires effective December 31, 2016
- Originally set to expire on June 30, 2016

Iowa Department of REVENUE

Iowa Department of REVENUE

Other Information

Standard Deduction Amounts

2016:
- Filing status 1 - $1,970
- Filing status 3 or 4 - $1,970 for each spouse
- Filing status 2, 5, or 6 - $4,860

2017:
- Filing status 1 - $2,000
- Filing status 3 or 4 - $2,000 for each spouse
- Filing status 2, 5, or 6 - $4,920

Iowa Department of REVENUE

College Savings Iowa 529 Plan

- $3,188 per beneficiary for 2016

Iowa Department of REVENUE

Taxpayers Trust Fund Credit Amount

- $54 for 2013
- $15 for 2014
- $0 for 2015
- $0 for 2016

Iowa Department of Revenue

Individual Income Tax Checkoffs

Same four checkoffs for 2016, 2017, & 2018:

- Fish & Wildlife Fund (Chickadee Checkoff)
- Iowa State Fair Foundation (Corn Dog Checkoff)
- Joint Fire Fighter Preparedness Fund / Veterans Trust Fund
- Child Abuse Prevention

Iowa Department of Revenue

Interest Rate

- 0.4% per month during 2016
- 0.4% per month during 2017

Iowa Department of Revenue

eFiling Statistics for Current Processing Year

- 90% of individual income tax returns
- 70% of corporation income tax returns
- 22% of fiduciary tax returns

Iowa Department of REVENUE

2D Barcode

- 46% of paper returns used 2D barcode
- The fillable IA 1040 on our website automatically creates a computer generated barcode on the return. The barcode allows the return to process faster than a handwritten paper return.
- Because the computer generates the barcode, all entries on the fillable IA 1040 must be made on the computer before the return is printed.
- **If you need to make changes to the return**, update the fillable form and reprint. All information you keyed into the form is reflected in the barcode.
- Handwritten information is not captured. Any information written on the return after it is printed will not be reflected in the barcode.

Iowa Department of REVENUE

New W-2 & 1099 Reporting Requirements

W-2s, W-2Gs, & 1099s

- Beginning in 2017 for tax year 2016:
  - Withholding agents with 50 or more employees must electronically file W-2 forms with the Department by the last day of January following the tax year.
  - Withholding agents with less than 50 employees may, but are not required to, electronically file W-2 forms with the Department by January 31, 2017.
  - Withholding agents may, but are not required to, electronically file W-2G and 1099 forms with the Department by January 31, 2017.
- Beginning in 2018 for tax year 2017:
  - All are required to electronically file W-2, W-2G, and 1099 forms with the Department by the last day of January following the tax year.

Verified Summary of Payments Report (VSP)

- All withholding agents are required to submit a completed VSP by January 31.

Iowa Department of REVENUE

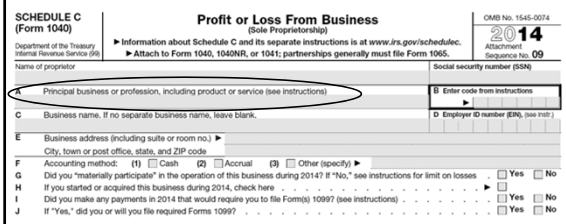
New W-2 & 1099 Reporting Requirements

- Publication 44-082, Iowa Department of Revenue Electronic Reporting of Wage Statements and Information Returns is now available on the Department's website. This publication contains specifications and instructions for this electronic reporting.
- For immediate notification when more details are available, please subscribe to our GovDelivery e-mail distribution list for W-2/1099 filers. Here is the link to subscribe:
  - https://public.govdelivery.com/accounts/IACIO/subscriber/topics?qsp=IACIO_1

When subscribing, the *IDR_W2/1099 Filers* option will be found under the *Electronic Filing* heading.

Iowa Department of REVENUE

File Schedule C?



SCHEDULE C (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)
► Information about Schedule C and its separate instructions is at *www.irs.gov/schedulec*.
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2014
Attachment Sequence No. 09

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service (see instructions) | B Enter code from instructions ►

C Business name. If no separate business name, leave blank. | D Employer ID number (EIN), (see instr.)

E Business address (including suite or room no.) ►
City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►

G Did you "materially participate" in the operation of this business during 2014? If "No," see instructions for limit on losses . ☐ Yes ☐ No

H If you started or acquired this business during 2014, check here . . . . . ► ☐

I Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) . . . . . ☐ Yes ☐ No

J If "Yes," did you or will you file required Forms 1099? . . . . . ☐ Yes ☐ No

Taxable Service?

Iowa Department of REVENUE

Common Taxable Services

- Appliance / Machine Repair
- Barber / Beauty / Cosmetology
- Carpentry
- Electrical Repair / Installation
- Janitorial / Cleaning / Building Maintenance
- Lawn Care / Landscaping / Tree Trimming & Removal
- Painting / Papering / Interior Decorating
- Pet Grooming
- Photography (sale of tangible personal property)
- Plumbing
- Vehicle Repair

Iowa Department of REVENUE

Which Services are Taxable?

List of taxable services on our website:

https://tax.iowa.gov/iowa-sales-and-use-tax-taxable-services-0

Iowa Department of REVENUE

Iowa Department of REVENUE

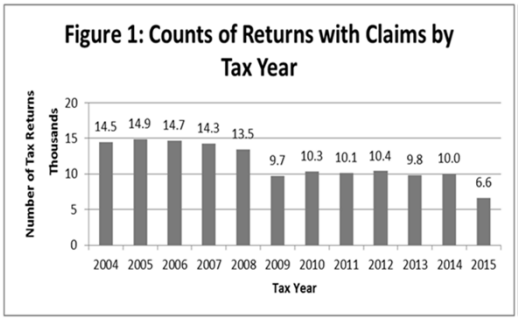
Iowa Capital Gain Deduction

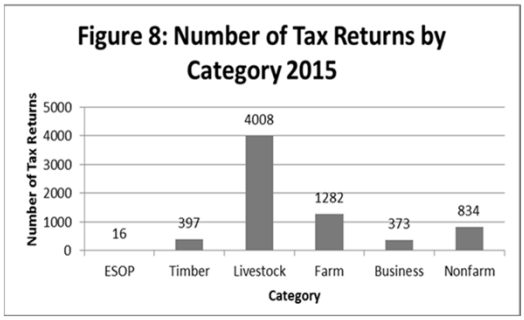
Questions About Specific Scenarios

- The following slides will present information regarding updates to the IA 100 Capital Gain Deduction Form.
- The information presented here is general in nature and is not intended to address specific scenarios.
- We cannot discuss specific scenarios during this presentation.
- If you have questions about a specific scenario, please e-mail idr@iowa.gov

Iowa Department of REVENUE

Iowa had under 2 million individual income taxpayers annually during this time





IA 100 Stakeholder Group

- Earlier this year, a stakeholder group was formed to review issues related to the IA 100.
- The group consisted of tax preparers, software developers, and the Iowa Department of Revenue.
- Revisions to the IA 100 were made to address many of the concerns expressed by the stakeholder group, legislators, and taxpayers.

IA 100 Form Changes

- The goal of the IA 100 is to request information up-front, rather than months or years after the return is filed.
- The revised 2016 IA 100 series generally requires less information than the 2015 form.
- Certain Information that required much effort for taxpayers to collect up-front is no longer requested.

Iowa Department of Revenue

IA 100 Form Changes

Installment Sales

- The IA 100 will be required each year for installment sales; however, less information is required to be provided than was the case for tax year 2015.

Iowa Department of Revenue

IA 100 Form Changes

For tax year 2016, the IA 100 has been broken up into the following series of forms:

- IA 100A – Cattle, Horses, or Breeding Livestock
- IA 100B – Real Property Used in a Farm Business
- IA 100C – Real Property Used in a Non-Farm Business
- IA 100D – Timber
- IA 100E – Business
- IA 100F – Employer Securities to a Qualified Iowa Employee Stock Ownership Plan

Iowa Department of Revenue

Form IA 100A – Cattle, Horses, or Breeding Livestock

Iowa Department of REVENUE

2016 IA 100A
Iowa Capital Gain Deduction – Cattle, Horses, or Breeding Livestock
https://tax.iowa.gov

Name(s)_____SSN_____

Part I: Sale of Cattle, Horses, or Breeding Livestock

1. Was the gain from the sale of livestock reported under IRC section 1231?
   No ☐ ..... Sale is not eligible for Iowa capital gain deduction. Stop.
   Yes ☐ .... Continue to line 2.
2. Report information on each livestock sale (see instructions)

Type of Livestock (for example Cattle, Horse, Swine)	Livestock Use (Breeding, Dairy, Draft, or Sporting)	Documented Sale Date	Meet Minimum Holding Period?	Purchaser Name if Lineal Descendent	Purchaser Relation if Lineal Descendent

Form IA 100B – Real Property Used in a Farm Business

Iowa Department of REVENUE

2016 IA 100B
Iowa Capital Gain Deduction – Real Property Used in a Farm Business
https://tax.iowa.gov

Name(s)_____SSN_____

Part I: Sale of Real Property Used in a Farm Business

1. Farmland address or legal description (include county)_____
2. Total number of acres sold_____
3. Ownership period
   a. Date acquired ..... 3a._____
   b. Date sold..... 3b._____
4. Length of holding period ..... Years 4a._____Months 4b._____
5. If the taxpayer did not own the property for at least ten years, explain how the taxpayer held the property for at least ten years under IRC section 1223.

Form IA 100C – Real Property Used in a Non-Farm Business

Iowa Department of REVENUE

2016 IA 100C
Iowa Capital Gain Deduction – Real Property Used in a Non-Farm Business
https://tax.iowa.gov

Name(s)_____SSN_____

Part I: Sale of Real Property Used in a Non-Farm Business

1. Business name_____
2. Activity of the business_____
3. Check the business organization type (check only one)
   Partnership ☐ S Corporation ☐
   Sole Proprietorship ☐ C Corporation ☐
   LLC ☐ Other ☐ (Explain:_____)
4. Real property address or legal description_____

Form IA 100D – Timber

Iowa Department of REVENUE

2016 IA 100D
Iowa Capital Gain Deduction - Timber
https://tax.iowa.gov

Name(s)_____SSN_____

Part I: Sale of Timber

1. Timber address_____
2. Ownership period
   a. Date acquired ..... 2a._____
   b. Date sold..... 2b._____
3. Length of holding period. ..... Years 3a._____Months 3b._____
4. Explain how the purchaser intends to use the timber_____
   _____
5. Was the gain from the sale of timber reported under IRC section 1231?
   No ☐..... Sale is not eligible for Iowa capital gain deduction. Stop.
   Yes ☐ .... Continue to Part II, line 1.

Form IA 100E – Business

Iowa Department of REVENUE

2016 IA 100E
Iowa Capital Gain Deduction - Business
https://tax.iowa.gov

Name(s)_____SSN_____

Part I: Sale of a Business

1. Business name_____
2. Business address_____
3. Activity of the business_____
   _____
4. Check the business organization type (check only one)
   Partnership ☐ S Corporation ☐
   Sole Proprietorship ☐ C Corporation ☐
   LLC ☐ Other ☐ (Explain_____)
5. Is the capital gain from the sale of capital stock or an ownership interest in the business?
   No ☐..... Continue to Part I, line 7.
   Yes ☐ .... Continue to Part I, line 6.
6. Was the sale treated as a sale or acquisition of assets for federal income tax purposes?
   No ☐..... Sale is not eligible for Iowa capital gain deduction. Stop.
   Yes ☐ .... Continue to Part I, line 7.

Form IA 100F – ESOP

Iowa Department of REVENUE

2016 IA 100F
Iowa Capital Gain Deduction – ESOP
https://tax.iowa.gov

Name(s)_____SSN_____

Part I: Sale of Employer Securities to a Qualified Iowa Employee Stock Ownership Plan (ESOP)

1. Name of Iowa corporation_____
2. Does the ESOP own at least 30% of all outstanding employer securities issued by the Iowa corporation?
   No ☐ ..... Sale is not eligible for Iowa capital gain deduction. Stop.
   Yes ☐ .... Continue to Part II, line 1.

Part II: Details of Property Sold

1. Was the property sold owned by a C corporation?
   No ☐ ..... Continue to Part II, line 2.
   Yes ☐ .... Sale is not eligible for Iowa capital gain deduction. Stop.
2. List all owner name(s) _____
   _____
3. Enter taxpayer's ownership share of the total property sold to three decimal places (for example 65.2%)..... 3. _____%

Iowa Department of REVENUE

Resources

https://tax.iowa.gov

Receive Automatic Updates

Email Updates

To sign up for updates or to access your subscriber preferences, please enter your contact information below.

Subscription Type Email

***Email Address**

Submit Cancel

Your contact information is used to deliver requested updates or to access your subscriber preferences.

Privacy Policy - Help

Iowa Department of REVENUE

Subscribe to the Following Topics

- Newsroom
- Tax Information
- eFile & Pay Information
- Sign-up for Due Date Reminders
- Economic, Fiscal, & Statistical Information
- Electronic Filing

NOTE: These replace the eLists formerly used

Iowa Department of REVENUE

Follow Us on Twitter

@IDRBusinessTax

@IDRIncomeTax

@IDRTaxPros

Iowa Department of REVENUE

Like Us on Facebook

www.facebook.com/iowadepartmentofrevenue

Iowa Department of REVENUE

Purpose of this Presentation

This presentation is intended for general educational purposes only.

Anyone involved in an audit or protest must contact the Department representative they are working with on that issue.

Iowa Department of REVENUE

What Questions Do You Have?

Iowa Department of REVENUE

THANK YOU!!

Bloethe

Tax School

Farm Income Averaging

3:45 p.m.-4:15 p.m.

Presented by
Adam Ullrich
Reimer, Lohman, Reitz, Sailer & Ullrich
25 S Main St.
Denison, IA 51442
Phone: 712-263-4627
Fax: 712-263-8395
Email: aullrich@frontiernet.net

WEDNESDAY, DECEMBER 7, 2016

Farm Income Averaging

I. Background, Definitions & Rules

A. History of income averaging

1. Farm income averaging was originally scheduled to be available to farmers only for 1998, 1999, and 2000. The Tax and Trade Relief Extension Act of 1998 made farm income averaging permanent.

B. Rules and Definitions

1. An individual engaged in a farming business may make a farm income averaging election to compute current year (election year) income tax liability by averaging, over a three year period (base years), all or a portion of the individual's current year electible farm income attributable to the farming business.[1]

    a. **Farming business**: The trade or business of farming involves the cultivation of land or the raising or harvesting of any agricultural commodity including the operation of a nursery or sod farm or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (but not evergreen trees that are more than six years when cut) or raising, shearing, feeding, caring for, training, and managing animals.[2]

        i. The instructions to Schedule J provide that a farm business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another nor does it include buying or reselling plants or animals grown or raised by another.

        ii. Taxpayers who have farm income during the tax year as a sole proprietor, a partner in a partnership or a shareholder in an S corporation may use income averaging without regard to whether the individual was engaged in a farming business in any prior year.[3]

2. **Election year**: Tax year for which the income averaging election is being made.

3. **Base years**: The three years before the election year (for example, 2013, 2014 and 2015 are the base years for 2016, the election year).

[1] Treas. Reg. § 1.1301-1.
[2] I.R.C. § 263A(e)(4).
[3] Treas. Reg. § 1.1301-1(b)(iii) & (iv).

4. **Electible farm income**: The amount of income which is eligible for averaging and includes items of income, deduction, gain, and loss attributable to an individual's farming business.[4]

    a. Farm losses include, to the extent attributable to a farming business, any NOL carryover or carryback or net capital loss carryover to an election year.

    b. Income, gain or loss from the sale of development rights, grazing rights, or similar rights are not attributable to a farming business and are thus not included in electible farm income.[5]

    c. Farm income does not include wages. However, wages may be included if received by a shareholder in a sub-S corporation engaged in a farming business.[6]

    d. Income earned by partners in a partnership which is attributable to a farming business is electible farm income regardless of whether the income is a distributive share or a guaranteed payment.[7]

    e. Since a C corp. isn't a pass-through entity for federal tax purposes, amounts paid by a C corp. to its shareholders-employees are not treated as farm income.[8]

    f. Gains from the sale or other disposition of farm property, **other than land**, that have been regularly used for a substantial period in the farming business are included in the definition of electible farm income.[9]

        i. Structures attached to land (barns, sheds, bin systems, etc.) do count as farm property and are thus eligible for income averaging.[10]

    g. If the taxpayer (or his/her partnership or S corporation) liquidate the farming business gains or losses on property sold within a reasonable time after operations stop can be designated as electible farm income. A period of 1 year after stopping operations is a reasonable time. After that, what is considered a reasonable time depends on the facts and circumstances.[11]

---

[4] Treas. Reg. § 1.1301-1(e)(1)(i).
[5] *Id*.
[6] *Id*.
[7] 34 Am. Jur. 2d *Income Tax Deductions, Foreign Income & Taxes, Valuation, Tax Practice* §20043 (2016).
[8] *Id*.
[9] Treas. Reg. § 1.1301-1(e)(1)(ii)(A).
[10] *Id*.
[11] Treas. Reg. § 1.1301-1(e)(1)(ii)(B).

h. The landlord's share of a crop-share lease qualifies as electible farm income regardless of whether the landlord materially participates in the production of the crop (i.e., whether or not the crop share rental income is reported on Schedule F as subject to SE tax or on Form 4835 as not subject to SE tax).

i. There must be a written crop share lease agreement entered into before the tenant begins significant activities on the land in order for the crop share rent income to qualify for averaging. If a landlord receives fixed rent or a rent payment under an unwritten agreement or late written agreement, the income is ineligible for averaging.[12]

Practice Point: Availability of income averaging coupled with availability of beginning farmer tax credits for custom farming may cause some landlords to consider crop-share leases.

5. **Elected farm income**: The amount of electible farm income that is designated by the taxpayer for the income averaging rules. Any portion of taxable income attributable to any farming business may be designated as elected farm income for averaging purposes. Elected farm income cannot exceed the taxable income of the taxpayer. Elected farm capital gain cannot exceed the taxpayer's total capital gain.[13]

6. Income averaging has no effect on self-employment tax in the election year or in the base years.

7. The American Jobs Creation Act of 2004 clarified that the alternative minimum tax (AMT) is determined using a taxpayer's regular tax liability without regard to income averaging. This allows the taxpayer to benefit from the full effect of income averaging because income averaging reduces the regular tax liability and the add-on AMT is not affected.[14]

8. Income averaging affects only the income tax liability in the election year. Income averaging does not change the amount of tax paid in prior years and therefore should not be viewed as a mechanism to carry income back to the prior three years. Rather, income averaging allows taxpayers to bring the unused tax brackets from the three base years forward to be used in calculating the income tax liability for the election year.

[12] Andrew R. Biebl, *Farm Taxation Update*, 5-3 (Christopher W. Hesse rev. ed., May 2015).
[13] Treas. Reg. §1.1301-1(e)(1)(i).
[14] Used with permission from Phillip E. Harris as presented at the "Navigating Changing Times Farm Tax Workshop" on September 9, 2016, in Ames, Iowa by Iowa State University Center for Agricultural Law and Taxation.

Practice Point: I.R.C. §1301 contains no requirements regarding a threshold percentage of farm income or any other prior tax return history of farming income as a condition for electing income averaging. Any individual engaged in a **farm business** may be able to elect income averaging to all or some of their **electible farm income**.

C. Examples to Illustrate the Rules & Definitions

1. Example: Taxpayer has ordinary income from a farming business of $200,000 and an ordinary loss of $50,000 that is not from a farming business.

    a. Taxpayer's taxable income is $150,000 ($200,000 - $50,000).

    b. Since electible farm income may not exceed taxable income Taxpayer's electible farm income is $150,000, all of which is ordinary income.[15]

2. Example: Daisy Fields, who is single, had $70,000 of taxable income in 2016, entirely from farm sources. Her taxable income for the 2013–2015 tax years is shown in Figure 1. [16]

FIGURE 1. DAISY'S TAXABLE INCOME BY TAX YEAR

Tax Year	Taxable Income
2013	$26,250 ($10,000 below the beginning of her 25% bracket)
2014	$21,900 ($15,000 below the beginning of her 25% bracket)
2015	$17,450 ($20,000 below the beginning of her 25% bracket)

    a. If Daisy does not use income averaging, what is her income tax liability for 2016?

    Using the 2016 tax tables, her income tax is $13,278 and her marginal tax rate is 25%. The 15% bracket for 2016 ends at $37,650 for a taxpayer whose filing status is single.

    b. What if Daisy designates $30,000 of her 2016 income as elected farm income for income averaging?

    She can use $10,000 of the unused 15% tax bracket for each of the base years to compute her 2016 income tax. Her total tax on the $30,000 of

[15] Treas. Reg. §1.1301-1(e)(2)(ii)(3).
[16] Harris, *supra* n. 12.

elected farm income is $4,500 (15% × $30,000), and the tax on her remaining $40,000 ($70,000 – $30,000) of taxable income is $5,778. With farm income averaging, Daisy's 2016 income tax is $10,278 ($5,778 + $4,500). The tax savings from $30,000 of elected farm income is $3,000 ($13,278 – $10,278).

Practice Point: Most tax preparation software will evaluate the effect of income averaging for the preparer. Many programs allow the preparer to check a box to "elect income averaging" after which the program will make the election and perform the calculations. However, it is important that preparers understand income averaging even though your software does the work.

II. Capital Gains

A. Taxpayers who have both ordinary income and capital gains that are eligible for income averaging may choose the amounts of each type of income that are included in elected farm income. The capital gain portion of elected farm income cannot exceed either the taxpayer's net capital gains or the net capital gains attributable to a farming business. When elected farm income includes both ordinary and capital gain income, each type of income must be allocated in equal portions among the tax brackets of the 3 prior years. Capital gains that are included in the tax bracket of a prior year do not offset capital losses in that prior year, and they are taxed at the lesser of the applicable capital gains rate for the prior year or the ordinary income rate for the prior year. [17]

B. Example: Ms. Case has a $10,000 long-term capital gain from the sale of assets used regularly in her farming business and a $4,000 capital loss on the sale of corporate stock. She designates $21,000 of her 2016 income as elected farm income.[18]

1. How much of the elected farm income can be capital gain?

   Ms. Case can treat no more than $6,000 ($10,000 – $4,000) of her elected farm income as capital gain.

2. If she designates $6,000 of capital gains and $15,000 of ordinary income as elected farm income, how much is allocated to each base year (2013–2015)?

   Ms. Case must divide the amounts evenly, allocating $2,000 of capital gain income and $5,000 of ordinary income to each of the 3 base years.

C. Example—Electing averaging to reduce capital gain rate: Jon Deere is a joint filer and has 2015 taxable income of $80,000, consisting of $75,000 of ordinary farm income and $5,000 of capital gains from security sales. For the prior three base years taxable income has been around $40,000. Without a 2015 income averaging election Fred's $5,000 of

[17] *Id*.
[18] *Id*.

long-term capital gains will be taxed at 15% (i.e., the ordinary income is considered to first fill up the lower 15% tax rate which currently ends at $74,900 of taxable income (for 2015), and capital gain, considered to be the last income, is then entirely taxed at 15%).

If Fred chooses to use farm income averaging, and designates $5,000 of his ordinary farm income as EFI, it will reduce his current year taxable income from $80,000 to $75,000 which will save no ordinary income tax because all ordinary income is taxed at 15% in both the current and three base years. However, by reducing the current year taxable income below the top of the 15% ordinary bracket, the $5,000 of capital gains are taxed at 0% rather than 15% saving $750 of federal income tax.[19]

III. Amended Returns

A. Taxpayers are permitted to elect income averaging in a late or amended return. Taxpayers may also amend to change the amount of elected farm income in a prior election, or to revoke a previously filed averaging election.[20] Amending a prior-year return can affect income averaging in the current year.

B. If marginal tax rates are equal across the years income averaging will not reduce the income tax liability in the election year. However, income averaging can be used to empty out base-year tax brackets so that elected farm income in future years will be taxed at a lower rate. In some instances, the tax savings can be realized in the current year by filing an amended return and making an income averaging election for a prior year.[21]

C. Example: Jonnie Bonanza is married and files a joint return. In 2016, the Bonanzas have $120,300 of taxable income, which is all electible farm income. Their taxable incomes for the 2012–2015 tax years are shown in **Figure 2**. The Bonanzas want to use income averaging to reduce their income taxes. The 15% bracket ends at $75,300 in 2016 for a married couple filing jointly.

FIGURE 2. BONANZAS' TAXABLE INCOME BEFORE AVERAGING

Tax Year	Taxable Income
2012	$50,700 ($20,000 below the beginning of their 25% bracket)
2013	$57,500 ($15,000 below the beginning of their 25% bracket)
2014	$53,800 ($20,000 below the beginning of their 25% bracket)
2015	$69,900 ($5,000 below the beginning of their 25% bracket)

[19] Andrew R. Biebl, *Farm Taxation Update*, 5-5 (Christopher W. Hesse rev. ed., May 2015).
[20] Treas. Reg. § 1.1301-1(c)(2).
[21] Harris, *supra* n. 12.

1. What happens if the Bonanzas elect to use farm income averaging for $15,000 of their 2016 electible farm income?

   The first $15,000 of elected farm income is taxed at an average rate of 15% because all 3 base years have at least $5,000 remaining in the 15% tax bracket. Therefore, the first $15,000 of elected farm income reduces their income liability by $1,500 ((25% – 15%) x $15,000)). The 15% tax bracket for 2015 is filled, and the election reduces the 2016 taxable income that is subject to the 2016 tax rates to $105,300 ($120,300 – $15,000).

2. What happens if they elect an additional $30,000 for farm income averaging?

   Because the 15% bracket for 2015 is filled, the next $30,000 of elected farm income is taxed at a rate of 18.33% [(15% + 15% + 25%) ÷ 3], saving the Bonanzas $2,000 (25% – 18.33% = 6.67% × $30,000). This fills the 15% bracket for 2013, and it reduces their 2016 taxable income that is subject to the 2016 tax rates to $75,300 ($105,300 – $30,000), which is the top of the 15% bracket. The tax savings from $45,000 of elected farm income is $3,500 ($1,500 + $2,000). Any further election of farm income results in income that is in the 15% rate bracket for 2016 being taxed at a higher base-year average marginal rate.

3. What happens if the Bonanzas elect farm income averaging on an amended return for 2015?

   Figure 3 shows the unused amounts of the Bonanzas' 15% tax brackets for 2012 through 2015 if they amend their 2015 return to designate $15,000 of elected farm income for 2015.

FIGURE 3. BONANZAS' UNUSED 15% TAX BRACKETS

AFTER INCOME AVERAGING IN 2014

Tax Year	Taxable Income
2012	$15,000 below the beginning of their 25% bracket
2013	$10,000 below the beginning of their 25% bracket
2014	$15,000 below the beginning of their 25% bracket
2015	$20,000 below the beginning of their 25% bracket

The income averaging election for 2015 has no effect on their income tax liability for 2015, because the marginal tax rates are all 15%, but it clears an additional $15,000

of the 2015 15% tax bracket for income averaging in a later year. A $30,000 income averaging election in 2016 is now taxed at a 15% [(15% + 15% + 15%) ÷ 3] average marginal rate. Therefore, the first $30,000 of elected farm income reduces the Bonanzas' tax liability by $3,000 (25% – 15% = 10% × $30,000). That fills the 15% bracket for 2013 and reduces the 2016 taxable income that is subject to the 2016 tax brackets to $90,300 ($120,300 – $30,000).

IV. Impact of an NOL on Income Averaging

A. Generally a taxpayer must carry back the entire amount of an NOL to the two tax years before the NOL year, beginning with the earliest of the two prior years, and then carry forward any remaining NOL for up to 20 years after the NOL year until the NOL is depleted.[22]

1. An exception exists to the 2-year carry back rule for farmers as farming operations qualify for a special 5-year carryback period.[23] Only the farming loss portion of the NOL can be carried back 5 years however. A farming loss is the smaller of:

    a. The amount that would be the NOL for the tax year if only income and deductions attributable to farming businesses were taken into account, or

    b. The NOL for the tax year.[24]

2. The 5-year carryback period may be waived by attaching a statement to the timely filed return electing to forgo the 5-year carryback period for farming losses. If this election is made, the 2-year carryback period applies unless the taxpayer also makes an election to forgo the default carryback. Elections to waive the carryback are irrevocable. If a return is filed without the election to forgo the 5-year carryback period, an amended return to make the election may be filed within six months of the original due date of the return. "Filed pursuant to §301.9100-2" should be entered at the top of the election statement. If the taxpayer wishes to forgo all carrybacks and only carry the NOL forward, an election to forgo the 2-year carryback should also be made at the same time.[25]

B. Dealing with a Negative Base Year.

1. Both the NOL rules and income averaging rules allow taxpayers to take advantage of deductions from other tax years in computing federal income tax (but not SE tax). The NOL rules allow taxpayers to deduct business and some personal losses arising in one tax year from income in another tax year. The

[22] *Net Operating Losses (NOLs) for Individuals*, I.R.S. Pub 536, at 3 (2015).
[23] I.R.C. § 172(b)(1)(G).
[24] *Net Operating Losses (NOLs) for Individuals*, I.R.S. Pub 536, at 3 (2015).
[25] *Id*.

income averaging rules allow taxpayers to use tax brackets from three base years to compute federal income tax for the election year.[26] Because these two provisions provide similar benefits, Congress expressed its intent that taxpayers should not realize a double benefit. The IRS implemented Congress's intent in both the regulations and form instructions.

2. In preparing Schedule J, a negative amount may be used for any of the three base years where a taxable loss was incurred, rather than limiting the base year on Schedule J to a zero amount.[27]

3. The Schedule J instructions state that amended returns for any base year should be completed before using Schedule J for the current year since prior income averaging elections affect current income averaging calculations.

4. Any base year loss that provided a benefit in another taxable year must be added back in determining base year taxable income.[28] Accordingly, NOLs and capital loss deductions that carry to other years to provide tax benefit must be adjusted in calculating a negative base year amount.

5. The instructions for Schedule J include a worksheet that adds back deductions that may provide a benefit in another tax year.

C. Example: NOL Carried to Base Year and Election Year.[29]

M.T. Pockets and his wife, Holly, file joint returns and claim the standard deduction and two personal exemption deductions each year. They had $5,000 of taxable income in each of the years 2012 and 2013, and $30,000 of taxable income in 2014. They did not elect farm income averaging for those years. The Pockets had $95,000 of taxable income and elected to average $30,000 of their $80,000 electible farm income in 2015. This resulted in a $12,322 income tax liability as shown on their 2015 Schedule J (Form 1040) in **Figure 1**.

In 2016, the Pockets had a $40,000 farm NOL, and they elected to forgo the 5-year carryback because their taxable income in 2011, 2012, and 2013 was lower than their taxable income in 2014 and 2015. Therefore, they carried the $40,000 NOL back to 2014 using the 2-year carryback rule.

The $40,000 NOL deduction reduces the Pockets' 2014 taxable income to a negative $10,000 ($30,000 – $40,000) and reduces their income tax from $3,596 to zero.

[26] Harris, *supra* n. 12.
[27] Treas. Reg. § 1.1301-1(d)(2)(i).
[28] *Id*.
[29] Harris, *supra* n. 12.

The Pockets can report the tax reduction as a refund request on Form 1045, Application for Tentative Refund, or on a 2014 Form 1040X, Amended U.S. Individual Income Tax Return.

The Pockets complete Schedule B (Form 1045) to determine their NOL carryover to 2015. It shows that $37,900 of the NOL was absorbed by the 2014 modified taxable income, so they can carry only $2,100 of the NOL to 2015 (see **Figure 2**). That $2,100 is added back to the $10,000 negative 2014 taxable income to compute the 2014 base-year taxable income, as shown on the 2014 Taxable Income Worksheet from the Schedule J (Form 1040) instructions (see **Figure 3**).

The Pockets carry the negative $7,900 of 2014 base-year taxable income to an amended Schedule J (Form 1040) for 2015. It replaces the $30,000 taxable income reported on line 13 of the original Schedule J (Form 1040) and reduces the tax reported on line 16 from $5,093 to $210, as shown in **Figure 4**.

The $2,100 NOL carried to 2015 reduces their 2015 taxable income on line 1 of Schedule J (Form 1040) to $92,900 ($95,000 – $2,100). Because the $2,100 NOL deducted in 2015 is a farm NOL, it reduces the farm income that is eligible for income averaging from $80,000 to $77,900. If the Pockets do not change their elected farm income, their tax on line 4 is reduced by $315 ($8,831 – $8,516).

To summarize, the $40,000 NOL carryback from 2016 that was deducted on their 2014 and 2015 tax returns reduced the Pockets' 2014 income taxes by $3,596 and their 2015 income taxes by $1,602 ($12,322 – $10,720), for a $5,198 ($3,596 + $1,602) total income tax reduction.

Note that the income averaging rules allowed the Pockets to offset the $10,000 of 2015 elected farm income that was taxed at their 2014 tax rate with their $7,900 personal exemptions deduction from 2014, even though the 2016 NOL carryback reduced their 2014 income below zero.

V. Application & Observations

A. Income averaging can apply to more than just your "farmer" clients.

B. If lower brackets exist in any of the base years, an election to average income should be made. Income averaging provides flexibility with the ability to elect any portion of current year income for averaging, just remember whatever portion is elected must be divided evenly over the base years.

C. Despite much lower grain and cattle prices, some farm incomes may still be higher in 2016 as there was a very large crop, many farmers had grain stored from 2015 when the 2016 harvest began and could have been forced to sell to make room for the 2016 crop. Practitioners may consider advising some clients to increase income in 2016 by way of

grain sales or reducing prepaid expenses in order to fill up lower brackets from 2013, 2014 and 2015 by way of income averaging. Remember farm clients have the option of pulling deferred grain contracts into current year income on a contract-by-contract basis. This may reduce the amount of income some clients are pushing into future tax years by way of deferred grain sales, prepaid expenses, depreciation, etc.

D. In some cases preparers may consider amending open tax years (2013, 2014, 2015) to make use of averaging in 2010, 2011 and 2012. This is particularly important if you've taken over a return in the past few years.

E. Income averaging has no effect on SE tax. This affords clients eligible for income averaging to spike income every three or four years with the intention of exceeding the SE base ($118,500 in 2016). Income averaging will bring the lower brackets from the base years into the high income year in order to smooth out the income tax cost of the high year. The large income may only be exposed to the 2.9% or 3.8% Medicare rate if the SE base is exceeded.

   This option may be attractive to clients with significant carryover grain, especially if grain prices move higher. This option may also be attractive to clients who continue to prepay substantial expenses as it allows them to push less income forward while saving SE tax.

FIGURE 1. 2015 TAXES BEFORE NOL CARRYBACK

SCHEDULE J (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Income Averaging for Farmers and Fishermen

► Attach to Form 1040 or Form 1040NR.
► Information about Schedule J and its separate instructions is at *www.irs.gov/schedulej.*

OMB No. 1545-0074

2015

Attachment Sequence No. 20

Name(s) shown on return: **M. T. Pockets**

Social security number (SSN): **172-01-1301**

1	Enter the taxable income from your **2015** Form 1040, line 43, or Form 1040NR, line 41			1	95,000
2a	Enter your **elected farm income** (see instructions). **Do not** enter more than the amount on line 1			2a	30,000
	Capital gain included on line 2a:				
b	Excess, if any, of net long-term capital gain over net short-term capital loss	2b			
c	Unrecaptured section 1250 gain	2c			
3	Subtract line 2a from line 1			3	65,000
4	Figure the tax on the amount on line 3 using the **2015** tax rates (see instructions)			4	8,831
5	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 11. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 15. • 2012 but not 2013 or 2014, enter the amount from your 2012 Schedule J, line 3. Otherwise, enter the taxable income from your **2012** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, see instructions.	5	5,000		
6	Divide the amount on **line 2a** by 3.0	6	10,000		
7	Combine lines 5 and 6. If zero or less, enter -0-	7	15,000		
8	Figure the tax on the amount on line 7 using the **2012** tax rates (see instructions)			8	1,500
9	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 15. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 3. Otherwise, enter the taxable income from your **2013** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, see instructions.	9	5,000		
10	Enter the amount from line 6	10	10,000		
11	Combine lines 9 and 10. If less than zero, enter as a negative amount	11	15,000		
12	Figure the tax on the amount on line 11 using the **2013** tax rates (see instructions)			12	1,500
13	If you used Schedule J to figure your tax for 2014, enter the amount from your 2014 Schedule J, line 3. Otherwise, enter the taxable income from your **2014** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, see instructions	13	30,000		
14	Enter the amount from line 6	14	10,000		
15	Combine lines 13 and 14. If less than zero, enter as a negative amount	15	40,000		
16	Figure the tax on the amount on line 15 using the **2014** tax rates (see instructions)			16	5,093
17	Add lines 4, 8, 12, and 16			17	16,924

18	Amount from line 17			18	16,924
19	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 12. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 16. • 2012 but not 2013 or 2014, enter the amount from your 2012 Schedule J, line 4. Otherwise, enter the tax from your **2012** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 42;* or Form 1040NR-EZ, line 15.	19	503		
20	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 16. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 4. Otherwise, enter the tax from your **2013** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 42;* or Form 1040NR-EZ, line 15.	20	503		
21	If you used Schedule J to figure your tax for 2014, enter the amount from your 2014 Schedule J, line 4. Otherwise, enter the tax from your **2014** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 42;* or Form 1040NR-EZ, line 15 . .	21	3,596		
	*__Only__ include tax reported on this line that is imposed by section 1 of the Internal Revenue Code (see instructions). **Do not** include alternative minimum tax from Form 1040A.				
22	Add lines 19 through 21			22	4,602
23	**Tax.** Subtract line 22 from line 18. Also include this amount on Form 1040, line 44; or Form 1040NR, line 42			23	12,322

Caution: Your tax may be less if you figure it using the 2015 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or Schedule D Tax Worksheet. Attach Schedule J only if you are using it to figure your tax.

FIGURE 2. NOL CARRYOVER TO 2015

Form 1045 (2016) Page 4

Schedule B—NOL Carryover (see instructions)

Complete one column before going to the next column. Start with the earliest carryback year.	2nd preceding tax year ended ▶	____ preceding tax year ended ▶	____ preceding tax year ended ▶
1 **NOL deduction** (see instructions). Enter as a positive number	40,000		
2 Taxable income before 2016 NOL carryback (see instructions). Estates and trusts, increase this amount by the sum of the charitable deduction and income distribution deduction	30,000		
3 Net capital loss deduction (see instructions)	0		
4 Section 1202 exclusion. Enter as a positive number	0		
5 Domestic production activities deduction	0		
6 Adjustment to adjusted gross income (see instructions)	0		
7 Adjustment to itemized deductions (see instructions)	0		
8 Individuals, enter deduction for exemptions (minus any amount on Form 8914, line 6, for 2006 and 2009; line 2 for 2008). Estates and trusts, enter exemption amount	7,900		
9 Modified taxable income. Combine lines 2 through 8. If zero or less, enter -0-	37,900		
10 **NOL carryover** (see instructions)	2,100		

FIGURE 3. 2014 TAXABLE INCOME WORKSHEET

2014 Taxable Income Worksheet—Line 13 *Keep for Your Records*

Complete this worksheet if your 2014 taxable income was zero or less. See the instructions above before completing this worksheet.

1. Figure the taxable income from your 2014 tax return (or as previously adjusted) without limiting it to zero. If you had an NOL for 2014, **don't** include any NOL carryovers or carrybacks to 2014. Enter the result as a positive amount	1.	10,000
2. If there is a loss on your 2014 Schedule D, line 21, add that loss (as a positive amount) and your 2014 capital loss carryover to 2015. Subtract from that sum the amount of the loss on your 2014 Schedule D, line 16, and enter the result	2.	
3. If you had an NOL for 2014, enter it as a positive amount. Otherwise, enter as a positive amount the portion, if any, of the NOL carryovers and carrybacks to 2014 that weren't used in 2014 and were carried to years after 2014	3.	2,100
4. Add lines 2 and 3	4.	2,100
5. Subtract line 4 from line 1. Enter the result as a **negative** amount on Schedule J, line 13	5.	7,900

FIGURE 4. 2015 TAXES AFTER NOL CARRYBACK)

SCHEDULE J (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Income Averaging for Farmers and Fishermen

► Attach to Form 1040 or Form 1040NR.
► Information about Schedule J and its separate instructions is at *www.irs.gov/schedulej.*

OMB No. 1545-0074

2015

Attachment Sequence No. 20

Name(s) shown on return: M. T. Pockets

Social security number (SSN): 172-01-1301

1	Enter the taxable income from your **2015** Form 1040, line 43, or Form 1040NR, line 41		1	92,900
2a	Enter your **elected farm income** (see instructions). **Do not** enter more than the amount on line 1		2a	30,000
	Capital gain included on line 2a:			
b	Excess, if any, of net long-term capital gain over net short-term capital loss	2b		
c	Unrecaptured section 1250 gain	2c		
3	Subtract line 2a from line 1		3	62,900
4	Figure the tax on the amount on line 3 using the **2015** tax rates (see instructions)		4	8,516
5	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 11. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 15. • 2012 but not 2013 or 2014, enter the amount from your 2012 Schedule J, line 3. Otherwise, enter the taxable income from your **2012** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, see instructions.	5	5,000	
6	Divide the amount on **line 2a** by 3.0	6	10,000	
7	Combine lines 5 and 6. If zero or less, enter -0-	7	15,000	
8	Figure the tax on the amount on line 7 using the **2012** tax rates (see instructions)		8	1,500
9	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 15. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 3. Otherwise, enter the taxable income from your **2013** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, see instructions.	9	5,000	
10	Enter the amount from line 6	10	10,000	
11	Combine lines 9 and 10. If less than zero, enter as a negative amount	11	15,000	
12	Figure the tax on the amount on line 11 using the **2013** tax rates (see instructions)		12	1,500
13	If you used Schedule J to figure your tax for 2014, enter the amount from your 2014 Schedule J, line 3. Otherwise, enter the taxable income from your **2014** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, see instructions	13	- 7,900	
14	Enter the amount from line 6	14	10,000	
15	Combine lines 13 and 14. If less than zero, enter as a negative amount	15	2,100	
16	Figure the tax on the amount on line 15 using the **2014** tax rates (see instructions)		16	210
17	Add lines 4, 8, 12, and 16		17	11,726

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 25513Y **Schedule J (Form 1040) 2015**

18	Amount from line 17			18	11,726
19	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 12. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 16. • 2012 but not 2013 or 2014, enter the amount from your 2012 Schedule J, line 4. Otherwise, enter the tax from your **2012** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 42;* or Form 1040NR-EZ, line 15.	19	503		
20	If you used Schedule J to figure your tax for: • 2014, enter the amount from your 2014 Schedule J, line 16. • 2013 but not 2014, enter the amount from your 2013 Schedule J, line 4. Otherwise, enter the tax from your **2013** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 42;* or Form 1040NR-EZ, line 15.	20	503		
21	If you used Schedule J to figure your tax for 2014, enter the amount from your 2014 Schedule J, line 4. Otherwise, enter the tax from your **2014** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 42;* or Form 1040NR-EZ, line 15	21	0		
	*__Only__ include tax reported on this line that is imposed by section 1 of the Internal Revenue Code (see instructions). **Do not** include alternative minimum tax from Form 1040A.				
22	Add lines 19 through 21			22	1,006
23	**Tax.** Subtract line 22 from line 18. Also include this amount on Form 1040, line 44; or Form 1040NR, line 42			23	10,720

Caution: Your tax may be less if you figure it using the 2015 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or Schedule D Tax Worksheet. Attach Schedule J only if you are using it to figure your tax.

Bloethe Tax School

New Farmer Credits

5:00 p.m.-5:30 p.m.

Presented by
Steve Ferguson
AG Program Specialist
2015 Grand Avenue
Des Moines, IA 50312
Phone: 515-725-4928

WEDNESDAY, DECEMBER 7, 2016

Title of presentation	Iowa's Beginning Farmer Loan and Tax Credit Programs

Presenter name	Steve Ferguson
Address	Iowa Finance Authority 2015 Grand Avenue Des Moines, IA 50312
Office phone	515-725-4928
Cell phone	515-494-4979
Fax	515-725-4900
Email	steve.ferguson@iowa.gov

Iowa's Beginning Farmer Loan and Tax Credit Programs

Basic information

1. Iowa Agricultural Development Division Staff
2. Iowa Agricultural Development Division History
   a. Formerly Iowa Agricultural Development Authority
   b. Became a Division of the Iowa Finance Authority in July, 2013
3. Administers loan and tax credit programs to benefit Beginning Farmers in Iowa.

Iowa Agricultural Development Division Programs

1. Beginning Farmer Loan Program (BFLP)
2. Loan Participation Program (LPP)
3. Beginning Farmer Tax Credit Program (BFTC)
4. Beginning Farmer Custom Farming Tax Credit Program (BFCF)
5. DNR Lease to Beginning Farmer Program -- Administered by DNR

Who is a Beginning Farmer? -- Same for ALL Programs

1. 2017 maximum net worth - less than $645,284
2. This amount changes every year
3. At least 18 years old (No upper age limit)
4. Resident of Iowa
5. Must be owner/operator of the farm
6. Cannot lease to someone else or hire someone else to do the work
7. Must have sufficient education, training and experience to manage farm operation
8. Not the same as FSA requirement of >3 years and <10 years
9. Must have access to working capital, farm machinery, livestock and/or ag land

Approval Procedures

1. All applications are due the by 1st of month
2. Reviewed by IADD board -- usually the 4th Wednesday of the month
3. Recommendation made to the IFA board -- usually the 1st Wednesday of the following month
4. After Board meeting
   a. Approval letter sent or
   b. Letter with additional requirements needed before application can be approved

Application Packets

1. For all IADD Programs
2. Program Application
3. Financial Statement less than 30 days old
   a. Signed by Beginning Farmer and spouse
   b. Witnessed by financial professional that helped prepare statement
4. Background letter explaining
   a. Education, training and experience for the anticipated farm operation
   b. Access to working capital, farm machinery, livestock and/or agricultural land
   c. Explain agreement for machinery use (rental or trading labor for use)
5. Application Fee
6. Other documentation specific to each program

Beginning Farmer Loan Program

1. Low-interest loan through a lender or contract seller
   a. Financed through a tax-exempt bond issued by IFA
   b. Interest earned is exempt from federal income taxes
   c. For contract sellers, interest is both federal and state tax-exempt income
2. Because the interest earned is tax-exempt, lenders and contract sellers can charge the beginning farmer a lower interest rate
3. Typically the beginning farmer will experience about a 25% interest rate reduction using the Beginning Farmer Loan Program (BFLP)

Beginning Farmer Loan Uses

1. Purchase
   a. Agricultural land
   b. Depreciable machinery or equipment
   c. Breeding livestock-not feeders
2. Make improvements
   a. Existing buildings
   b. New farm improvements
3. Cannot finance
   a. Operating expenses
   b. Refinance previous purchases

Financing or Constructing a Facility

1. If financing a feeding facility, per federal regulations the feeding contract must be on a per head/per day basis
2. This restriction can cause complications, but most integrators are willing to change the contract when they know it is a requirement of the financing
3. The per head/per day contract format must be maintained for the life of the loan
4. The program cannot be used for any type of rental, so the federal restriction on the feeding contract is to distinguish between
    a. Rental agreement (per pig space) -- not eligible
    b. Service agreement (per head/per day) – is eligible

Maximum bond amounts - adjusts annually on January 1st

1. $524,200 for real estate
2. $250,000 for existing buildings or farm improvements and new depreciable agricultural property
3. $62,500 for “used” depreciable agricultural property
4. Federal legislation has been introduced to increase all maximums to the maximum bond amount – H.R. 5335

Restrictions

1. Dwelling may not exceed 5% of bond proceeds
2. CRP ground may not exceed 25% of bond proceeds
3. Combination of the above can be used up to maximum bond

Other BFLP Factors -- additional eligibility requirement

1. If beginning farmer does now or has in the past owned land it must be less than 30% of the county median
    (The federal legislation introduced would also change the maximum land ownership from 30% of the county median to 30% of the county average.)
2. Purchases from closely related family members (parents, grandparents or siblings) are permitted but:
    a. They must be financed through a 3rd party lender (no contract sale)
    b. Must be sold for at least the appraised value
3. Contract sale allowed if not immediate family -- can be with aunts, uncles, cousins.

Other BFLP Factors

1. May reapply and benefit from the program until:
    a. Maximum bond amount has been used
    b. Land owned exceeds the county limit
2. Beginning farmer negotiates down payment/loan terms with bank or contract seller

3. If eligible, down payment assistance may be used with:
   a. Farm Service Agency (FSA) loan (5/45/50 program)
   b. IADD Loan Participation Program -- only when financed through a bank

Using the BFLP and FSA 5/45/50 Together

1. Example of Savings Using the Beginning Farmer Loan Program
   Comparing 5.33% Interest with reduced 4.00% Interest via BFLP

Other Provisions and Fees

1. Applications can be approved if bank loan or contract transaction completed:
   BUT must be approved by IADD-IFA board within 60 days of any financing
2. Non-refundable $50 application fee
3. Closing fee
   a. 1.50% of Bond up to $250,000
   b. 0.75% of Bond amount over $250,000
   c. $300 minimum
   d. Closing fee is paid when loan closes

How To Get Started

1. Talk to your lender and let them know you would like to use the IADD BFLP
2. Lender will underwrite your loan to determine if they are willing to finance the project
3. Once bank approval has been decided:
   a. Loan term and tax exempt interest rate will be negotiated
   b. Lender and beginning farmer jointly fill out application
4. Applications, program summaries and additional information is available at website: IowaFinanceAuthority.gov/IADD
5. Submit application materials to IADD by the 1st of the month

Questions on the Beginning Farmer Loan Program?

Loan Participation Program

Background Information

1. Established in 1996
2. Supplements a beginning farmer's down payment to purchase agricultural assets
3. Can be used for the same purposes as the Beginning Farmer Loan Program (BFLP)
4. Can be used in conjunction with the Beginning Farmer Loan Program (BFLP)

Loan Terms

1. IADD's LPP reduces the lender's risk -- LPP is Last-in/last-out
2. Allows lender to finance more of the beginning farmer's project
3. Maximum loan participation is 30% of project up to $150,000
4. Current interest rate is 2.50%
5. Fixed for 5 years then adjusted 1.00% above FSA Direct Farm Ownership Program
6. 10 year balloon (amortized over 20 years for land and 12 years for facilities)
7. There are no restrictions on related party transactions

LPP Underwriting Criteria

1. Current assets to current liabilities > 1.1 at time of application
2. Farm debt-to-asset ratio < 80% at closing
3. Aggregate amount of participated loan (total amount financed) < 3 times the borrower's net worth
4. Debt repayment ratio > 120%
5. Off-farm income < 50% of projected gross income
6. Loan-to-value < 100% of appraised value
7. Collateral appraisals by qualified 3rd party appraiser
8. Property not eligible if house value > 50% of appraisal

Other Provisions and Fees

1. Applications can be approved if bank loan has been completed: BUT must be approved by IADD-IFA board within 60 days of any financing
2. Non-refundable application fee -- $100 closing fee
3. Closing fee:
   a. 1.25% of IADD participation loan -- $300 minimum
   b. Fee is paid when loan closes

Using the LPP and BFLP Together For Hog Facility Construction

1. Example of savings using the Loan Participation Program
   Comparing 5.33% Interest with 2.5% Interest

How To Get Started

1. Talk to your lender and let them know you would like to use the LPP
2. Lender will underwrite your loan to determine if they are willing to participate in financing the project
3. Once bank approval has been determined, fill out the application with your lender
4. Applications, programs summaries and additional information is available at: IowaFinanceAuthority.gov/IADD

5. Submit application and attachments to IADD by the 1st of the month
   a. Pro-forma financial statement
   b. Cash flow analysis
   c. 3 Years of Federal Tax Returns
6. Application is reviewed by IADD Board Credit Committee
7. Application is approved by IADD and IFA Boards
8. Process typically takes 5-6 weeks
9. Interim financing is allowed
10. IADD works with bank on closing documents--funds are sent to bank via ACH
11. All loan payments are made directly to the bank
12. Bank sends IADD its payment amount

Questions on the Loan Participation Program?

Beginning Farmer Tax Credit Program

1, Established in 2007
2. Encourages agricultural asset owners to lease land, equipment and/or breeding livestock to qualified beginning farmers
3. Provides asset owner a credit on Iowa income taxes owed
   a. 7% on cash rent
   b. 17% on crop share
   c. 1% additional first year if beginning farmer is a military veteran

Key Requirements

1. Lease must have a term between 2-5 years
2. Cash rent amount or crop share percentage does not have to be the same for each year of the lease as long as it is established on application
3. Tax credit issued annually through lease term
4. Tax credit can be renewed at expiration
   a. Must reapply
   b. Beginning Farmer must still qualify
5. Flex leases only calculated on base rent -no tax credit on bonus/variable factors
6. Lease value cannot be substantially higher/lower than market
7. Lease can be between related parties – including immediate family members

Key Requirements

1. If crop share lease, Beginning Farmer must receive at least 33% of crop
2. FSA Form 156 must be submitted with application
   a. Confirms farm location, acres, ownership

b. Beginning farmer must be listed as operator
c. All names of application, lease and 156 MUST match

Example Calculating Cash Rent Tax Credit

1. 160 acres cash rented at $200 per acre
2. Gross lease income: 160 x $200 = $32,000
3. Iowa income tax credit: $32,000 x 7% = $2,240

Example Calculating Crop Share Tax Credit

1. Allocation of acres and yield
   a. 50% to corn and 50% to beans
   b. Yield and price determined by USDA data
      i. Yield = Previous year's county's T-yield
      ii. Price = USDA RMA previous year's state fall price
      iii. Yield and price information is on website
2. Crop share is calculated on the asset owners percentage

Example Calculating Crop Share Tax Credit *(using a specific county's yield info)*

1. 160 Acres allocated ½ to corn, ½ to soybeans with 50/50 crop share:
   a. 80 acres corn x 167 bu/acre x 50% x $3.83 x 17% = $4,349.35
      Total corn crop = 13,360 bushels
      Owner's share = 6,680 bu.
   b. 80 acres soybeans x 48 bu/acre x 50% x $8.91 x 17% = $2,908.22
      Total soybeans crop = 3,840 bushels
      Owner's share = 1,920 bu.
      Total Iowa tax credit = $7,257.57

Calculating Cow-Calf Share Lease

1. Eligibility Requirements:
   a. Cow-calf lease operation is based in Iowa year-round
   b. Beginning Farmer provides all labor
   c. Beginning Farmer must receive at least 33.3% of the calf crop
   d. Assume 95% calf crop, allowing for 5% in death losses
   e. Asset Owner provides all breeding stock and/or semen for the herd
2. Factors Used to Calculate Tax Credit Amount:
   a. Weight: all calves will be considered at 550 lbs.
   b. Prices : FSA prices for 550 lb. feeder steer used for cash flows
   c. 2016 FSA price used = $2.10 per lb. (adjusted each January 1st)

Other Provisions and Fees

1. September 1st application deadline
2. $200 Application fee -- $100 more after July 1st
3. Service fee
   a. $50/year for cash rent lease
   b. $100/year for crop share lease
4. Application and service fees are due with application
5. Tax certificates sent in January

Lease Change Requests

1. Must be received/approved by IADD board before enacted
2. Changes only beneficial to Beginning Farmer will be considered
   a. Reduction of cash rent amount (no increases)
   b. Additional acres added to the lease
   c. Swapping one Beginning Farmer for another due to circumstances
3. Asset owner cannot cancel lease
4. Requests must be received before December 1st
5. $100 Processing Fee
6. No $100 fee required for:
   a. Asset owner address changes
   b. Death of spouse who received tax credit certificate

How to get started

1. Beginning Farmer negotiates with asset owner the lease terms
2. Application is prepared/signed by both the Asset Owner and the Beginning Farmer
3. Applications and additional information is available at: IowaFinanceAuthority.gov/IADD
4. Submit Tax Credit application and attachments by September 1st
5. IFA staff reviews application for eligibility and completeness
6. Approval letters are sent out after IFA Board approval
7. Tax Credit Certificates mailed in January through the term of the approved lease

Questions on the Beginning Farmer Tax Credit Program?

Custom Farming Tax Credit Program

1. Established in 2013
2. Encourages agricultural asset owners to custom hire qualifying beginning farmers
3. Provides asset owner a credit against Iowa income taxes
4. Tax credit equals 7% of amount paid to beginning farmer

Program Requirements

1. Contracted work must be for the production of crops or livestock
2. Contract terms set by the Beginning Farmer and the person hiring him/her to do custom work
3. Contract must be:
   a. In writing
   b. Less than 24 months
   c. Signed by all parties involved
4. Beginning farmer must provide everything needed for contracted work (including labor and machinery)
5. Taxpayer must provide proof of payment
6. Contract cannot be between spouses, children, or siblings

Other Requirements and Fees

1. November 1st application deadline
2. $200 Application fee -- $50 more of application received after October 1st
3. Tax certificates sent in January
4. If the same person hires the same beginning farmer for multiple jobs, all work can be put on one application
5. Separate applications needed if beginning farmer does contract work for multiple farmers

IADD Tax Credit Programs

1 IADD has $12 million in Iowa tax credits to allocate between the two programs
2 $50,000 maximum tax credit per year per application or taxpayer
3 Unused credits
   a. Can be carried forward 10 years
   b. Cannot carry back to prior years

How to get started!

1. Submit Custom Farming application packet by November 1st
2. Signed Custom Contract (up to 24 months)
3. Verification of Payment – copy of check received
4. Applications and additional information is available at IowaFinanceAuthority.gov/IADD
5. IFA staff reviews application for eligibility and completeness
6. Approval letters are sent out after IFA Board approval
7. Tax Credit Certificates mailed each January through term of the approved contract

Questions on the Custom Farming Tax Credit Program?

DNR Lease to Beginning Farmer Program

1. Created in 2013
2. Provides leasing opportunities to Iowa beginning farmers
3. Offered and administered by the Iowa Department of Natural Resources (DNR)
4. IADD must certify that Beginning Farmer is eligible
5. Same eligibility requirements as other IADD programs
6. For more information on the program, contact DNR

Available to Provide Workshops For Your Clients

1. We do workshops all around Iowa for banks, CPAs, attorney, ag organizations
2. Let us know when and where you would like a workshop provided in your community

10 Regional Workshops In 2017

Tues, 2-14-17	Northeast Iowa CC	Calmar
Thur, 2-16-17	Hawkeye CC	Waterloo
Wed, 2-22-17	Iowa Lakes CC	Emmetsburg
Thurs. 2-23-17	Iowa Central CC	Ft. Dodge
Tues, 2-28-17	North Iowa CC	Mason City
Thur, 3-2-17	Des Moines CC	Ankeny
Tues, 3-7-17	Southwestern CC	Creston
Thur, 3-9-17	Indian Hills CC	Centerville
Tues, 3-14-17	Kirkwood CC	Cedar Rapids
Tues, 6-6-17	Muscatine CC	Wilton

For More Information Contact

Iowa Finance Authority
2015 Grand Ave
Des Moines, IA 50312
515.725.4900
IADD@iowa.gov
IowaFinanceAuthority.gov/IADD

Steve's cell phone: 515-494-4979

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

2016 Beginning Farmer Loan and Tax Credit Programs

Iowa Agricultural Development Division Staff

Steve Ferguson
Tax Credit Program Specialist
515.725.4928
steve.ferguson@iowa.gov

Tammy Nebola
Loan Program Specialist
515.725.4919
tammy.nebola@iowa.gov

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Iowa Agricultural Development Division

- Formerly Iowa Agricultural Development Authority
- Became a Division of the Iowa Finance Authority in July, 2013
- Administers loan and tax credit programs to benefit Beginning Farmers in Iowa.

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Iowa Agricultural Development Division Programs

- Beginning Farmer Loan Program (BFLP)
- Loan Participation Program (LPP)
- Beginning Farmer Tax Credit Program (BFTC)
- Beginning Farmer Custom Farming Tax Credit Program (BFCF)
- DNR Lease to Beginning Farmer Program*

  * Administered by DNR

Who is a Beginning Farmer?
Same for ALL Programs

- 2017 maximum net worth less than $645,284
  - This amount changes every year
- At least 18 years old (No upper age limit)
- Resident of Iowa
- Must be owner/operator of the farm
  - Cannot lease to someone else or hire someone else to do the work
- Must have sufficient education, training and experience for the anticipated farm operation
  - But not the same as FSA requirement of >3 years and <10 years
- Must have access to adequate working capital, farm machinery, livestock and/or agricultural land

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Approval Procedures

- All applications are due the by 1st of month
- Reviewed by IADD board
  - Usually the 4th Wednesday of the month
- Recommendation made to the IFA board
  - Usually meets 1st Wednesday of the following month
- After Board meeting
  - Approval letter sent or
  - Letter detailing additional requirements needed before application can be approved

Application Packets

- For all IADD Programs
  - Program Application
  - Financial Statement less than 30 days old
    - Signed by Beginning Farmer and spouse
    - Witnessed by financial professional that helped prepare statement
  - Background letter explaining
    - Education, training and experience for the anticipated farm operation
    - Access to working capital, farm machinery, livestock and/or agricultural land
      - Explain agreement for machinery use (rental or trading labor for use)
  - Application Fee
  - Other documentation specific to each program

Beginning Farmer Loan Program

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Beginning Farmer Loan Program

- Low-interest loan through a lender or contract seller
  - Financed through a tax-exempt bond issued by IFA
  - Interest earned is exempt from federal income taxes
  - For contract sellers, interest is both federal and state tax-exempt income
- Because the interest earned is tax-exempt, lenders and contract sellers can charge the beginning farmer a lower interest rate
- Typically the beginning farmer will see about a 25% interest rate reduction using the Beginning Farmer Loan Program (BFLP)

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Beginning Farmer Loan Uses

- **Purchase**
  - Agricultural land
  - Depreciable machinery or equipment
  - Breeding livestock-not feeders
- **Make improvements**
  - Existing buildings
  - New farm improvements
- **Cannot finance**
  - Operating expenses
  - Refinance previous purchases

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Financing or Constructing a Facility

- If financing a feeding facility, per federal regulations the feeding contract must be on a per head/per day basis
- This restriction can cause complications, but most integrators are willing to change the contract when they know it is a requirement of the financing
- The per head/per day contract format must be maintained for the life of the loan
- The program cannot be used for any type of rental, so the federal restriction on the feeding contract is to distinguish between
  - Rental agreement (per pig space)
    - Not eligible
  - Service agreement (per head/per day)
    - Eligible

Maximum Bond Amounts

Maximum bond amount - adjusts annually on January 1st

- $524,200 for real estate
- $250,000 for existing buildings or farm improvements and new depreciable agricultural property
- $ 62,500 for “used” depreciable agricultural property
- Federal legislation has been introduced to increase all maximums to the maximum bond amount – H.R. 5335

Restrictions

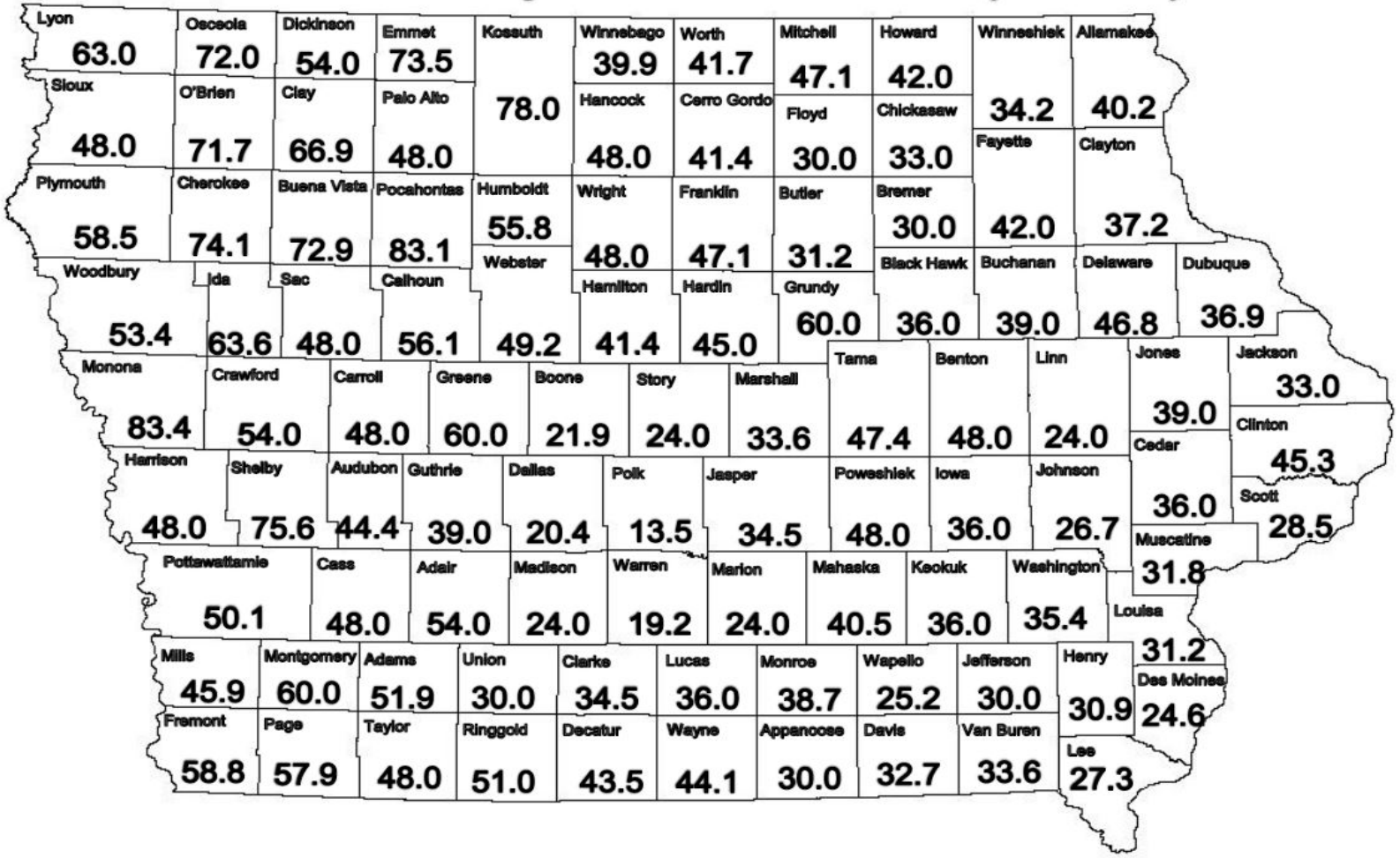
- Dwelling may not exceed 5% of bond proceeds
- CRP ground may not exceed 25% of bond proceeds
- Combination of the above can be used up to maximum bond

Other BFLP Factors

- Additional Eligibility requirement
  - If beginning farmer does now or has in the past owned land it must be less than 30% of the county median
    - The federal legislation introduced would also change the maximum land ownership from 30% of the county median to 30% of the county average.
  - Purchases from closely related family members (parents, grandparents or siblings) are permitted but:
    - they must be financed through a 3rd party lender (no contract sale)
    - Must be sold for at least the appraised value
  - Contract sale allowed if not immediate family
    - So can be with aunts, uncles, cousins, etc.

IOWA AGRICULTURAL DEVELOPMENT DIVISION

30% County Farm Median (Acres)



IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Other BFLP Factors

- May reapply and benefit from the program until the maximum bond amount has been used or land owned exceeds the limit
- Beginning farmer negotiates down payment and loan terms with bank or contract seller
- If eligible, down payment assistance may be used with:
  - Farm Service Agency (FSA) loan (5/45/50 program)
  - IADD Loan Participation Program (LPP) loan
    - Only when financed through a bank

Using the BFLP and FSA 5/45/50 Together

% of Project	Funding Source	Total	Interest Rate	1st year Interest
5% of project	Down payment	$ 43,158		
45% of project	FSA Loan	$300,000	1.50%	$4,500
50% of project	BFLP Aggie Bond	$520,000	4.00%	$20,800
		$863,158		**$25,300**

% of Project	Funding Source	Total	Interest Rate	1st year Interest
100% of project	Traditional Loan	**$863,158**	**5.33%**	**$46,006**

$20,706 Interest Savings in the 1st year

IOWA AGRICULTURAL DEVELOPMENT DIVISION

Example of Savings Using the Beginning Farmer Loan Program

5.33% Interest Loan Amortization Schedule

Loan Information		Summary	
Loan Amount	520,000.00	Rate (per period)	5.330%
Annual Interest Rate	5.33%	Number of Payments	30
Term of Loan in Years	30	Total Payments	1,053,292.73
First Payment Date	1/1/2015	Total Interest	533,292.73
Payment Frequency	Annual	Est. Interest Savings	0.06
Compound Period	Annual		
Payment Type	End of Period		
Annual Payment	**35,109.76**		

4.00% Interest Loan Amortization Schedule

Loan Information		Summary	
Loan Amount	520,000.00	Rate (per period)	4.000%
Annual Interest Rate	4.00%	Number of Payments	30
Term of Loan in Years	30	Total Payments	902,149.54
First Payment Date	1/1/2015	Total Interest	382,149.54
Payment Frequency	Annual	Est. Interest Savings	0.01
Compound Period	Annual		
Payment Type	End of Period		
Annual Payment	**30,071.65**		

	5.33% Interest	4.00% Interest	Total Savings using BFLP
Loan Amount	$520,000	$520,000	
Total Interest	$533,293	$382,150	**$151,143**
Annual P&I Payments	$35,110	$30,072	**$5,038**
Total P&I Payments	$1,053,293	$902,150	**$151,143**

IOWA AGRICULTURAL DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Other Provisions and Fees

- Applications can be approved if bank loan or contract transaction completed:
  - **BUT** must be approved by IADD-IFA board within 60 days of any financing
- Non-refundable $50 application fee
- Closing fee
  - 1.50% of Bond up to $250,000
  - 0.75% of Bond amount over $250,000
  - $300 minimum
- Closing fee is paid when loan closes

How to get started!

- Talk to your lender and let them know you would like to use the IADD Beginning Farmer Loan Program (BFLP)
- Lender will underwrite your loan to determine if they are willing to finance the project
- Once bank approval has been decided:
  - Loan term and tax exempt interest rate will be negotiated
  - Lender and beginning farmer jointly fill out application
  - Applications, program summaries and additional information is available our website at:

IowaFinanceAuthority.gov/IADD

How to get started!

- Submit application and all attachments to IADD by the 1st of the month
- Application is reviewed/approved by IADD-IFA Boards
  - process typically takes about six weeks
  - interim financing allowed
- After approval, IADD sends loan closing packet to lender
  - Loan is assigned to lender or contract seller at closing
  - All payments are made directly to the lender or contract seller

Questions

on the

Beginning Farmer Loan Program?

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Loan Participation Program

Loan Participation Program

- The Loan Participation Program (LPP):
  - Established in 1996
  - Supplements a beginning farmer's down payment to purchase agricultural assets
- The program can be used for the same purposes as the Beginning Farmer Loan Program (BFLP)
- Can be used in conjunction with the Beginning Farmer Loan Program (BFLP)

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Maximum and Loan Terms

- IADD's LPP reduces the lender's risk:
  - LPP is Last-in/last-out
  - Allows lender to finance more of the beginning farmer's project
- Maximum loan participation is 30% of project up to $150,000
- Current interest rate is 2.50%
  - Fixed for 5 years then adjusted
    - 1.00% above FSA Direct Farm Ownership Down Payment Loan Program
- 10 year balloon (amortized over 20 years for land and 12 years for facilities)
- There are no restrictions on related party transactions

LPP Underwriting criteria

- Current assets to current liabilities > 1.1 at time of application
- Farm debt-to-asset ratio < 80% at closing
- Aggregate amount of participated loan (total amount financed) < 3 times the borrower's net worth
- Debt repayment ratio > 120%
- Off-farm income < 50% of projected gross income
- Loan-to-value < 100% of appraised value
  - Collateral appraisals by qualified 3rd party appraiser
  - Property not eligible if house value > 50% of appraisal

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Other Provisions and Fees

- Applications can be approved if bank loan has been completed:
  - **BUT** must be approved by IADD-IFA board within 60 days of any financing
- Non-refundable application fee
  - $100
- Closing fee
  - 1.25% of IADD participation loan
  - $300 minimum
- Closing fee is paid when loan closes

Using the LPP and BFLP Together for Hog Facility Construction

% of Project	Funding Source	Total	Interest Rate	1st year Interest
30% of project	LPP Loan	$150,000	2.50%	$3,750
F.I. Limit	BFLP Aggie Bond	$250,000	4.00%	$10,000
Remaining	Traditional Loan	$300,000	5.33%	$15,990
12 year amort.		**$700,000**		**$29,740**

% of Project	Funding Source	Total	Interest Rate	1st year Interest
100% of project	Traditional Loan	**$700,000**	**5.33%**	**$37,310**

$7,570 Interest Savings in the 1st year

IOWA AGRICULTURAL DEVELOPMENT DIVISION

Example of Savings Using the Loan Participation Program

5.33% Interest Loan Amortization Schedule

Loan Amount	$150,000	Number of Payments	12
Annual Interest Rate	5.33%	Total Payments	$206,882.96
Term of Loan in Years	12	Total Interest	$56,882.96
Annual Payment	$17,240.24	Balloon Payment	None

2.50% Interest Loan Amortization Schedule

Loan Amount	$150,000	Number of Payments	10
Annual Interest Rate	2.50%	Total Payments	$174,415.50
Term of Loan in Years	12	Total Interest	$24,415.54
Annual Payment	$14,623.07	Balloon Payment	$42,807.91

	5.33% Interest	2.50% Interest	Total Savings using LPP
Loan Amount	$150,000	$150,000	
Total Interest	$56,883	$24,416	**$32,467**
Annual P&I Payments	$17,240	$14,623	**$2,617**
Total P&I Payments	$206,883	$174,416	**$32,467**

IOWA AGRICULTURAL DEVELOPMENT DIVISION

How to get started!

- Talk to your lender and let them know you would like to use the IADD Loan Participation Program (LPP)
- Lender will underwrite your loan to determine if they are willing to participate in financing the project
- Once bank approval has been determined, fill out the application with your lender
- Applications, programs summaries and additional information is available at:

  IowaFinanceAuthority.gov/IADD

- Submit application and attachments to IADD by the 1st of the month
  - Pro-forma financial statement
  - Cash flow analysis
  - 3 Years of Federal Tax Returns

IOWA AGRICULTURAL DEVELOPMENT DIVISION

How to get started!

- IADD will review and underwrite the application
- Application is reviewed by IADD Board Credit Committee
- Application is approved by IADD-IFA Board
  - process which typically takes 5-6 weeks
  - interim financing is allowed
- IADD works with bank on closing documents
- At closing, funds are sent to bank via ACH
- All loan payments are made directly to the bank
- Bank sends IADD its payment amount

Questions

on the

Loan Participation Program?

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Beginning Farmer Tax Credit Program

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Beginning Farmer Tax Credit Program

- Established in 2007
- Encourages agricultural asset owners to lease land, equipment and/or breeding livestock to qualified beginning farmers
- Provides owner a credit on **Iowa** income taxes owed
  - 7% on cash rent
  - 17% on crop share
  - 1% additional first year if beginning farmer is a military veteran

Key Requirements

- Lease must have a term between 2-5 years
  - Cash rent amount or crop share percentage does not have to be the same for each year of the lease as long as it is established on application
- Tax credit issued annually through lease term
- Renewable at expiration
  - Must reapply
  - Beginning Farmer must still qualify
- Flex leases only calculated on base rent
  - No tax credit on bonus/variable factors
- Lease value cannot be substantially higher/lower than market
- Lease can be between related parties – including immediate family members

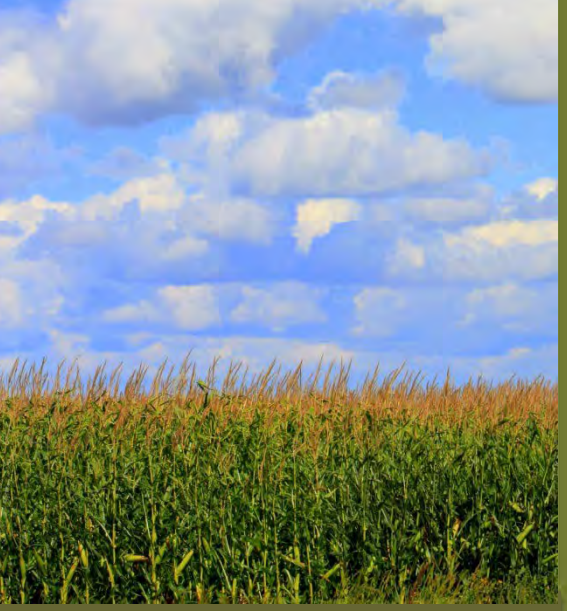
Key Requirements

- If crop share lease, Beginning Farmer must receive at least 33% of crop
- FSA Form 156 must be submitted with application
  - Confirms farm location, acres, ownership
  - Beginning farmer must be listed as operator
- **All Names MUST be the same:**
  - **Names on 156 Form**
  - **Names on lease**
  - **Names on application**

Calculating Cash Rent Tax Credit

- 160 acres cash rented
- $200 per acre
- gross lease income: 160 x $200 = $32,000
- **Iowa** income tax credit: $32,000 x 7% = **$2,240**

IOWA AGRICULTURAL
DEVELOPMENT DIVISION



IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Calculating Crop Share Tax Credit

- Allocation of acres and yield
  - ➢ 50% to corn and 50% to beans
  - ➢ Yield determined by USDA data

    (Historical average of county's T-yield)
- Price = USDA RMA state fall price
  - ➢ County list is on website
- ➢ Crop share is calculated on the asset owners percentage

Corn and Soybean
2016 County Yields and State Fall Prices

(To Calculate Crop Share Tax Credit Amounts)

	CORN			SOYBEANS	
County	Yield	Price	County	Yield	Price
Adair	157	3.83	Adair	46	8.91
Adams	151	3.83	Adams	45	8.91
Allamakee	164	3.83	Allamakee	48	8.91
Appanoose	138	3.83	Appanoose	42	8.91
Audubon	164	3.83	Audubon	49	8.91
Benton	180	3.83	Benton	51	8.91
Black Hawk	172	3.83	Black Hawk	49	8.91
Boone	175	3.83	Boone	48	8.91
Bremer	177	3.83	Bremer	50	8.91

All county information posted at www.Iowafinanceauthority.gov/iadd under Forms and Resources tab.

IOWA AGRICULTURAL DEVELOPMENT DIVISION

Crop Share Example

160 Acres allocated ½ to corn, ½ to soybeans with 50/50 crop share:

- 80 acres corn x 167 bu/acre x 50% x $3.83 x 17% = **$4,349.35**
  - Total corn crop = 13,360 bushels
  - Owner's share = 6,680 bu.
- 80 acres soybeans x 48 bu/acre x 50% x $8.91 x 17% = **$2,908.22**
  - Total soybeans crop = 3,840 bushels
  - Owner's share = 1,920 bu.
- Total **Iowa** tax credit = **$7,257.57**

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Calculating Cow-Calf Share Lease

Eligibility Requirements:

- Cow-calf lease operation is based in Iowa year-round
- Beginning Farmer provides all labor
- Beginning Farmer must receive at least 33.3% of the calf crop
  - assume 95% calf crop, allowing for 5% in death losses
- Asset Owner provides all breeding stock and/or semen for the herd

Factors Used to Calculate Tax Credit Amount:

- Weight : all calves will be considered at 550 lbs.
- Prices : FSA prices for 550 lb. feeder steer used for cash flows
- 2016 FSA price used = $2.10 per lb. (adjusted each January 1st)

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Other Provisions and Fees

- September 1st application deadline
- $200 Application fee
  - $100 more after July 1st
- Service fee
  - $50/year for cash rent lease
  - $100/year for crop share lease
- Application and service fees are due with application
- Tax certificates sent in January

Lease Change Requests

- Must be received/approved by IADD board before enacted
- Changes *only beneficial to Beginning Farmer* will be considered
  - Reduction of cash rent amount (no increases)
  - Additional acres added to the lease
  - Swapping one Beginning Farmer for another due to circumstances
- Asset owner cannot cancel lease
- Requests must be received before December 1st
- $100 Processing Fee
  - No $100 fee required for:
    - Asset owner address changes
    - Death of spouse who received tax credit certificate

How to get started!

- Beginning Farmer negotiates with asset owner the lease terms
- Application is prepared and signed by both the Asset Owner and the Beginning Farmer
- Applications and additional information is available at:

  IowaFinanceAuthority.gov/IADD

- Submit Tax Credit application and attachments by **September 1st**
- IFA staff reviews application for eligibility and completeness
- Approval letters are sent out after IFA Board approval
- Tax Credit Certificates are mailed out each January throughout the term of the approved lease

Questions

on the

Beginning Farmer Tax Credit Program?

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Custom Farming Tax Credit Program

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Custom Farming Tax Credit Program

- Established in 2013
- Encourages agricultural asset owners to custom hire qualifying beginning farmers
- Provides owner a credit against Iowa income taxes
- Credit equals 7% of amount paid to beginning farmer

Program Requirements

- Contracted work must be for the production of crops or livestock
- Contract terms are set by the Beginning Farmer and the person hiring him/her for custom work
- Contract must be:
  - in writing
  - for less than 24 months
  - signed by all parties involved
- Beginning farmer must provide everything needed for contracted work (including labor and machinery)
- Taxpayer must provide proof of payment
- Contract cannot be between spouses, children, or siblings

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Other Requirements and Fees

- November 1st application deadline
- $200 Application fee
  - $50 more after October 1st
- Tax certificates sent in January
- If the same person hires the same beginning farmer for multiple jobs, all work can be put on one application
- If either the beginning farmer or the employer is different, multiple applications are needed

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IADD Tax Credit Programs

- IADD has $12 million in **Iowa** tax credits to allocate between the two programs
- $50,000 maximum tax credit per year per application or taxpayer
- Unused credits
  - Can be carried forward 10 years
  - Cannot carry back to prior years

How to get started!

- Submit Custom Farming application packet by November 1st
  - Signed Custom Contract (up to 24 months)
  - Verification of Payment
- Applications and additional information is available at:

  IowaFinanceAuthority.gov/IADD
- IFA staff reviews application for eligibility and completeness
- Approval letters are sent out after IFA Board approval
- Tax Credit Certificates are mailed out each January throughout the term of the approved contract

Questions

on the

Custom Farming Tax Credit Program?

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

DNR Lease to Beginning Farmer Program

DNR Lease to Beginning Farmer Program

- Created in 2013
- Provides leasing opportunities to Iowa beginning farmers
- Offered and administered by the Iowa Department of Natural Resources (DNR)
- IADD must certify that Beginning Farmer is eligible
  - Same eligibility requirements as other programs
- For more information on the program, contact DNR

Available to Provide Workshops

- Do workshops for banks, CPAs, attorneys, ISU Extension, ag organizations
- Let us know when and where you would like a workshop provided in your community

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

10 Regional Workshops In 2017

From 9:00 am to 11:15 am

• Tues, 2-14-17	Northeast Iowa CC	Calmar
• Thur, 2-16-17	Hawkeye CC	Waterloo
• Wed, 2-22-17	Iowa Lakes CC	Emmetsburg
• Thurs, 2-23-17	Iowa Central CC	Ft. Dodge
• Tues, 2-28-17	North Iowa CC	Mason City
• Thur, 3-2-17	Des Moines CC	Ankeny
• Tues, 3-7-17	Southwestern CC	Creston
• Thur, 3-9-17	Indian Hills CC	Centerville
• Tues, 3-14-17	Kirkwood CC	Cedar Rapids
• Tues, 6-6-17	Muscatine CC	Wilton

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Steve Ferguson
Ag Program Specialist
515.725-4928
Steve.Ferguson@iowa.gov

Tammy Nebola
Ag Program Specialist
515.725-4919
Tammy.Nebola@iowa.gov

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Contact Us

2015 Grand Ave
Des Moines, IA 50312
515.725.4900
IADD@iowa.gov
IowaFinanceAuthority.gov/IADD

Making a Dream a Reality

Getting started on your own in farming requires capital, and that can be a challenge. The Beginning Farmer Loan Program enables beginning farmers, like Jeremiah Gingerich, to purchase necessary land with a low interest rate.

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

A Family Tradition

Aaron Lorch is happy to be back at home as the fourth generation in his family's farming operation. The affordable financing available through the Beginning Farmer Loan Program made farming an easier endeavor for Aaron.

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

Home on the Farm

The Beginning Farmer Tax Credit program has been a valuable resource for landlords and tenants since 2007. Brian Kautzky is proud about the program allowing him and his brothers to return to the family farm.

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

"After graduating from college, it was always my plan to return to our family farm, expand the Soules Farms operation and begin my career in agriculture. ***The Beginning Farmer Loan Program***, provided through the Iowa Agricultural Development Division, made my goals a reality with affordable financing. Assistance from the program enabled me to purchase my first farm of nearly 200 acres and continue the lifestyle my family has enjoyed for three generations."

Chris Soules
Arlington

IOWA AGRICULTURAL
DEVELOPMENT DIVISION

IOWA AGRICULTURAL DEVELOPMENT DIVISION

2016 Beginning Farmer Loan and Tax Credit Programs

1

Iowa Agricultural Development Division Staff

Steve Ferguson
Tax Credit Program Specialist
515.725.4928
steve.ferguson@iowa.gov

Tammy Nebola
Loan Program Specialist
515.725.4919
tammy.nebola@iowa.gov

IOWA AGRICULTURAL DEVELOPMENT DIVISION

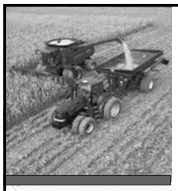
2

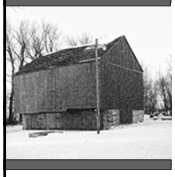
Iowa Agricultural Development Division

- Formerly Iowa Agricultural Development Authority
- Became a Division of the Iowa Finance Authority in July, 2013
- Administers loan and tax credit programs to benefit Beginning Farmers in Iowa.

IOWA AGRICULTURAL DEVELOPMENT DIVISION

3





Iowa Agricultural Development Division Programs

- Beginning Farmer Loan Program (BFLP)
- Loan Participation Program (LPP)
- Beginning Farmer Tax Credit Program (BFTC)
- Beginning Farmer Custom Farming Tax Credit Program (BFCF)
- DNR Lease to Beginning Farmer Program*

  * Administered by DNR

IOWA AGRICULTURAL DEVELOPMENT DIVISION

4

Who is a Beginning Farmer?
Same for ALL Programs

- 2017 maximum net worth less than $645,284
  - This amount changes every year
- At least 18 years old (No upper age limit)
- Resident of Iowa
- Must be owner/operator of the farm
  - Cannot lease to someone else or hire someone else to do the work
- Must have sufficient education, training and experience for the anticipated farm operation
  - But not the same as FSA requirement of >3 years and <10 years
- Must have access to adequate working capital, farm machinery, livestock and/or agricultural land

IOWA AGRICULTURAL DEVELOPMENT DIVISION

5

Approval Procedures

- All applications are due the by 1st of month
- Reviewed by IADD board
  - Usually the 4th Wednesday of the month
- Recommendation made to the IFA board
  - Usually meets 1st Wednesday of the following month
- After Board meeting
  - Approval letter sent or
  - Letter detailing additional requirements needed before application can be approved

IOWA AGRICULTURAL DEVELOPMENT DIVISION

6

Application Packets

- For all IADD Programs
  - Program Application
  - Financial Statement less than 30 days old
    - Signed by Beginning Farmer and spouse
    - Witnessed by financial professional that helped prepare statement
  - Background letter explaining
    - Education, training and experience for the anticipated farm operation
    - Access to working capital, farm machinery, livestock and/or agricultural land
      - Explain agreement for machinery use (rental or trading labor for use)
  - Application Fee
  - Other documentation specific to each program

IOWA AGRICULTURAL DEVELOPMENT DIVISION

7

Beginning Farmer Loan Program

IOWA AGRICULTURAL DEVELOPMENT DIVISION

8

Beginning Farmer Loan Program

- Low-interest loan through a lender or contract seller
  - Financed through a tax-exempt bond issued by IFA
  - Interest earned is exempt from federal income taxes
  - For contract sellers, interest is both federal and state tax-exempt income
- Because the interest earned is tax-exempt, lenders and contract sellers can charge the beginning farmer a lower interest rate
- Typically the beginning farmer will see about a 25% interest rate reduction using the Beginning Farmer Loan Program (BFLP)

9

Beginning Farmer Loan Uses

- **Purchase**
  - Agricultural land
  - Depreciable machinery or equipment
  - Breeding livestock-not feeders
- **Make improvements**
  - Existing buildings
  - New farm improvements
- **Cannot finance**
  - Operating expenses
  - Refinance previous purchases

10

Financing or Constructing a Facility

- If financing a feeding facility, per federal regulations the feeding contract must be on a per head/per day basis
- This restriction can cause complications, but most integrators are willing to change the contract when they know it is a requirement of the financing
- The per head/per day contract format must be maintained for the life of the loan
- The program cannot be used for any type of rental, so the federal restriction on the feeding contract is to distinguish between
  - Rental agreement (per pig space)
    - Not eligible
  - Service agreement (per head/per day)
    - Eligible

IOWA AGRICULTURAL DEVELOPMENT DIVISION

11

Maximum Bond Amounts

Maximum bond amount - adjusts annually on January 1st

- $524,200 for real estate
- $250,000 for existing buildings or farm improvements and new depreciable agricultural property
- $ 62,500 for "used" depreciable agricultural property
- Federal legislation has been introduced to increase all maximums to the maximum bond amount – H.R. 5335

Restrictions

- Dwelling may not exceed 5% of bond proceeds
- CRP ground may not exceed 25% of bond proceeds
- Combination of the above can be used up to maximum bond

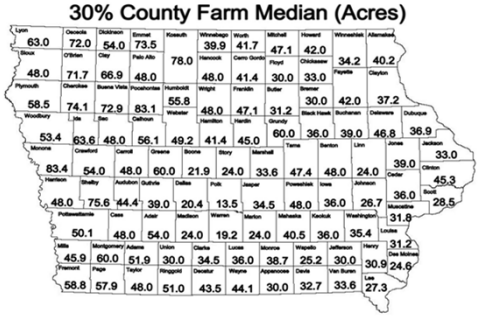
12

Other BFLP Factors

- Additional Eligibility requirement
  - If beginning farmer does now or has in the past owned land it must be less than 30% of the county median
    - The federal legislation introduced would also change the maximum land ownership from 30% of the county median to 30% of the county average.
  - Purchases from closely related family members (parents, grandparents or siblings) are permitted but:
    - they must be financed through a 3rd party lender (no contract sale)
    - Must be sold for at least the appraised value
  - Contract sale allowed if not immediate family
    - So can be with aunts, uncles, cousins, etc.

13

30% County Farm Median (Acres)



14

Other BFLP Factors

- May reapply and benefit from the program until the maximum bond amount has been used or land owned exceeds the limit
- Beginning farmer negotiates down payment and loan terms with bank or contract seller
- If eligible, down payment assistance may be used with:
  - Farm Service Agency (FSA) loan (5/45/50 program)
  - IADD Loan Participation Program (LPP) loan
    - Only when financed through a bank

IOWA AGRICULTURAL DEVELOPMENT DIVISION

15

Using the BFLP and FSA 5/45/50 Together

% of Project	Funding Source	Total	Interest Rate	1st year Interest
5% of project	Down payment	$ 43,158		
45% of project	FSA Loan	$300,000	1.50%	$4,500
50% of project	BFLP Aggie Bond	$520,000	4.00%	$20,800
		$863,158		**$25,300**

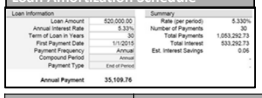
% of Project	Funding Source	Total	Interest Rate	1st year Interest
100% of project	Traditional Loan	**$863,158**	**5.33%**	**$46,006**

$20,706 Interest Savings in the 1st year

16

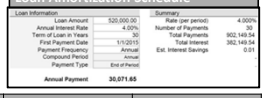
Example of Savings Using the Beginning Farmer Loan Program

5.33% Interest
Loan Amortization Schedule



Loan Information		Summary	
Loan Amount	520,000.00	Rate (per period)	5.330%
Annual Interest Rate	5.33%	Number of Payments	30
Term of Loan in Years	30	Total Payments	1,053,292.73
First Payment Date	1/1/2015	Total Interest	533,292.73
Payment Frequency	Annual	Est. Interest Savings	0.06
Compound Period	Annual		-
Payment Type	End of Period		
Annual Payment	35,109.76		

4.00% Interest
Loan Amortization Schedule



Loan Information		Summary	
Loan Amount	520,000.00	Rate (per period)	4.000%
Annual Interest Rate	4.00%	Number of Payments	30
Term of Loan in Years	30	Total Payments	902,149.54
First Payment Date	1/1/2015	Total Interest	382,149.54
Payment Frequency	Annual	Est. Interest Savings	0.01
Compound Period	Annual		-
Payment Type	End of Period		
Annual Payment	30,071.65		

	5.33% Interest	4.00% Interest	Total Savings using BFLP
Loan Amount	$520,000	$520,000	
Total Interest	$533,293	$382,150	**$151,143**
Annual P&I Payments	$35,110	$30,072	**$5,038**
Total P&I Payments	$1,053,293	$902,150	**$151,143**

17

IOWA AGRICULTURAL DEVELOPMENT DIVISION

Other Provisions and Fees

- Applications can be approved if bank loan or contract transaction completed:
  - **BUT** must be approved by IADD-IFA board within 60 days of any financing
- Non-refundable $50 application fee
- Closing fee
  - 1.50% of Bond up to $250,000
  - 0.75% of Bond amount over $250,000
  - $300 minimum
- Closing fee is paid when loan closes

18

How to get started!

- Talk to your lender and let them know you would like to use the IADD Beginning Farmer Loan Program (BFLP)
- Lender will underwrite your loan to determine if they are willing to finance the project
- Once bank approval has been decided:
  - Loan term and tax exempt interest rate will be negotiated
  - Lender and beginning farmer jointly fill out application
  - Applications, program summaries and additional information is available our website at:

IowaFinanceAuthority.gov/IADD

IOWA AGRICULTURAL DEVELOPMENT DIVISION

19

How to get started!

- Submit application and all attachments to IADD by the 1st of the month
- Application is reviewed/approved by IADD-IFA Boards
  - process typically takes about six weeks
  - interim financing allowed
- After approval, IADD sends loan closing packet to lender
  - Loan is assigned to lender or contract seller at closing
  - All payments are made directly to the lender or contract seller

IOWA AGRICULTURAL DEVELOPMENT DIVISION

20

Questions

on the

Beginning Farmer Loan Program?

IOWA AGRICULTURAL DEVELOPMENT DIVISION

21

IOWA AGRICULTURAL DEVELOPMENT DIVISION

Loan Participation Program

22

Loan Participation Program

- The Loan Participation Program (LPP):
  - Established in 1996
  - Supplements a beginning farmer's down payment to purchase agricultural assets
- The program can be used for the same purposes as the Beginning Farmer Loan Program (BFLP)
- Can be used in conjunction with the Beginning Farmer Loan Program (BFLP)

23

Maximum and Loan Terms

- IADD's LPP reduces the lender's risk:
  - LPP is Last-in/last-out
  - Allows lender to finance more of the beginning farmer's project
- Maximum loan participation is 30% of project up to $150,000
- Current interest rate is 2.50%
  - Fixed for 5 years then adjusted
    - 1.00% above FSA Direct Farm Ownership Down Payment Loan Program
- 10 year balloon (amortized over 20 years for land and 12 years for facilities)
- There are no restrictions on related party transactions

IOWA AGRICULTURAL DEVELOPMENT DIVISION

24

LPP Underwriting criteria

- Current assets to current liabilities > 1.1 at time of application
- Farm debt-to-asset ratio < 80% at closing
- Aggregate amount of participated loan (total amount financed) < 3 times the borrower's net worth
- Debt repayment ratio > 120%
- Off-farm income < 50% of projected gross income
- Loan-to-value < 100% of appraised value
  - Collateral appraisals by qualified 3rd party appraiser
  - Property not eligible if house value > 50% of appraisal

IOWA AGRICULTURAL DEVELOPMENT DIVISION

25

Other Provisions and Fees

- Applications can be approved if bank loan has been completed:
  - **BUT** must be approved by IADD-IFA board within 60 days of any financing
- Non-refundable application fee
  - $100
- Closing fee
  - 1.25% of IADD participation loan
  - $300 minimum
- Closing fee is paid when loan closes

IOWA AGRICULTURAL DEVELOPMENT DIVISION

26

Using the LPP and BFLP Together for Hog Facility Construction

% of Project	Funding Source	Total	Interest Rate	1st year Interest
30% of project	LPP Loan	$150,000	2.50%	$3,750
F.I. Limit	BFLP Aggie Bond	$250,000	4.00%	$10,000
Remaining	Traditional Loan	$300,000	5.33%	$15,990
12 year amort.		**$700,000**		**$29,740**

% of Project	Funding Source	Total	Interest Rate	1st year Interest
100% of project	Traditional Loan	**$700,000**	**5.33%**	**$37,310**

$7,570 Interest Savings in the 1st year

27

Example of Savings Using the Loan Participation Program

5.33% Interest Loan Amortization Schedule

Loan Amount	$150,000	Number of Payments	12
Annual Interest Rate	5.33%	Total Payments	$206,882.96
Term of Loan in Years	12	Total Interest	$56,882.96
Annual Payment	$17,240.24	Balloon Payment	None

2.50% Interest Loan Amortization Schedule

Loan Amount	$150,000	Number of Payments	10
Annual Interest Rate	2.50%	Total Payments	$174,415.50
Term of Loan in Years	12	Total Interest	$24,415.54
Annual Payment	$14,623.07	Balloon Payment	$42,807.91

	5.33% Interest	2.50% Interest	Total Savings using LPP
Loan Amount	$150,000	$150,000	
Total Interest	$56,883	$24,416	**$32,467**
Annual P&I Payments	$17,240	$14,623	**$2,617**
Total P&I Payments	$206,883	$174,416	**$32,467**

28

How to get started!

- Talk to your lender and let them know you would like to use the IADD Loan Participation Program (LPP)
- Lender will underwrite your loan to determine if they are willing to participate in financing the project
- Once bank approval has been determined, fill out the application with your lender
- Applications, programs summaries and additional information is available at:

  IowaFinanceAuthority.gov/IADD
- Submit application and attachments to IADD by the 1st of the month
  - Pro-forma financial statement
  - Cash flow analysis
  - 3 Years of Federal Tax Returns

IOWA AGRICULTURAL DEVELOPMENT DIVISION

29

How to get started!

- IADD will review and underwrite the application
- Application is reviewed by IADD Board Credit Committee
- Application is approved by IADD-IFA Board
  - process which typically takes 5-6 weeks
  - interim financing is allowed
- IADD works with bank on closing documents
- At closing, funds are sent to bank via ACH
- All loan payments are made directly to the bank
- Bank sends IADD its payment amount

IOWA AGRICULTURAL DEVELOPMENT DIVISION

30

Questions

on the

Loan Participation Program?

IOWA AGRICULTURAL DEVELOPMENT DIVISION

31

IOWA AGRICULTURAL DEVELOPMENT DIVISION

Beginning Farmer Tax Credit Program

32

Beginning Farmer Tax Credit Program

- Established in 2007
- Encourages agricultural asset owners to lease land, equipment and/or breeding livestock to qualified beginning farmers
- Provides owner a credit on **Iowa** income taxes owed
  - 7% on cash rent
  - 17% on crop share
  - 1% additional first year if beginning farmer is a military veteran

IOWA AGRICULTURAL DEVELOPMENT DIVISION

33

Key Requirements

- Lease must have a term between 2-5 years
  - Cash rent amount or crop share percentage does not have to be the same for each year of the lease as long as it is established on application
- Tax credit issued annually through lease term
- Renewable at expiration
  - Must reapply
  - Beginning Farmer must still qualify
- Flex leases only calculated on base rent
  - No tax credit on bonus/variable factors
- Lease value cannot be substantially higher/lower than market
- Lease can be between related parties – including immediate family members

IOWA AGRICULTURAL DEVELOPMENT DIVISION

34

Key Requirements

- If crop share lease, Beginning Farmer must receive at least 33% of crop
- FSA Form 156 must be submitted with application
  - Confirms farm location, acres, ownership
  - Beginning farmer must be listed as operator
- **All Names MUST be the same:**
  - **Names on 156 Form**
  - **Names on lease**
  - **Names on application**

IOWA AGRICULTURAL DEVELOPMENT DIVISION

35

Calculating Cash Rent Tax Credit

- 160 acres cash rented
- $200 per acre
- gross lease income: 160 x $200 = $32,000
- **Iowa** income tax credit: $32,000 x 7% = **$2,240**

IOWA AGRICULTURAL DEVELOPMENT DIVISION

36

Calculating Crop Share Tax Credit

- Allocation of acres and yield
  - ➢ 50% to corn and 50% to beans
  - ➢ Yield determined by USDA data
    (Historical average of county's T-yield)
- Price = USDA RMA state fall price
  - ➢ County list is on website
- ➢ Crop share is calculated on the asset owners percentage

IOWA AGRICULTURAL DEVELOPMENT DIVISION

37

Corn and Soybean 2016 County Yields and State Fall Prices

(To Calculate Crop Share Tax Credit Amounts)

	CORN			SOYBEANS	
County	Yield	Price	County	Yield	Price
Adair	157	3.83	Adair	46	8.91
Adams	151	3.83	Adams	45	8.91
Allamakee	164	3.83	Allamakee	48	8.91
Appanoose	138	3.83	Appanoose	42	8.91
Audubon	164	3.83	Audubon	49	8.91
Benton	180	3.83	Benton	51	8.91
Black Hawk	172	3.83	Black Hawk	49	8.91
Boone	175	3.83	Boone	48	8.91
Bremer	177	3.83	Bremer	50	8.91

All county information posted at www.Iowafinanceauthority.gov/iadd under Forms and Resources tab.

IOWA AGRICULTURAL DEVELOPMENT DIVISION

38

Crop Share Example

160 Acres allocated ½ to corn, ½ to soybeans with 50/50 crop share:

- 80 acres corn x 167 bu/acre x 50% x $3.83 x 17% = **$4,349.35**
  - Total corn crop = 13,360 bushels
  - Owner's share = 6,680 bu.
- 80 acres soybeans x 48 bu/acre x 50% x $8.91 x 17% = **$2,908.22**
  - Total soybeans crop = 3,840 bushels
  - Owner's share = 1,920 bu.
- Total **Iowa** tax credit = **$7,257.57**

IOWA AGRICULTURAL DEVELOPMENT DIVISION

39

Calculating Cow-Calf Share Lease

Eligibility Requirements:

- Cow-calf lease operation is based in Iowa year-round
- Beginning Farmer provides all labor
- Beginning Farmer must receive at least 33.3% of the calf crop
  - assume 95% calf crop, allowing for 5% in death losses
- Asset Owner provides all breeding stock and/or semen for the herd

Factors Used to Calculate Tax Credit Amount:

- Weight : all calves will be considered at 550 lbs.
- Prices : FSA prices for 550 lb. feeder steer used for cash flows
- 2016 FSA price used = $2.10 per lb. (adjusted each January 1st)

IOWA AGRICULTURAL DEVELOPMENT DIVISION

40

Other Provisions and Fees

- September 1st application deadline
- $200 Application fee
  - $100 more after July 1st
- Service fee
  - $50/year for cash rent lease
  - $100/year for crop share lease
- Application and service fees are due with application
- Tax certificates sent in January

IOWA AGRICULTURAL DEVELOPMENT DIVISION

41

Lease Change Requests

- Must be received/approved by IADD board before enacted
- Changes *only beneficial to Beginning Farmer* will be considered
  - Reduction of cash rent amount (no increases)
  - Additional acres added to the lease
  - Swapping one Beginning Farmer for another due to circumstances
- Asset owner cannot cancel lease
- Requests must be received before December 1st
- $100 Processing Fee
  - No $100 fee required for:
    - Asset owner address changes
    - Death of spouse who received tax credit certificate

IOWA AGRICULTURAL DEVELOPMENT DIVISION

42

How to get started!

- Beginning Farmer negotiates with asset owner the lease terms
- Application is prepared and signed by both the Asset Owner and the Beginning Farmer
- Applications and additional information is available at:

  IowaFinanceAuthority.gov/IADD
- Submit Tax Credit application and attachments by **September 1st**
- IFA staff reviews application for eligibility and completeness
- Approval letters are sent out after IFA Board approval
- Tax Credit Certificates are mailed out each January throughout the term of the approved lease

IOWA AGRICULTURAL DEVELOPMENT DIVISION

43

Questions

on the

Beginning Farmer Tax Credit Program?

IOWA AGRICULTURAL DEVELOPMENT DIVISION

44

IOWA AGRICULTURAL DEVELOPMENT DIVISION

Custom Farming Tax Credit Program

45

Custom Farming Tax Credit Program

- Established in 2013
- Encourages agricultural asset owners to custom hire qualifying beginning farmers
- Provides owner a credit against Iowa income taxes
- Credit equals 7% of amount paid to beginning farmer

IOWA AGRICULTURAL DEVELOPMENT DIVISION

46

Program Requirements

- Contracted work must be for the production of crops or livestock
- Contract terms are set by the Beginning Farmer and the person hiring him/her for custom work
- Contract must be:
  - in writing
  - for less than 24 months
  - signed by all parties involved
- Beginning farmer must provide everything needed for contracted work (including labor and machinery)
- Taxpayer must provide proof of payment
- Contract cannot be between spouses, children, or siblings

IOWA AGRICULTURAL DEVELOPMENT DIVISION

47

Other Requirements and Fees

- November 1st application deadline
- $200 Application fee
  - $50 more after October 1st
- Tax certificates sent in January
- If the same person hires the same beginning farmer for multiple jobs, all work can be put on one application
- If either the beginning farmer or the employer is different, multiple applications are needed

IOWA AGRICULTURAL DEVELOPMENT DIVISION

48

IADD Tax Credit Programs

- IADD has $12 million in **Iowa** tax credits to allocate between the two programs
- $50,000 maximum tax credit per year per application or taxpayer
- Unused credits
  - Can be carried forward 10 years
  - Cannot carry back to prior years

IOWA AGRICULTURAL DEVELOPMENT DIVISION

49

How to get started!

- Submit Custom Farming application packet by November 1st
  - Signed Custom Contract (up to 24 months)
  - Verification of Payment
- Applications and additional information is available at:

  IowaFinanceAuthority.gov/IADD
- IFA staff reviews application for eligibility and completeness
- Approval letters are sent out after IFA Board approval
- Tax Credit Certificates are mailed out each January throughout the term of the approved contract

IOWA AGRICULTURAL DEVELOPMENT DIVISION

50

Questions

on the

Custom Farming Tax Credit Program?

IOWA AGRICULTURAL DEVELOPMENT DIVISION

51

IOWA AGRICULTURAL DEVELOPMENT DIVISION

DNR Lease to Beginning Farmer Program

52

DNR Lease to Beginning Farmer Program

- Created in 2013
- Provides leasing opportunities to Iowa beginning farmers
- Offered and administered by the Iowa Department of Natural Resources (DNR)
- IADD must certify that Beginning Farmer is eligible
  - Same eligibility requirements as other programs
- For more information on the program, contact DNR

IOWA AGRICULTURAL DEVELOPMENT DIVISION

53

Available to Provide Workshops

- Do workshops for banks, CPAs, attorneys, ISU Extension, ag organizations
- Let us know when and where you would like a workshop provided in your community

IOWA AGRICULTURAL DEVELOPMENT DIVISION

54

10 Regional Workshops In 2017

From 9:00 am to 11:15 am

• Tues, 2-14-17	Northeast Iowa CC	Calmar
• Thur, 2-16-17	Hawkeye CC	Waterloo
• Wed, 2-22-17	Iowa Lakes CC	Emmetsburg
• Thurs, 2-23-17	Iowa Central CC	Ft. Dodge
• Tues, 2-28-17	North Iowa CC	Mason City
• Thur, 3-2-17	Des Moines CC	Ankeny
• Tues, 3-7-17	Southwestern CC	Creston
• Thur, 3-9-17	Indian Hills CC	Centerville
• Tues, 3-14-17	Kirkwood CC	Cedar Rapids
• Tues, 6-6-17	Muscatine CC	Wilton

IOWA AGRICULTURAL DEVELOPMENT DIVISION

55

Steve Ferguson
Ag Program Specialist
515.725-4928
Steve.Ferguson@iowa.gov

Tammy Nebola
Ag Program Specialist
515.725-4919
Tammy.Nebola@iowa.gov

Contact Us

2015 Grand Ave
Des Moines, IA 50312
515.725.4900
IADD@iowa.gov
IowaFinanceAuthority.gov/IADD

56

IOWA AGRICULTURAL DEVELOPMENT DIVISION

57

A Family Tradition

Aaron Lorch is happy to be back at home as the fourth generation in his family's farming operation. The affordable financing available through the Beginning Farmer Loan Program made farming an easier endeavor for Aaron.

IOWA AGRICULTURAL DEVELOPMENT DIVISION

58

Home on the Farm

The Beginning Farmer Tax Credit program has been a valuable resource for landlords and tenants since 2007. Brian Kautzky is proud about the program allowing him and his brothers to return to the family farm.

IOWA AGRICULTURAL DEVELOPMENT DIVISION

59

"After graduating from college, it was always my plan to return to our family farm, expand the Soules Farms operation and begin my career in agriculture. ***The Beginning Farmer Loan Program***, provided through the Iowa Agricultural Development Division, made my goals a reality with affordable financing. Assistance from the program enabled me to purchase my first farm of nearly 200 acres and continue the lifestyle my family has enjoyed for three generations."

Chris Soules
Arlington

IOWA AGRICULTURAL DEVELOPMENT DIVISION

60

Bloethe Tax School

Presented by the ISBA Tax Section

THURSDAY, DECEMBER 8
Downtown Des Moines Marriott
Des Moines, Iowa

Bloethe Tax School

Succession Planning - Ethics

10:30 a.m.-11:25 a.m.

Presented by
Jenna Lain
The Law Office of Jenna K. Lain, PLLC
PO Box 386
Corydon, IA 50060
Phone: 641-872-1304
Email: jennalainlaw@gmail.com

THURSDAY, DECEMBER 8, 2016

Death and Disability Planning by Iowa Attorneys:

Rule 39.18 and Associated Rules

Prepared by: Jenna K. Lain
The Law Office of Jenna K. Lain, PLLC
PO Box 386, Corydon, IA 50060
641-872-1304
jennalainlaw@gmail.com

A. Current Iowa Court Rule 39.18

a. Effective date is January 1, 2018 (per Iowa Supreme Court order dated August 29, 2016)

b. Current rule applies only to sole practitioners (39.18(1) and 38.18(8):

   i. Any attorney practicing alone

   ii. An attorney practicing only with other attorneys who do not own equity in the practice

   iii. An attorney practicing in an association of sole practitioners, or

   iv. Any other structure in which no other attorney owns equity in the practice.

c. Provisions of Current Rule: MUST Have a Death or Disability Plan

   i. The Plan MUST:

      1. Plan must be written.

      2. Plan must be reviewed and updated annually.

      3. Plan must be available for review by the office of professional regulation or by client security commission.

      4. Plan must designation of both a primary and alternate active Iowa attorney to review files, notify clients, and determine needs for immediate action.

      5. Both primary and alternate attorneys must consent in writing.

      6. Authorization for designated attorneys to prepare trust accountings, disburse trust account funds, dispose of inactive files, store records, access electronic files and records.

      7. Identify location of electronic files and records and provide passwords and security information required for access.

8. Plan must include sufficient language to make the designated attorneys' powers durable in the event of the sole practitioner's disability.

ii. The plan MAY authorize the designated attorney to:

1. Collect fees
2. Pay firm expenses and client costs
3. Compensate staff
4. Terminate leases
5. Liquidate or sell the practice or
6. Perform other administrative tasks.

iii. The Designated Attorney MUST NOT:

1. Examine any documents or acquire any information containing real or potential conflicts with the designated attorney's clients.

B. Rule 39.18 Study Committee

a. In response to questions from the bar concerning the rule, the Iowa Bar Association and the Board of Governors approved appointment of a Rule 39.18 Study Committee.

b. The committee met five times from March 2016 through July 2016 and approved a detailed report, which is included in the appendix.

c. The Study Committee concluded that the current Rule should be vacated and proposed an alternative Rule.

d. On August 29, 2016, the Supreme Court issued an Order requesting public comment on the new PROPOSED Rule 39.18 and associated rules.

e. The comment period closed October 31, 2016 with two comments, one by the Iowa Academy of Trial Lawyers in support of the changes and one from a private practitioner with suggestions and questions.

f. Proposed rule is likely to be adopted as there were no negative comments.

C. Proposed Iowa Court Rule 39.18

a. The new proposed rule applies to all attorneys in private practice, not just sole practitioners.

i. This includes attorneys who actively engage in the practice of law in Iowa, but who reside in other states.

b. Provisions of PROPOSED rule:

   i. **Each private practitioner MUST identify and authorize a designated representative each year**

      1. Designation made as part of the annual questionnaire required by Iowa Court Rule 39.11
      2. Designated Representative(s) may be:
         a. A qualified lawyer servicing association: defined as a bar association, a company authorized to sell lawyers professional liability insurance in Iowa, or an Iowa bank with trust powers issued by the Iowa Department of Banking;
         b. An Iowa law firm that includes Iowa attorneys in good standing: defined as a minimum of two attorneys in a law partnership, professional corporation, or other association authorized to practice law; or
         c. An active Iowa attorney in good standing.
         d. Note: the private practitioner may designate the Iowa firm of which the attorney is a member.
      3. Without any further action on behalf of the private practitioner, the designated representative IS AUTHORIZED BY THE RULE to:
         a. Review client files,
         b. Notify clients of the attorney's death or disability,
         c. Determine whether there is a need for other immediate action to protect the clients' interests,
         d. Serve as a successor signatory for any client trust account,
         e. Prepare final trust accountings for clients,
         f. Make trust account disbursements,
         g. Dispose of inactive files,
         h. Store files and records,
      4. Said authorizations take effect upon the death or disability of the designating attorney.

a. Designated attorney MAY apply to the chief judge for an order confirming death or disability.

ii. Each private practitioner MUST maintain a current list of active clients, in a location accessible by the attorney or entity designated under this rule.

1. Must identify the custodian of the client list
2. Must identify the location of the client list
3. Must identify the custodian of the electronic and paper files and records
4. Must identify the location of the electronic and paper files and records
5. Must identify the custodian of the passwords and security protocols require to access electronic files and records
6. Must identify the location of the passwords and security protocols require to access electronic files and records
7. The attorney or entity designated is authorized to access the files and records as necessary

iii. A private practitioner MAY prepare a written supplemental plan to authorize an attorney or entity to:

1. Collect fees, pay firm expenses and client costs, compensate staff, terminate leases, liquidate or sell the practice, or perform other law firm administration tasks.
2. IF you create a plan, THEN it MUST include language sufficient to make the designated attorneys' or entity's power durable in the event of disability.

iv. Designated attorney or entity MUST NOT:

1. Examine any documents or acquire any information containing real or potential conflicts with the designated attorney's clients.

D. <u>Associated Rules</u>

a. 34.17 Disability suspension; and 34.18 Death, suspension, or disbarment of practicing attorney.

i. Both rules allow for appointment of a trustee by the Chief Judge of the District

ii. Proposed changes incorporate this language: “In appointing a trustee, the chief judge will give due regard to any designation or stand-by nomination made under the provisions of Iowa Court Rule 39.18.

iii. Also amends the rule to allow the application for trustee to be made by a local bar association or an attorney or entity designated or nominated on a stand-by basis as described in Iowa Court Rule 39.18.

In the Iowa Supreme Court

Request for Public Comment on Proposed Changes Regarding Death and Disability Planning by Iowa Attorneys	))))	**Order**

The Iowa Supreme Court seeks public comment on proposed amendments to Iowa Court Rule 39.18 and associated rules regarding death and disability planning by Iowa attorneys.

After a previous 60-day public comment period, during which time the court did not receive any comment relating to then-proposed rule 39.18, the court on November 20, 2015, adopted Iowa Court Rule 39.18 requiring sole practitioners to have a written succession plan for their law practices.

The proposed amendments to rule 39.18 now before the court originated from The Iowa State Bar Association Rule 39.18 Study Committee (ISBA committee). The key provisions of the ISBA request include the following:

- The proposed amendments would create two "tiers" of succession planning. The first tier would be a mandatory short form designation of an assisting attorney or entity as part of the annual questionnaire filed with the Client Security Commission. The designation would identify the assisting attorney, law firm (which could be the planning attorney's own firm, if the planning attorney is a member of a firm), or qualified lawyer servicing association. The designation also would identify where records are located, including the current client list, and authorize the assisting attorney or entity to perform tasks necessary to protect the interests of clients. The listed tasks include reviewing client files, notifying clients of the planning attorney's death or disability, determining if other actions are necessary to protect the clients' interests, and administering the planning attorney's trust account.

- The second tier would be a written plan created by the planning attorney that would be optional but encouraged. In the optional written plan, the planning attorney would be able to provide further guidance and authority to perform law firm management and administrative tasks. Those tasks include collecting fees, paying law firm expenses and client costs, compensating staff, terminating leases, and selling the practice.

- All attorneys in private practice would be required to complete the first

tier, mandatory short form designation, as part of the annual client security questionnaire. If a planning attorney is a member of a law firm that includes other Iowa attorneys in good standing, the planning attorney may designate his or her own firm as the assisting law firm.

- Attorneys not in private practice in Iowa would be permitted to provide that response to a direct question on the annual questionnaire, and would not be required to complete the remainder of that portion of the questionnaire pertaining to succession planning.

- Maintenance of a current client list would be required on the part of all attorneys in private practice.

- The assisting attorney or entity would be authorized to apply to the district chief judge for an order confirming the death or disability of the planning attorney.

- A qualified lawyer servicing association would be defined as a bar association all or part whose members are admitted to practice in Iowa, a company authorized to sell professional liability insurance to Iowa attorneys, or an Iowa bank with trust powers issued by the Iowa Department of Banking.

- The assisting attorney or entity would be authorized to petition for appointment of a trustee under the provisions of Iowa Court Rules 34.17 or 34.18, as applicable, if the assisting attorney or entity believes it beneficial to be court appointed as a trustee, or believes it appropriate that an independent trustee be appointed. In any situation in which a trustee appointment under rules 34.17 or 34.18 is applied for, the new rules would require the chief judge to give due regard to any designation or stand-by nomination made by a planning attorney under the provisions of Iowa Court Rule 39.18.

- The Office of Professional Regulation would not implement the new mandatory portion of the annual client security report until the 2018 reporting season.

- The proposed amendments to rule 39.18 would include appropriate amendments to rule 34.17 (disability suspension) and rule 34.18 (death, suspension, or disbarment of practicing attorney).

The ISBA committee studying rule 39.18 believes that adding a mandatory short form designation as part of the annual client security questionnaire would make it easier for Iowa attorneys to fulfill the basic planning requirement, place information regarding every private practitioner's plan in the possession of the Client Security Commission for quick retrieval,

prompt annual updating by the attorney as part of the annual reporting process, and obviate the need for auditors of the Client Security Commission to check on succession planning during trust account audits. Iowa attorneys nonetheless would have the option of authoring their own, more expansive written plans to address matters not covered in the mandatory short form designation.

Prior to further consideration of the proposed amendments to rule 39.18, the court seeks public comment on the amendments. The proposed amendments, the report of the ISBA Rule 39.18 Study Committee, and a letter against the ISBA committee report are provided with this order and may be found on the Iowa Judicial Branch website at: http://www.iowacourts.gov/About_the_Courts/Supreme_Court/Orders. In addition, copies are available at the office of the Clerk of the Supreme Court, Judicial Branch Building, 1111 East Court Avenue, Des Moines, Iowa 50319.

Any interested organization, agency, or person may submit comments regarding the proposed amendments. All comments must refer to the specific rule number (for example, rule 39.18(3)) and the specific numbered line or lines to which the comments refer. Comments sent by email must be emailed to **rules.comments@iowacourts.gov**, must state **"Proposed Amendments to Rule 39.18"** in the subject line of the email, and must be sent **as an attachment to the email in Microsoft Word format**. Instead of submission by email, comments may be delivered in person or mailed to the Clerk of the Supreme Court, Judicial Branch Building, 1111 East Court Avenue, Des Moines, Iowa, 50319.

The deadline for submitting comments is 4:30 p.m. on October 31, 2016.

To accommodate further consideration of rule 39.18 and the 60-day

public comment period on proposed amendments to the rule, the court amends by this order the effective date for the current Iowa Court Rule 39.18—Requirement for Death or Disability Plan, which currently is January 1, 2017. **The effective date for current rule 39.18, is now delayed until January 1, 2018.**

Dated this 29th day of August, 2016.

The Iowa Supreme Court

By _____
Mark S. Cady, Chief Justice

Report of the Rule 39.18 Study Committee

July 2016

On November 20, 2015 the Iowa Supreme Court adopted Court Rule 39.18 requiring sole practitioners to have a written plan of succession for their practice effective January 1, 2016. The rule was adopted after receiving just one comment during the 30 day public comment period. After adoption, it quickly became apparent to the Iowa State Bar Association and the Court that more time was needed to study the impact of the rule on Iowa lawyers and the rule effective date was eventually delayed to January 1, 2017. In response to questions raised by the bar concerning the rule, then President Bruce Walker formed and the Board of Governors approved the appointment of the Rule 39.18 Study Committee to be chaired by Past President Joe Feller from Sibley.

The additional members of the committee were Past Presidents David Beckman, Burlington, Nick Critelli Jr., Des Moines and Joe Holland, Iowa City, along with John (Rick) Bierman III, Grinnell, Phil Brooks, Cedar Rapids, Frank Hoyt Jr., West Des Moines, Kate Kohorst, Harlan, Michel Nelson, Carroll, Deb Petersen, Council Bluffs, Office of Professional Regulation Director Paul Wieck II and ISBA Executive Director Dwight Dinkla (ex-officio).

President Walker charged the committee to research the implementation of the rule and how it was to be interpreted. As initially adopted Rule 39.18 applied to many more lawyers than just the traditional sole practitioners and bar leadership was concerned that application of the rule would create liabilities for the assisting attorneys as well as financial costs to the estate of the deceased or disabled attorney.

The Committee met in person on four occasions, March 16, 2016, April 27, 2016, May 18, 2016 and June 13, 2016. On July 22, 2016, the Committee met by phone conference, approved this report and concluded its work.

The Committee concluded that the present Rule 39.18 requiring sole practitioners to prepare mandatory succession plans should be vacated and replaced with a rule described below that would not require a written succession plan, make compliance easier and apply to all private practice attorneys, while at the same time protecting the interests of our clients and the public.

All the members of the Committee agree that succession planning is very important both for our clients and our families and that the Court and the bar should encourage all lawyers to complete written succession plans and also take steps to improve their office practice management procedures so that their offices are ready for succession in the event of death or disability. At each meeting of the Committee the members engaged in very dynamic discussions regarding many different issues related to the implementation of Rule 39.18 as currently adopted.

The Committee reviewed the background for the current rule, numbers of attorneys affected by the rule, immunity/liability for the designated attorneys, role of professional liability insurance, compensation for designated attorneys, definitions for "disability", fiduciary duties of designated attorneys and conflicts of interest, and dealing with electronic and traditional client files, along with other issues. Many of the Committee members had personal experience helping to close the law office for a deceased attorney and their perspectives were very helpful. Succession planning necessarily encompasses many more issues than this Committee was formed to review and while a discussion of those issues was necessary to properly evaluate Rule 39.18, a full examination and proposed resolutions to deal with those issues is beyond the work of this Committee.

Eventually the Committee narrowed its focus to a review of Rule 39.18 and while recognizing the need for succession planning, struggled with the requirement that only sole practitioners were required to have written succession plans rather than all private practitioners. However, the Committee did not believe that the requirements of the current Rule 39.18 should be extended to all private practitioners either. In the end the Committee resolved the matter with its current recommendations that would require all attorneys answer a few more questions in connection with the annual license renewal and promote written succession plans on a voluntary basis. The Committee concluded that we would recommend the Court revise the current Rule 39.18 to make compliance easier for attorneys and also provide a method for the Office of Professional Regulation to gather the information the office needs in advance of an event where a law office is left unattended due to death or disability of the practitioner.

The revision of Iowa Court Rule 39.18 and associated rules proposed by the Committee would create two tiers of succession planning. The first tier would be a mandatory short form designation of an assisting attorney or entity as part of the annual questionnaire filed with the Client Security Commission. The authority of the assisting attorney or entity designated in the mandatory short form would be focused on tasks necessary to protect the interests of clients and complete trust account matters. The second tier would be a written plan created by the planning attorney that would be optional but encouraged. In the optional written plan, the planning attorney would be able to authorize additional tasks, mostly in law firm management and administration.

The Committee believes that adding a mandatory short form designation as part of the annual client security questionnaire would make it easier for Iowa attorneys to fulfill the basic planning requirement, place information regarding every private practitioner's plan in the possession of the Client Security Commission for quick retrieval, prompt annual updating by the attorney as part of the annual reporting process, and obviate the need for auditors of the Client Security Commission to check on succession planning during trust account audits. Iowa attorneys nonetheless would have the option of authoring their own, more expansive written plans to address matters not covered in the mandatory short form designation.

The concept recommended by the Committee would require all attorneys in private practice to complete a new portion of the annual client security questionnaire that identifies their assisting attorney, law firm (which can be their firm, if they are in a firm), or qualified lawyer servicing association, identifies where their records are located including their current client list, and authorizes the assisting attorney or entity to perform certain tasks in the event of the planning attorney's death or disability. Maintenance of a current client list would be required. The assisting attorney or entity would be authorized to apply to the district chief judge for an order confirming the death or disability. The listed tasks include reviewing client files, notifying clients of the planning attorney's death or disability, determining if other actions are necessary to protect the clients' interests, and administering the planning attorney's trust account. A qualified lawyer servicing association would be defined as a bar association all or part of whose members are admitted to practice in Iowa, a company authorized to sell professional liability insurance to Iowa attorneys, or an Iowa bank with trust powers issued by the Iowa Department of Banking.

Attorneys not in private practice in Iowa would be permitted to provide that response to a direct question on the annual questionnaire, and would not be required to complete the remainder of that portion of the questionnaire pertaining to succession planning.

Attorneys would still be permitted (and encouraged) to have their own written plan that provides further guidance and authority to perform law firm management and administrative tasks. Those tasks include collecting fees, paying law firm expenses and client costs, compensating staff, terminating leases, and selling the practice.

The assisting attorney or entity would be authorized to petition for appointment of a trustee under the provisions of Iowa Court Rules 34.17 or 34.18, as applicable, if the assisting attorney or entity believes it beneficial to be court appointed as a trustee, or believes it appropriate that an independent trustee be appointed. In any situation in which a trustee appointment under rules 34.17 or 34.18 is applied for, the new rules would require the chief judge to give due regard to any designation or stand by nomination made by a planning attorney under the provisions of Iowa Court Rule 39.18.

The Committee also recommends that the Office of Professional Regulation would not implement the new mandatory portion of the annual client security report until the 2018 reporting season.

The Committee further recommends that the ISBA continue to work with the Iowa Academy of Trust and Estate Counsel to provide updated law practice succession planning documents to our members. And finally the Committee recommends that the ISBA continue to provide continuing legal education to our members to assist them with their succession planning.

Copies of the original Rule 39.18 as well as the Committee's new proposed language for Rules 34.17, 34.18 and 39.18 are attached to this report.

ATTACHMENT A – (CURRENT RULE)

Rule 39.18 Requirement for death or disability plan.

39.18(1) Each sole practitioner must have a written plan that designates a primary and an alternate active Iowa attorney in good standing to review client files, notify each client of the attorney's death or disability, and determine whether there is a need for other immediate action to protect the interests of clients. The primary and alternate attorneys must consent in writing to their designation in the plan.

39.18(2) The plan must authorize the designated attorneys to prepare final trust accountings for clients, make trust account disbursements, properly dispose of inactive files, and arrange for storage of files and trust account records. The plan must identify the location of electronic files and records, authorize the designated attorneys to access electronic files and records as necessary to perform duties as a designated attorney, and provide the designated attorneys access to passwords and other security protocols required to access those electronic files and records.

39.18(3) The plan may authorize the designated attorneys to collect fees, pay firm expenses and client costs, compensate staff, terminate leases, liquidate or sell the practice, or perform other law firm administration tasks.

39.18(4) The plan must include language sufficient to make the designated attorneys' powers durable in the event of the sole practitioner's disability. *See* Iowa Code § 633B.1; Iowa R. Prof'l Conduct 32:1.3 cmt. [5].

39.18(5) The plan must be made available for review upon request by the director of the office of professional regulation or by any representative of the client security commission

.

39.18(6) The plan must be reviewed and updated annually.

39.18(7) A designated attorney must not examine any documents or acquire any information containing real or potential conflicts with the designated attorney's clients. Should any such information be acquired inadvertently, the designated attorney must, as to such matters, protect the privacy interests of the planning attorney's clients by prompt recusal or refusal of employment.

39.18(8) For purposes of this rule, a sole practitioner includes an attorney practicing alone, an attorney practicing only with other attorneys who do not own equity in the practice, an attorney practicing in an association of sole practitioners, or any other structure in which no other attorney owns equity in the practice.

[Court Order November 20, 2015, effective January 1, 2016; November 24, 2015, effective March 1, 2016; January 15, 2016, effective January 1, 2017]

ATTACHMENT B - (CURRENT RULE WITH PROPOSED REVISIONS)

34.17 Disability suspension.

34.17(1) In the event an attorney is at any time in any jurisdiction duly adjudicated a mentally incapacitated person, or a person with a substance-related disorder, or is committed to an institution or hospital for treatment thereof, the clerk of any court in Iowa in which the adjudication or commitment is entered must, within 10 days, certify the adjudication or commitment to the supreme court clerk.

34.17(2) Upon the filing of an adjudication or commitment certificate or a like certificate from another jurisdiction, upon a supreme court determination pursuant to a sworn application on behalf of a local bar association, or upon a disciplinary board determination that an attorney is not discharging professional responsibilities due to disability, incapacity, abandonment of practice, or disappearance, the supreme court may enter an order suspending the attorney's license to practice law in this state until further order of the court. Not less than 20 days prior to the effective date of the suspension, the attorney or the attorney's guardian, and the director of the institution or hospital to which the attorney has been committed, if any, must be notified in writing, directed by restricted certified mail to the last address as shown in the records accessible to the supreme court, that the attorney has a right to appear before one or more justices of the supreme court at a specified time and place and show cause why such suspension should not take place. Upon a showing of exigent circumstances, emergency, or other compelling cause, the supreme court may reduce or waive the 20-day period and the effective date of action set forth above. Any hearing will be informal and the strict rules of evidence will not apply. The decision rendered may simply state the conclusion and decision of the participating justice or justices and may be orally delivered to the attorney at the close of the hearing or sent to the attorney in written form at a later time. A copy of such suspension order must be given to the suspended attorney or to the attorney's guardian and to the director of the institution or hospital to which the suspended attorney has been committed, if any, by restricted mail or personal service as the supreme court may direct.

34.17(3) Upon the voluntary retirement of an Iowa judicial officer for disability under Iowa Code section 602.9112, or upon the involuntary retirement of an Iowa judicial officer for disability under Iowa Code section 602.2106(3)(a), the supreme court may enter an order suspending the retired judicial officer's license to practice law in this state in the event the underlying disability prevents the discharge of an attorney's professional responsibilities. The suspension is effective until further order of the supreme court. A copy of the suspension order must be given to the suspended attorney or to the attorney's guardian and to the director of the institution or hospital to which the suspended attorney is committed, if any, by restricted mail or personal service as the supreme court may direct.

34.17(4) Any attorney suspended pursuant to rule 34.17 must refrain, during the suspension, from all facets of ordinary law practice including, but not limited to, the examination of abstracts; consummation of real estate transactions; preparation of legal briefs, deeds, buy and sell agreements, contracts, wills, and tax returns; acting as a fiduciary; and when possible, remove all advertising of the attorney's services or holding out to the public that he or she is a licensed attorney. The suspended attorney may, however, act as a fiduciary for an estate, including a conservatorship or guardianship, of any person related to the suspended attorney within the second degree of affinity or consanguinity.

34.17(5) No attorney suspended due to disability under rule 34.17 may engage in the practice of law in this state until reinstated by supreme court order.

34.17(6)

a. Upon being notified of the suspension of an attorney, the chief judge in the judicial district in which the attorney practiced may appoint an attorney or attorneys to serve as trustee to inventory the attorney's files, sequester client funds, and take any other appropriate action to protect the interests of the attorney's clients and other affected persons. In appointing a trustee, the chief judge will give due regard to any designation or stand-by nomination made under the provisions of Iowa Court Rule 39.18. Any trustee appointment is subject to supreme court confirmation. The appointed attorney serves as a special member of the board and as a commissioner of the supreme court for the purposes of the appointment.

b. While acting as trustee, the trustee must not serve as an attorney for the clients of the disabled attorney or other affected persons. The trustee also must not examine any papers or acquire any information concerning real or potential conflicts with the trustee's clients. Should any such information be acquired inadvertently, the trustee must, as to such matters, protect the privacy interests of the disabled attorney's clients by prompt recusal or refusal of employment.

c. The trustee may seek reasonable fees and reimbursement of costs of the trust from the suspended attorney. If reasonable efforts to collect such fees and costs are unsuccessful, the trustee may submit a claim for payment from the Clients' Security Trust Fund of the Bar of Iowa. The Client Security Commission, in the exercise of its sole discretion, must determine the merits of the claim and the amount of any payment from the fund.

d. When the suspended attorney is reinstated to practice law in this state, all pending representation of clients is completed, or the purposes of the trust are accomplished, the trustee may apply to the appointing chief judge for an order terminating the trust.

e. Trustee fees and expenses paid by the Client Security Commission must be assessed to the disabled attorney by the Client Security Commission and are due upon assessment. Trustee fees and expenses assessed under this rule must be paid as a condition of reinstatement and may be collected by the Client Security Commission as part of the annual statement and assessment required by rule 39.8.

Rule 34.18 Death, suspension, or disbarment of practicing attorney.

34.18(1) Upon a sworn application on behalf of a local bar association, an attorney or entity designated or nominated on a stand-by basis as described in Iowa Court Rule 39.18, or the disciplinary board showing that a practicing attorney has died or has been suspended or disbarred from the practice of law and that a reasonable necessity exists, the chief judge in the judicial district in which the attorney practiced may appoint an attorney to serve as trustee to inventory the attorney's files, sequester client funds, and take any other appropriate action to protect the interests of the attorney's clients and other affected persons. In appointing a trustee, the chief judge will give due regard to any designation or stand-by nomination made under the provisions of Iowa Court Rule 39.18. The appointment is subject to supreme court confirmation. The appointed attorney serves as a special member of the disciplinary board and as a commissioner of the supreme court for the purposes of the appointment.

34.18(2) While acting as trustee, the trustee must not serve as an attorney for the clients of the disabled attorney or other affected persons. The trustee also must not examine any papers or acquire any information concerning real or potential conflicts with the trustee's clients. If the trustee acquires such information inadvertently, the trustee must, as to such matters, protect the privacy interests of the disabled attorney's clients by prompt recusal or refusal of employment.

34.18(3) The trustee may seek reasonable fees and reimbursement of costs of the trust from the deceased attorney's estate or the attorney whose license to practice law has been suspended or revoked. If reasonable efforts to collect such fees and costs are unsuccessful, the trustee may submit a claim for payment from the Clients' Security Trust Fund of the Bar of Iowa. The Client Security Commission, in the exercise of its sole discretion, must determine the merits of the claim and the amount of any payment from the fund.

34.18(4) When all pending representation of clients is completed or the purposes of the trust are accomplished, the trustee may apply to the appointing chief judge for an order terminating the trust.

34.18(5) Trustee fees and expenses paid by the Client Security Commission must be assessed to the deceased, suspended, or disbarred attorney by the Client Security Commission and are due upon assessment. Trustee fees and expenses assessed under this rule must be paid as a condition of reinstatement and may be collected by the Client Security Commission as part of the annual statement and assessment required by rule 39.8.

ATTACHMENT C - (PROPOSED REVISED RULE)

Rule 39.18 Requirement for death or disability designation and authorization.

39.18(1) *Required designation and authorization in annual questionnaire.*

a. Each attorney in private practice must identify and authorize each year, as part of the annual questionnaire required by Iowa Court Rule 39.11, a qualified lawyer servicing association, an Iowa law firm that includes Iowa attorneys in good standing, or an active Iowa attorney in good standing, to serve as the attorney's designated representative or representatives under this rule. An attorney may identify and authorize an Iowa law firm of which the attorney is a member to serve under this rule.

b. The attorney or entity designated under this rule is authorized to review client files, notify each client of the attorney's death or disability, and determine whether there is a need for other immediate action to protect the interests of clients.

c. The attorney or entity designated under this rule also is authorized to serve as a successor signatory for any client trust account maintained by the private practitioner under Iowa Court Rule 45.11, prepare final trust accountings for clients, make trust account disbursements, properly dispose of inactive files, and arrange for storage of files and trust account records.

d. The authority of the attorney or entity designated under this rule takes effect upon the death or disability of the designated attorney. The designated attorney or entity may apply to the chief judge of the judicial district in which the designating attorney practiced for an order confirming the death or disability of the designating attorney.

39.18(2) *Client list and location of key information.* Each attorney in private practice must maintain a current list of active clients, in a location accessible by the attorney or entity designated under this rule. As part of the annual questionnaire required by Iowa Court Rule 39.11, each attorney in private practice must identify the custodian and the location of the client list, the custodian and location of electronic and paper files and records, and the custodian and location of passwords and other security protocols required to access the electronic files and records. The attorney or entity designated under this rule is authorized to access electronic and paper files and records as necessary to perform duties as a designated attorney, and is authorized to access passwords and other security protocols required to access those electronic files and records.

39.18(3) *Supplemental plan.* An attorney in private practice may prepare a written plan that is supplemental to the designation and authority in the annual client security questionnaire. The supplemental written plan may designate an attorney or entity to collect fees, pay firm expenses and client costs, compensate staff, terminate leases, liquidate or sell the practice, or perform other law firm administration tasks. The supplemental written plan also may nominate an attorney or entity to serve as trustee if proceedings are commenced under the provisions of Iowa Court Rules 34.17 or 34.18.

39.18(4) *Durability.* A designation or plan under this rule must include language sufficient to make the designated attorneys' or entity's powers durable in the event of the private practitioner's disability. *See* Iowa Code § 633B.104; Iowa R. Prof'l Conduct 32:1.3 cmt. [5].

39.18(5) *Conflicts of interest.* A designated attorney or entity must not examine any documents or acquire any information containing real or potential conflicts with the designated attorney's clients. Should any such information be acquired inadvertently, the designated attorney or entity must, as to such matters, protect the privacy interests of the planning attorney's clients by prompt recusal or refusal of employment.

39.18(6) *Availability of Trustee Provisions.* A designated attorney or entity may petition the court, at any time, for appointment as the trustee or appointment of an independent trustee under the provisions of Iowa Court Rules 34.17 or 34.18, as applicable.

39.18(7) *Definitions.* For purposes of this rule, the following definitions apply:

A "*qualified lawyer servicing association*" is a bar association all or part of whose members are admitted to practice law in the state of Iowa; a company authorized to sell lawyers professional liability insurance in Iowa; or an Iowa bank with trust powers issued by the Iowa Department of Banking.

A "*law firm*" is a minimum of two attorneys in a law partnership, professional corporation, or other association authorized to practice law.

An "*attorney in private practice*" includes an active Iowa attorney who resides outside Iowa but engages in the private practice of law in Iowa.

ATTACHMENT D – (PROPOSED CHANGES TO QUESTIONNAIRE)

Death or Disability Planning Addendum to Annual Client Security Questionnaire

Questions 25 through 30 implement the requirement in Iowa Court Rule 39.18 that each attorney in private practice designate annually an attorney or entity to perform certain duties in the event of the designating attorney's death or disability. If you are not engaged in private practice in Iowa, you may answer No to question 25 and skip questions 26 through 30. If you are engaged in private practice in Iowa, you must answer questions 25 through 30. An attorney in private practice in Iowa includes any active Iowa attorney who resides outside Iowa or maintains a virtual law practice but serves Iowa clients.

You may designate an active Iowa lawyer in good standing, a law firm that includes Iowa attorneys in good standing, or a qualified lawyer servicing association. A qualified lawyer servicing association includes a bar association all of part of whose members are admitted to practice law in Iowa, a company authorized to sell lawyers professional liability insurance in Iowa, or an Iowa bank with trust powers issued by the Iowa Department of Banking. If you are a member of a law firm that includes other Iowa attorneys in good standing, you may designate your own firm to perform these duties.

25. I am engaged in the private practice of law in Iowa Yes / No

26. I designate the following named active Iowa attorney in good standing, qualified lawyer servicing association, or Iowa law firm that includes Iowa attorneys in good standing, as my representative or representatives under Iowa Court Rule 39.18:

Name of Designated Attorney or Entity:

Address Line 1:

Address Line 2:

Address Line 3:

City:

State:

Zip Code:

Zip Plus 4:

Telephone Number:

27. My list of active clients can be found in the custody of the following named person at the location indicated:

Name of Custodian:

Address Line 1:

Address Line 2:

Address Line 3:

City:

State:

Zip Code:

Zip Plus 4:

Telephone Number:

28. My electronic files and records can be found in the custody of the following named person at the location indicated:

If the same person listed in response to question 27 has custody of your electronic files and records, click the toggle here and proceed to question 29: O

Name of Custodian:

Address Line 1:

Address Line 2:

Address Line 3:

City:

State:

Zip Code:

Zip Plus 4:

Telephone Number:

29. My paper files and records can be found in the custody of the following named person at the location indicated:

If the same person listed in response to question 27 has custody of your paper files and records, click the toggle here and proceed to question 30:

Name of Custodian:

Address Line 1:

Address Line 2:

Address Line 3:

City:

State:

Zip Code:

Zip Plus 4:

Telephone Number:

30. The passwords and other security protocols required to access my electronic files and records can be found in the custody of the following named person at the location indicated:

If the same person listed in response to question 27 has custody of your passwords and other security protocols, click the toggle here and proceed to the questionnaire certification: O

Name of Custodian:

Address Line 1:

Address Line 2:

Address Line 3:

City:

State:

Zip Code:

Zip Plus 4:

Telephone Number:

The authority of the attorney or entity I have designated above takes effect upon my death or disability. The designated attorney or entity may apply to the chief judge of the judicial district

in which the designating attorney practiced for an order confirming my death or disability. The authority contained in this designation is durable in the event of my disability.

I authorize the attorney or entity I have designated above to review client files, notify each client of my death or disability, and determine whether there is a need for other immediate action to protect the interests of my clients. I also authorize the attorney or entity designated above to serve as a successor signatory under Iowa Court Rule 45.11 for any client trust account I may have, prepare final trust accountings for clients, make trust account disbursements, properly dispose of inactive files, and arrange for storage of files and trust account records. I further authorize the attorney or entity designated under this rule to access my paper and electronic files and records as necessary to perform duties as a designated attorney, and to access passwords and other security protocols required to access those electronic files and records.

I certify that I have read and answered completely and truthfully this statement/questionnaire.

_____ _____

Date Signature

Make check payable to: Client Security Trust Fund

Mail report and check to: Office of Professional Regulation
Client Security Commission
Judicial Branch Building
1111 East Court Ave.
Des Moines, Iowa 50319
Telephone: (515) 725-8029

Chapter 34

Administrative and General Provisions

. . . .

General Disciplinary Rules of Grievance Commission and Disciplinary Board

. . . .

34.17 Disability suspension.

34.17(1) In the event an attorney is at any time in any jurisdiction duly adjudicated a mentally incapacitated person, or a person with a substance-related disorder, or is committed to an institution or hospital for treatment thereof, the clerk of any court in Iowa in which the adjudication or commitment is entered must, within 10 days, certify the adjudication or commitment to the supreme court clerk.

34.17(2) Upon the filing of an adjudication or commitment certificate or a like certificate from another jurisdiction, upon a supreme court determination pursuant to a sworn application on behalf of a local bar association, or upon a disciplinary board determination that an attorney is not discharging professional responsibilities due to disability, incapacity, abandonment of practice, or disappearance, the supreme court may enter an order suspending the attorney's license to practice law in this state until further order of the court. Not less than 20 days prior to the effective date of the suspension, the attorney or the attorney's guardian, and the director of the institution or hospital to which the attorney has been committed, if any, must be notified in writing, directed by restricted certified mail to the last address as shown in the records accessible to the supreme court, that the attorney has a right to appear before one or more justices of the supreme court at a specified time and place and show cause why such suspension should not take place. Upon a showing

of exigent circumstances, emergency, or other compelling cause, the supreme court may reduce or waive the 20-day period and the effective date of action set forth above. Any hearing will be informal and the strict rules of evidence will not apply. The decision rendered may simply state the conclusion and decision of the participating justice or justices and may be orally delivered to the attorney at the close of the hearing or sent to the attorney in written form at a later time. A copy of such suspension order must be given to the suspended attorney or to the attorney's guardian and to the director of the institution or hospital to which the suspended attorney has been committed, if any, by restricted mail or personal service as the supreme court may direct.

34.17(3) Upon the voluntary retirement of an Iowa judicial officer for disability under Iowa Code section 602.9112, or upon the involuntary retirement of an Iowa judicial officer for disability under Iowa Code section 602.2106(3)(a), the supreme court may enter an order suspending the retired judicial officer's license to practice law in this state in the event the underlying disability prevents the discharge of an attorney's professional responsibilities. The suspension is effective until further order of the supreme court. A copy of the suspension order must be given to the suspended attorney or to the attorney's guardian and to the director of the institution or hospital to which the suspended attorney is committed, if any, by restricted mail or personal service as the supreme court may direct.

34.17(4) Any attorney suspended pursuant to rule 34.17 must refrain, during the suspension, from all facets of ordinary law practice including, but not limited to, the examination of abstracts; consummation of real estate transactions; preparation of legal briefs, deeds, buy and sell agreements, contracts, wills, and tax returns; acting as a fiduciary; and when possible, remove all advertising of the attorney's services or holding out to the public

that he or she is a licensed attorney. The suspended attorney may, however, act as a fiduciary for an estate, including a conservatorship or guardianship, of any person related to the suspended attorney within the second degree of affinity or consanguinity.

34.17(5) No attorney suspended due to disability under rule 34.17 may engage in the practice of law in this state until reinstated by supreme court order.

34.17(6)

a. Upon being notified of the suspension of an attorney, the chief judge in the judicial district in which the attorney practiced may appoint an attorney or attorneys to serve as trustee to inventory the attorney's files, sequester client funds, and take any other appropriate action to protect the interests of the attorney's clients and other affected persons. In appointing a trustee, the chief judge will give due regard to any designation or stand-by nomination made under the provisions of Iowa Court Rule 39.18. Any trustee appointment is subject to supreme court confirmation. The appointed attorney serves as a special member of the board and as a commissioner of the supreme court for the purposes of the appointment.

b. While acting as trustee, the trustee must not serve as an attorney for the clients of the disabled attorney or other affected persons. The trustee also must not examine any papers or acquire any information concerning real or potential conflicts with the trustee's clients. Should any such information be acquired inadvertently, the trustee must, as to such matters, protect the privacy interests of the disabled attorney's clients by prompt recusal or refusal of employment.

c. The trustee may seek reasonable fees and reimbursement of costs of the trust from the suspended attorney. If reasonable efforts to collect such fees and

costs are unsuccessful, the trustee may submit a claim for payment from the Clients' Security Trust Fund of the Bar of Iowa. The Client Security Commission, in the exercise of its sole discretion, must determine the merits of the claim and the amount of any payment from the fund.

d. When the suspended attorney is reinstated to practice law in this state, all pending representation of clients is completed, or the purposes of the trust are accomplished, the trustee may apply to the appointing chief judge for an order terminating the trust.

e. Trustee fees and expenses paid by the Client Security Commission must be assessed to the disabled attorney by the Client Security Commission and are due upon assessment. Trustee fees and expenses assessed under this rule must be paid as a condition of reinstatement and may be collected by the Client Security Commission as part of the annual statement and assessment required by rule 39.8.

. . . .

Rule 34.18 Death, suspension, or disbarment of practicing attorney.

34.18(1) Upon a sworn application on behalf of a local bar association, an attorney or entity designated or nominated on a stand-by basis as described in Iowa Court Rule 39.18, or the disciplinary board showing that a practicing attorney has died or has been suspended or disbarred from the practice of law and that a reasonable necessity exists, the chief judge in the judicial district in which the attorney practiced may appoint an attorney to serve as trustee to inventory the attorney's files, sequester client funds, and take any other appropriate action to protect the interests of the attorney's clients and other affected persons. In appointing a trustee, the chief judge will give due regard to any designation or stand-by nomination made under the provisions of Iowa

Court Rule 39.18. The appointment is subject to supreme court confirmation. The appointed attorney serves as a special member of the disciplinary board and as a commissioner of the supreme court for the purposes of the appointment.

34.18(2) While acting as trustee, the trustee must not serve as an attorney for the clients of the disabled attorney or other affected persons. The trustee also must not examine any papers or acquire any information concerning real or potential conflicts with the trustee's clients. If the trustee acquires such information inadvertently, the trustee must, as to such matters, protect the privacy interests of the disabled attorney's clients by prompt recusal or refusal of employment.

34.18(3) The trustee may seek reasonable fees and reimbursement of costs of the trust from the deceased attorney's estate or the attorney whose license to practice law has been suspended or revoked. If reasonable efforts to collect such fees and costs are unsuccessful, the trustee may submit a claim for payment from the Clients' Security Trust Fund of the Bar of Iowa. The Client Security Commission, in the exercise of its sole discretion, must determine the merits of the claim and the amount of any payment from the fund.

34.18(4) When all pending representation of clients is completed or the purposes of the trust are accomplished, the trustee may apply to the appointing chief judge for an order terminating the trust.

34.18(5) Trustee fees and expenses paid by the Client Security Commission must be assessed to the deceased, suspended, or disbarred attorney by the Client Security Commission and are due upon assessment. Trustee fees and expenses assessed under this rule must be paid as a condition of reinstatement and may be collected by the Client Security Commission as part of the annual statement and assessment required by rule 39.8.

. . . .

Chapter 39

Client Security Commission

. . . .

[New proposed] Rule 39.18 Requirement for death or disability designation and authorization.

39.18(1) *Required designation and authorization in annual questionnaire.*

a. Each attorney in private practice must identify and authorize each year, as part of the annual questionnaire required by Iowa Court Rule 39.11, a qualified lawyer servicing association, an Iowa law firm that includes Iowa attorneys in good standing, or an active Iowa attorney in good standing, to serve as the attorney's designated representative or representatives under this rule. An attorney may identify and authorize an Iowa law firm of which the attorney is a member to serve under this rule.

b. The attorney or entity designated under this rule is authorized to review client files, notify each client of the attorney's death or disability, and determine whether there is a need for other immediate action to protect the interests of clients.

c. The attorney or entity designated under this rule also is authorized to serve as a successor signatory for any client trust account maintained by the private practitioner under Iowa Court Rule 45.11, prepare final trust accountings for clients, make trust account disbursements, properly dispose of inactive files, and arrange for storage of files and trust account records.

d. The authority of the attorney or entity designated under this rule takes effect upon the death or disability of the designated attorney. The designated attorney or entity may apply to the chief judge of the judicial district in which

the designating attorney practiced for an order confirming the death or disability of the designating attorney.

39.18(2) *Client list and location of key information.* Each attorney in private practice must maintain a current list of active clients, in a location accessible by the attorney or entity designated under this rule. As part of the annual questionnaire required by Iowa Court Rule 39.11, each attorney in private practice must identify the custodian and the location of the client list, the custodian and location of electronic and paper files and records, and the custodian and location of passwords and other security protocols required to access the electronic files and records. The attorney or entity designated under this rule is authorized to access electronic and paper files and records as necessary to perform duties as a designated attorney, and is authorized to access passwords and other security protocols required to access those electronic files and records.

39.18(3) *Supplemental plan.* An attorney in private practice may prepare a written plan that is supplemental to the designation and authority in the annual client security questionnaire. The supplemental written plan may designate an attorney or entity to collect fees, pay firm expenses and client costs, compensate staff, terminate leases, liquidate or sell the practice, or perform other law firm administration tasks. The supplemental written plan also may nominate an attorney or entity to serve as trustee if proceedings are commenced under the provisions of Iowa Court Rules 34.17 or 34.18.

39.18(4) *Durability.* A designation or plan under this rule must include language sufficient to make the designated attorneys' or entity's powers durable in the event of the private practitioner's disability. *See* Iowa Code § 633B.104; Iowa R. Prof'l Conduct 32:1.3 cmt. [5].

39.18(5) *Conflicts of interest.* A designated attorney or entity must not examine any documents or acquire any information containing real or potential conflicts with the designated attorney's clients. Should any such information be acquired inadvertently, the designated attorney or entity must, as to such matters, protect the privacy interests of the planning attorney's clients by prompt recusal or refusal of employment.

39.18(6) *Availability of Trustee Provisions.* A designated attorney or entity may petition the court, at any time, for appointment as the trustee or appointment of an independent trustee under the provisions of Iowa Court Rules 34.17 or 34.18, as applicable.

39.18(7) *Definitions.* For purposes of this rule, the following definitions apply:

a. A "*qualified lawyer servicing association*" is a bar association all or part of whose members are admitted to practice law in the state of Iowa; a company authorized to sell lawyers professional liability insurance in Iowa; or an Iowa bank with trust powers issued by the Iowa Department of Banking.

b. A "*law firm*" is a minimum of two attorneys in a law partnership, professional corporation, or other association authorized to practice law.

c. An "*attorney in private practice*" includes an active Iowa attorney who resides outside Iowa but engages in the private practice of law in Iowa.

Independent Contractors vs. Employee: Classifications, Considerations, and Consequences

11:25 a.m.-12:15 p.m.

Presented by

Daniel Fischer
Hall Hudson Fischer P.C.
502 Market Street, PO Box 726
Harlan, IA 51537
Phone: 712-755-2111
Email: dfischer@hallhudson.com

James Hinchliff
Finneseth, Dalen & Powell, P.L.C.
1401 Willis Avenue
P.O. Box 487
Perry, IA 50220
Phone: 515-465-4641

THURSDAY, DECEMBER 8, 2016

Independent Contractor vs. Employee: Classifications, Considerations, and Consequences

2016 Bloethe Tax School
Iowa State Bar Association
December 8, 2016

Daniel P. Fischer
Hall Hudson Fischer, P.C.
502 Market Street, PO Box 726
Harlan, IA 51537
712.755.2111
dfischer@hallhudson.com

I. Introduction

Taxpayer businesses employ workers and assistance in numerous ways. For example, an operational law firm requires regular help through paralegals, secretaries, bookkeepers, and office managers, and possibly less frequent help through computer technicians, CPAs, and consultants. Most other business owners cannot perform every single task on their own, thus hiring workers to assist in the many varying needs of the business.

Businesses are responsible for determining whether such workers are employees or independent contractors. For both tax and labor and employment law reasons, businesses must be careful in properly classifying workers as employees or independent contractors, and following the necessary reporting for either class of workers. Furthermore, advisers should be aware of consequences for misclassification, and how to rectify such misclassifications.

This outline provides a general overview of

1. the laws that determine whether a worker is an employee or independent contractor;
2. the tax and labor and employment laws that are implicated by this determination;
3. the procedure for seeking determinations;
4. the consequences of errant classifications; and
5. programs available for correcting misclassifications.

II. Legal and Tax Implications of Classification of Employee or Independent Contractor

Businesses often prefer and seek to classify workers as independent contractors, as the classification is more favorable to the employer in multiple areas of the law. A business hiring an independent contractor will not be responsible for payroll taxes or income tax withholding. Likewise, a business hiring an independent contractor will not need to observe or comply with Worker's Compensation laws or the Fair Labor Standards Act protections such as minimum wage, overtime compensation, or other protective employment laws.

A. Tax Law

1. Tax Responsibilities in Employer-Employee Relationship[1]

Employers and employees have a responsibility to withhold and pay a number of different payroll taxes, including the following:

a. Federal Insurance Contributions Act (FICA) tax

- Social Security: 12.4% on wages up to $118,500 in 2016 (employers are responsible for 6.2%; employees are responsible for 6.2%; employers can deduct FICA tax paid on behalf of employee)
- Medicare: 2.9% on all wages (employers are responsible for 1.45%; employees are responsible for 1.45%); additionally, employees are responsible for an additional 0.9% on all wages in excess of $200,000.

FICA taxes are reported on Form 941 for most businesses; farmers and agricultural employers report FICA taxes on Form 943.

b. Federal Unemployment Tax Act (FUTA) tax

Employers are responsible for a 6.0% tax on the first $7,000 of wages for each employee in a calendar year. Employers are given a credit of 5.4% if all state unemployment taxes are paid in previous year. Therefore, FUTA is effectively a 0.6% tax on an employer's payment of the first $7,000 of an employee's wages.

FUTA taxes are reported on Form 940.

c. Federal Income Tax

Employers have a responsibility to withhold federal income tax from employees' wages in accordance with IRS instructions.

Employers use Form W-2 to report taxable wages and taxes withheld to the employee, the IRS, and the Iowa Department of Revenue. Federal income tax withholdings are reported on Form 941 for most businesses; farmers and agricultural employers report federal income tax withholding on Form 943.

---

[1] *See generally* Internal Revenue Service, *Publication 15 (Circular E), Employer's Tax Guide* (2016), *available at* https://www.irs.gov/pub/irs-pdf/p15.pdf.

d. Iowa Employment Security Law Tax
Employers are responsible for a tax between 0% and 9% on the employee's taxable wage base ($28,300 in 2016). Iowa's unemployment law states that unemployment taxes are collected from employers according to eight different tax rate tables depending on the employer's benefit ratio, figured according to an employer's propensity to lay off workers.[2]

e. State Income Tax
Employers have a responsibility to withhold state income tax from employee's wages in accordance with Iowa Department of Revenue instructions.[3]

2. Taxes in Independent Contractor Relationship
For a business hiring an independent contractor, the business will report non-employee compensation payments on Form 1099. The business will not be responsible for any payroll or income tax payments or withholding, other than payments subject to non-payroll income tax withholding.[4]

Independent contractors are subject to self-employment taxes and responsible for all reporting and payments.

B. Labor and Employment Law

1. Labor and Employment Laws for Employees
Employers have a responsibility to comply with a number of laws that affect and protect employees, including the following:

- **Fair Labor Standards Act:** Provides minimum wage and overtime protections to employees.

- **Affordable Care Act:** Larger employers have an obligation to provide healthcare insurance to employees but not to independent contractors.

---

[2] Iowa Workforce Development, *Unemployment Insurance, Employer's Handbook* (2015-2016); *available at* https://www.iowaworkforcedevelopment.gov/sites/search.iowaworkforcedevelopment.gov/files/70-5007%20Handbook%20For%20Employers_1.pdf.
[3] Iowa Department of Revenue, *Withholding Tax Information* (2016) https://tax.iowa.gov/withholding-tax-information-0.
[4] Payments subject to non-payroll income tax withholding include: Pensions (including distributions from tax-favored retirement plans, for example, section 401(k), section 403(b), and governmental section 457(b) plans) and annuities; Military retirement; Gambling winnings; Indian gaming profits; Certain government payments on which the recipient elected voluntary income tax withholding; Dividends and other distributions by an Alaska Native Corporation (ANC) on which the recipient elected voluntary income tax withholding; and Payments subject to backup withholding.

- **Unemployment Benefits:** Employers are responsible for paying taxes for unemployment benefits and insurance, as described above.

- **Workers' Compensation:** Employers must purchase insurance and cover employees for workers' compensation claims. Independent contractors are not eligible for workers' compensation coverage; employers are not required to purchase coverage for independent contractors.

- **Occupational Safety and Health Act of 1970**

- **Employment-Based Discrimination Laws:** Employees are protected from discrimination pursuant to the federal Civil Rights Act, Lily Ledbetter Fair Pay Act, Americans with Disabilities Act, and Age Discrimination in Employment Act, along with protections under Iowa's civil rights statutes.

2. Labor and Employment Laws for Independent Contractors

Independent contractors generally do not receive the protections described above. Likewise, businesses have fewer reporting and compliance responsibilities when hiring independent contractors.

III. Tests for Determining Status of Employees or Independent Contractors

A number of tests have been established for determining whether a worker is an employee or independent contractor. These tests differ for various purposes, including tax determination and employee protection. The Iowa test is established for worker's compensation and state tax purposes. The IRS test follows common law tests as established, and are used solely for tax determinations. The Department of Labor has established its own guidance for labor and employment law purposes. While each test varies, the federal agencies and states, including Iowa, have entered into agreements to work with one another for finding misclassifications.

A. Iowa

Iowa's workers' compensation act provides coverage for "all personal injuries sustained by an employee arising out of and in the course of the employment."[5] An employee is "a person who has entered into the employment of, or works under contract of service, express or implied, or apprenticeship, for an employer." [6] Independent contractors are not considered employees.[7] A workers' compensation claimant must establish that the worker was rendering services for the business; the business then has a burden to prove the worker was an independent contractor and not an employee.[8]

In determining whether a worker is an employee or independent contractor for workers' compensation claims, Iowa follows the standard set in *Nelson v. Cities Serv. Oil Co.*[9] An employer-employee relationship is indicated by the following factors:

1. The right of selection, or to employ at will;
2. Responsibility for payment of wages by the employer;
3. The right to discharge or terminate the relationship;
4. The right to control the work; and
5. The identity of the employer as the authority in charge of the work or for whose benefit it is performed.

On the other hand, an independent contractor relationship is indicated by the following factors:

1. The existence of a contract for the performance by a person of a certain piece or kind of work at a fixed price;
2. Independent nature of the worker's business or of the worker's distinct calling;
3. Employment of assistants, with the right to supervise their activities;
4. Obligation to furnish necessary tools, supplies, and materials;
5. Right to control the progress of the work, except as to final results;
6. The time for which the worker is employed;
7. The method of payment, whether by time or by job;

---

[5] Iowa Code § 85.3(1).
[6] Iowa Code § 85.61(11).
[7] Iowa Code § 85.61(11)(c)(2).
[8] *Daggett v. Nebraska-Easetern Exp., Inc.*, 107 NW2d 102 (Iowa 1961).
[9] *Nelson v. Cities Serv. Oil Co*., 146 N.W.2d 261 (Iowa 1966); *see also Stark Constr. V. Lauterwasser*, 847 N.W.2d 612 (Iowa Ct. App. 2014).

8. Whether the work is part of the regular business of the employer.

The Court has stated that the parties' intent may be used to shed light upon the true status of the parties. Additionally, community custom may be considered in determining if a service is normally provided by employees or independent contractors.

B. Internal Revenue Service

The Internal Revenue Service (IRS) used a longstanding "Twenty Factor" test to determine whether workers were employees or independent contractors. In an attempt to consolidate and simplify the test, the IRS revised the factors in January 2006. Guidance is now found in the IRS Publication 15-A, updated annually.[10] The Twenty Factor test is now consolidated into 11 main tests, organized into three groups:

- Behavioral Control;
- Financial Control; and
- The Type of Relationship Between the Two Parties.

1. Behavioral Control

Behavioral control is indicated by facts showing that the business has a right to direct and control how the worker does the task for which hired. This is evinced by the following factors.

a. Instructions That The Business Gives To The Workers.

Employees are subject to business instructions about when, where, and how to work. The IRS states that the following are examples of types of instructions about how to do work:

- When and where to do the work;
- What tools or equipment to use;
- What workers to hire or to assist with the work;
- Where to purchase supplies and services;
- What work must be performed by a specified individual; and
- What order or sequence to follow.

While instructions may not be given, behavioral control exists if the employer has the right to give instructions or control how the work is done.

b. Training that the Business Gives to the Worker

Businesses generally train employees to perform tasks in a certain manner. Independent contractors have the right to perform according to their own training and methods.

2. Financial Control

Financial control is indicated by facts that show the business has a right to control the business and financial aspects of the worker's tasks. This is evinced by the following factors.

a. The Extent to Which the Worker Has Unreimbursed Business Expenses

[10] Internal Revenue Service, *Publication 15 (Circular E), Employer's Tax Guide* (2016), *available at* https://www.irs.gov/pub/irs-pdf/p15.pdf.

Independent contractors are more likely to have unreimbursed expenses, including fixed ongoing costs regardless of whether work is being performed for an employer.

b. The Extent of the Worker's Investment
While not necessary to show independent contractor status, an independent contractor often has significant investment in the facilities and tools used in performing services.

c. The Extent to Which the Worker Makes His or Her Services Available to the Relevant Market
Independent contractors are able and free to seek out other business opportunities. Independent contractors often advertise and market their own business, and do not strictly work for the employer.

d. How the Business Pays the Worker
Employees are guaranteed regular wages for specific work intervals, even if supplemented by bonuses and commissions. Independent contractors are paid flat fees or on a time and material basis for a specific job.

e. The Extent to Which the Worker Can Realize a Profit or Loss
Independent contractors are able to make a profit or loss, while profits or losses from an employee return to the employer.

3. The Type of Relationship Between the Two Parties
Certain facts will demonstrate the type of relationship between the parties.

a. Written Contracts Describing the Relationship the Parties Intended to Create
A contract indicating an employment relationship or an independent contractor relationship will be evidence of the type of relationship the parties intended to create, although this factor is not ultimately determinative.

b. Whether or Not the Business Provides Employee-Type Benefits, such as Insurance, Pension, Vacation, Sick Pay
Employees are generally provided certain types of benefits, such as those described above, with independent contractors generally not receiving such benefits.

c. Permanency of the Relationship
An indefinite relationship indicates an employment relationship. Hiring for a specific project or set time frame indicates the hiring of an independent contractor.

d. The Extent to Which Services Performed by the Worker Are Key Aspects of the Regular Business of the Company
Hiring workers for key regular business activities indicates an employment relationship, as the employer is more likely to have behavioral control described above.

4. Statutory Employees

Certain types of workers are considered employees by statute for IRS and payroll tax purposes, even if satisfying the common law tests for independent contractors. Those types of workers include:

- Agent drivers who deliver food, beverages, laundry, or dry cleaning for someone else;
- Full-time life insurance salespeople in certain situations;
- Homeowners who work by the guidelines of the person for whom the work is done with materials furnished by and returned to that person or that person's designees;
- Traveling or city salespeople who work full time for one firm or person getting orders for customers, if the orders are for items of resale or used as supplies in the customer's business.

C. Department of Labor

On July 15, 2015, the U.S. Department of Labor ("DOL") released Administrator's Interpretation No. 2015-1, [11] specifying how it interprets laws governing whether employment or independent contractor relationships exist. The DOL noted that improper classification results in fewer workplace protections for workers through laws governing minimum wage, overtime compensation, unemployment insurance, and workers' compensation, as well as lower tax revenues and uneven playing fields between businesses. To combat misclassification, the DOL has entered into memoranda of understanding with many states, including Iowa, as well as the Internal Revenue Service.

For DOL interpretation, the standard for determination is governed by the Fair Labor Standards Act ("FLSA") definition of "employ." This is stated as "to suffer or permit to work," with such standard determined by the "economic realties" test. This test often creates a broader scope of employment than the common law test used by states and the IRS, and furthermore, the FLSA statutory directive states that the scope of the employment relationship is very broad. The DOL states that "most workers are employees under the FLSA's broad definitions."

Describing the test, the DOL states that all of the factors must be considered in each case, with no factor specifically controlling. The goal of applying and considering the factors is to determine whether the worker is economically dependent on the employer, or if the worker is actually in business for himself or herself. The questions for determination under the DOL interpretation are as follows.

1. Is the Work an Integral Part of the Employer's Business

Employees usually perform work that is integral to the employer's business. Determining whether work is integral to the employer's business requires specific inspection of the nature and purpose of the business. Independent contractor's often perform work that supports the business, but that is not integral on a continuing basis.

---

[11] U.S. Department of Labor, Wage and Hour Division, *Administrator's Interpretation No. 2015-1* (July 15, 2015), *available at* https://www.dol.gov/whd/workers/Misclassification/AI-2015_1.pdf.

2. Does the Worker's Managerial Skill Affect the Worker's Opportunity for Profit or Loss?

Independent contractors and those in business for themselves face the opportunity for profits and the risk for loss. Not only does that occur in the specific work done for a business, but this affects future opportunities and risks on other jobs.

3. How Does the Worker's Relative Investment Compare to the Employer's Investment?

An independent contractor is more likely to make some investments and have risks of loss in their business, while an employer generally makes investments and is responsible for losses of an employee. For classification as an independent contractor, the investment must be significant in nature and magnitude relative to the employer's investment in its overall business.

4. Does the Work Performed Require Special Skill and Initiative?

A worker's business skills, judgment, and initiative are factors that assist in determination of status, in regards to whether the worker is economically dependent or independent. Technical or specialized skills, on their own, do not indicate independent contractor status.

5. Is the Relationship Between the Worker and the Employer Permanent or Indefinite?

A worker being hired permanently or for an indefinite time suggests an employment relationship. Independent contractors are in business for themselves and are hired for specific tasks or projects. A lack of permanent hiring does not automatically suggest an independent contractor relationship. The key consideration is whether the lack of permanence or indefiniteness is due to the operational conditions of the business or due to the worker's initiative.

6. What is the Nature and Degree of the Employer's Control?

Employer's control is analyzed on whether the worker is economically dependent or an independent business. The worker must actually exercise control their own aspects of work.

IV. IRS Determination

For tax purposes, taxpayers can seek determination of a current or proposed arrangement from the IRS through the filing of a Form SS-8.[12] Through this form, the taxpayer answers a number of questions regarding the relationship between the business and the worker, including:

- how the worker obtained the job,
- how the business operates,
- what activities the worker performs and for whom,
- who directs the work, how the worker is paid, and what conditions and
- benefits does the worker receive.

Often, filling out the form will allow the taxpayer to consider the facts and make a determination, without having the IRS complete an actual review.

Similarly, workers who believe they have been misclassified can file an SS-8 to report a perceived or alleged misclassification. For employment law purposes, workers can report misclassification to the Iowa Workforce Development through Form 69-0009.[13]

The process of determination begins by either a business or a worker sending in a completed SS-8.[14] The IRS will contact the other party with a blank SS-8 to obtain and verify information that has been provided. The IRS will send a formal determination to both parties, which will apply to a worker or class of workers requesting it.

There is no fee for filing an SS-8. However, the IRS states that it can take at least six months to get a determination. For businesses that frequently hire similar types of workers, an advance determination could be helpful.

---

[12] Internal Revenue Service, *Form SS-8 Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding* (Rev. May 2014), *available at* https://www.irs.gov/pub/irs-access/fss8_accessible.pdf.

[13] Iowa Workforce Development, *Misclassification Report Form 69-0009, available at* https://www.iowaworkforcedevelopment.gov/sites/search.iowaworkforcedevelopment.gov/files/69-0009%20Misclassification%20Report%20Form.pdf.

[14] Internal Revenue Service, *Instructions for Form SS-8* (Rev. May 2014), *available at* https://www.irs.gov/pub/irs-pdf/iss8.pdf.

VI. Enforcement and Penalties for Misclassification

A business or employer that has misclassified a worker as an independent contractor faces substantial penalties. Risks include years of exposure to some of the most common forms of independent contractor misclassification liability, such as:

- unpaid federal and state and income tax withholdings and Social Security and Medicare contributions;
- unpaid unemployment insurance taxes, both to the federal government and to state governments;
- unpaid workers' compensation premiums
- unpaid overtime compensation and/or minimum wages
- unpaid work-related expenses
- unpaid sick and vacation pay.[15]

For large employers, misclassification can also result in liabilities under the Affordable Care Act. If an employer has more than 50 full-time equivalent employees when properly classified, the Affordable Care Act requires the business to provide health insurance.

The following are a number of Internal Revenue Code sections implicated by misclassification:

- Section 6651: For failing to file Form 941 reporting payroll taxes, the taxpayer business is subject to a 5% penalty per month on the tax amount required to be shown, up to 25% maximum.
- Section 6656: For failing to make employment tax deposits, a 10% penalty is imposed.
- Section 6662: For an inaccurate return, a 20% penalty is imposed on the underpaid tax attributable to negligence or substantial understatement.
- Section 7202: For businesses that willfully misclassify employees, criminal penalties of a $10,000 fine or five year imprisonment are possible. Worker misclassification is unlikely to trigger criminal prosecution in the absence of continuing evidence of a knowing violation.

Both government authorities and private workers are able to seek relief based on misclassifications.

[15] Richard J. Reibstein, Pepper Hamilton, LLP, The 2015 White Paper on Independent Contractor Misclassification: How Companies Can Minimize the Risks (April 27, 2015), http://www.pepperlaw.com/resource/5395/6F3.

VII. Correcting Errors of Misclassification and Relief Provisions

Under Internal Revenue Code § 3509, businesses that have misclassified workers as independent contractors can obtain reduced penalties. Under § 3509, an employer's liability for underwithholding of federal income taxes and nonpayment of payroll taxes is reduced as follows:

- From the amount the employer was required to withhold for income tax withholding to 1.5% of the employee's wages; and
- For payroll taxes, from 7.65% of the employee's wages to 20% of that amount.

If the employer did not make necessary 1099 reporting, these percentages are doubled.

To become eligible for Section 3509 rates, the business must meet several requirements:

- The employer has treated the worker as a nonemployee for income tax withholding and payroll taxes;
- The employer must have treated the worker as a nonemployee for information reporting;
- The employer did not intentionally disregard deduction and withholding requirements.

A. Classification Settlement Program

If an employer is subject to an audit, the business is eligible for reduced rates under § 3509 if they agree to the terms of an IRS Classification Settlement Program. Under a settlement, the employer agrees to reclassify workers as employees for years under audit and in the future. Under such a settlement, no interest or penalty is assessed, and the reduced rates described above are applied to taxes that were not paid or withheld.

B. Voluntary Classification Settlement Program

The IRS established the Voluntary Classification Settlement Program (VCSP) in 2011.[16] To be eligible for the VCSP, employers must have treated workers as independent contractors, filed all necessary 1099 documents, and not be under an employment tax audit. The VCSP is elected by filing Form 8952 prior to being audited.[17]

If an employer elects treatment under VCSP prior to audit, the employer agrees to classify workers as employees in the future. Additionally, the employer will pay a penalty of only 10% of the already reduced rates under § 3509.

---

[16] Internal Revenue Service, *Voluntary Classification Settlement Program* (September 14, 2016) https://www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program.
Internal Revenue Bulletin: 2012-51 *Voluntary Classification Settlement Program* (December 17, 2012) https://www.irs.gov/irb/2012-51_IRB/ar16.html.

[17] Internal Revenue Service, *Form 8952, Application for Voluntary Classification Settlement Program* (Rev. Nov. 2013) *available at* https://www.irs.gov/pub/irs-access/f8952_accessible.pdf.

C. Section 530 Safe Harbor

Businesses treating workers as independent contractors may prevail against worker classifications against the IRS under Section 530 of the Revenue Act of 1978.[18] Under § 530, an individual is not considered an employee if a business treated the worker as nonemployees for all periods, had a reasonable basis for doing so, and filed all necessary information and returns consistent with that status. A taxpayer has a reasonable basis for treating a worker as an independent contractor if reasonably relying on:

- Judicial precedent, published rulings, or technical advice with respect to the taxpayer, or a letter ruling;
- A past IRS audit that did not produce an adverse result for such workers or similarly situated workers;
- Long-standing recognized practice of a significant segment of an industry.

In addition to these specific safe harbors, a taxpayer is entitled to show any other reasonable basis for treating workers as independent contractors.

[18] William Hays Weissman, *Section 530: Its History and Application in Light of the Federal Definition of Employer-Employee Relationship for Federal Tax Purposes* (February 28, 2009), *available at* https://www.irs.gov/pub/irs-utl/irpac-br_530_relief_-_appendix_natrm_paper_09032009.pdf
Claire Y. Nash, *Independent Contractors and the Section 530 Safe Harbor*, Journal of Accountancy, (July 1, 2012) http://www.journalofaccountancy.com/issues/2012/jul/20125528.html.

CHOICE OF ENTITY: AVOIDING FEDERAL INCOME TAX PITFALLS

77th Annual Bloethe Tax School
Iowa State Bar Association
December 9, 2016

James R. Hinchliff
Finneseth, Dalen & Powell, P.L.C.
1401 Willis Avenue, P.O. Box 487
Perry, Iowa 50220-0487
(515) 465-4641
jhinchliff@fdplawfirm.com

Introduction

Every decision made by a business owner is important, but none may be as important as choice of entity on the long-term federal income tax attributes the business retains. In 1997, the Internal Revenue service established a "check-the-box" system for choice of entity through Treasury Regulations.[1] The Regulations apply to entities formed under Iowa law, including corporations, general partnerships, limited partnerships, and limited liability companies.[2] For federal income taxation purposes, entities formed under state law are generally treated as C Corporations, S Corporations, Partnerships, or Disregarded Entities.

Corporations formed under Iowa law are taxed under Subchapter C of the Internal Revenue Code or, if the proper election is made, under Subchapter S of the Internal Revenue Code.[3] Partnerships and LLCs formed under Iowa law with more than one partner or member are taxed as partnerships under Subchapter K of the Internal Revenue Code by default, but may be taxed as a corporation if an election is made.[4] Single-member LLCs or other individually owned entities are taxed as sole proprietorships as a default; tax attributes are reported on Schedule C of the owner's Form 1040.[5] Sole proprietorships,

[1] *See generally*, Treas. Regs. §§ 301.7701-1, 301.7701-2, 301.7701-3.
[2] *See generally*, Iowa Code §§ 486A, 488, 489, 490 (2016).
[3] Treas. Reg. § 301.7701-2(b)(1); IRC §§ 1361, 1362; *See* IRS Form 2553.
[4] Treas. Regs. §§ 301.7701-2(c)(1), 301.7701-3(a), 301.7701-3(c)(1); *See* IRS Form 8832.
[5] Treas. Reg. § 301.7701-3(b)(1)(ii); *See* Schedule C, Form 1040.

treated as a disregarded entity for federal income tax purposes, may elect corporate taxation status.[6]

*Note: For useful charts on choice of entity considerations, refer to Section J, Pages 61-64 of the 2015 Tax Manual.

[6] Treas. Reg. § 301.7701-3(a); *See* IRS Form 8832.

Appendix 1

Comparison of Corporate and Noncorporate Attributes

Explanation: This table illustrates the differences between operating a business as an S corporation, C corporation, proprietorship, partnership, or LLC.

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC[a]
Continuity of life	Indefinite; but stock ownership must be monitored	Indefinite	Ceases on death of proprietor	Terminates if 50% or more of total interest in capital and profits is sold or exchanged within a 12-month period	Generally no; but available in some states. Terminates for federal taxes if 50% or more of capital and profits interests are transferred during a 12-month period
Transferability of interests	Generally freely transferable; can be restricted through buy/sell agreements; must observe limitations on who can own stock	Generally freely transferable; can be restricted through buy/sell agreements	Freely transferable by selling the entire business	Generally subject to partners' approval; can be restricted through buy/sell agreements	Generally subject to members' approval; can be restricted through buy/sell agreements
Management	Centralized; board of directors; corporate officers	Centralized; board of directors; corporate officers	Centralized	General partnership: not centralized; Limited partnership: generally centralized	Can be either centralized or not centralized
Liability of owners	Generally limited to assets in corporation	Generally limited to assets in corporation	Unlimited	General partnership: unlimited; Limited partnership: general partner unlimited, limited partner limited to assets in partnership	Limited to assets in the LLC
Contribution of property	Nontaxable only if transaction meets Section 351 requirements	Nontaxable only if transaction meets Section 351 requirements	Nontaxable transaction	Generally a non-taxable transaction; assumption of liabilities by partnership may trigger gain recognition	Generally a nontaxable transaction; assumption of liabilities by LLC may trigger gain recognition
Taxability of income	Generally taxable to shareholder	Taxable to corporation	Taxable to proprietor	Taxable to partner	Taxable to member
Deductibility of losses	Generally deductible by shareholder; liabilities do not increase basis for deducting losses except for direct loans from shareholder	Deductible by corporation	Deductible by proprietor	Generally deductible by partner to extent of basis; liabilities may increase basis for deducting losses	Generally deductible by member to extent of basis; liabilities may increase basis for deducting losses
Special allocation of income/loss	Not permitted	Not applicable	Not applicable	Permitted as long as there is substantial economic effect	Permitted as long as there is substantial economic effect

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC[a]
Passive losses	May not offset active or portfolio income (limits apply at shareholder level)	May offset active income but not portfolio income of closely held corporation; may not offset active or portfolio income of personal service corporation	May not offset active or portfolio income	Cannot offset active or portfolio income (limits apply at partner level)	Cannot offset active or portfolio income (limits apply at member level); generally, members treated as limited partners
Tax year	Generally must use calendar year or make Section 444 election	May select any fiscal year if not a personal service corporation	Must use tax year of proprietor	Generally must use fiscal year of majority interest partners or make Section 444 election	Generally must use fiscal year of majority interest members or make Section 444 election
Qualified retirement plans for employee-owner	Payments are deductible if plan is nondiscriminatory	Payments are deductible if plan is nondiscriminatory	Payments to a Keogh Plan or SEP are deductible	Payments to a Keogh Plan or SEP are deductible	Payments to a Keogh Plan or SEP are deductible
Life insurance for employee-owner	Deductible as compensation	Premiums for first $50,000 group-term life are deductible and not taxable to employee	Premiums are not deductible	Premiums are not deductible	Premiums are not deductible
Health insurance for employee-owner	Deductible by corporation as compensation; 100% deductible by more-than-2% shareholder	Payments are deductible	100% deductible	Typically deductible by partnership as guaranteed payment; reported as income by partners; 100% deductible by partner	Typically deductible by LLC as guaranteed payment; reported as income by members; 100% deductible by member
Distribution to owner	Nontaxable to shareholder to extent of basis in stock; distribution of appreciated property results in gain recognition by corporation	Not deductible by corporation; generally ordinary income to shareholder; distribution of appreciated property results in gain recognition by corporation	Nontaxable	Nontaxable to extent of basis in partnership; disproportionate distribution of Section 751 assets may trigger gain	Nontaxable to extent of basis in LLC; disproportionate distribution of Section 751 assets may trigger gain
Gain on sale of interest	Capital	Capital; up to 100% of gain from qualified small business stock may be excluded	Capital and/or ordinary depending upon character of assets	Capital (unless *hot asset* partnership rules apply under IRC Sec. 751)	Capital (unless *hot asset* partnership rules apply under IRC Sec. 751)
Loss on sale of interest	Ordinary to extent of Section 1244 stock; otherwise, loss is capital	Ordinary to extent of Section 1244 stock; otherwise, loss is capital	Capital and/or ordinary depending upon character of assets	Generally capital	Generally capital
Liquidating distribution	At corporate level treated as sale of property; gain passes through and increases shareholder basis; could trigger built-in gains tax	At corporation level treated as sale of property; gain to shareholder if FMV exceeds stock basis	Nontaxable	Generally, nontaxable; cash distribution in excess of basis will trigger gain; disproportionate distribution of Section 751 assets may trigger gain	Generally, nontaxable; cash distribution in excess of basis will trigger gain; disproportionate distribution of Section 751 assets may trigger gain

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC[a]
Accumulation of earnings	No restrictions	Corporation could be subject to accumulated earnings tax on unreasonable accumulation	No restrictions	No restrictions	No restrictions
Section 179 dollar limitation applied at single level?	No; The dollar limitation applies at the S corporation level and again at the shareholder level	Yes	Yes	No; The dollar limitation applies at the partnership level and again at the partner level	No; The dollar limitation applies at the LLC level and again at the member level
Maximum tax rate	Generally taxed at individual shareholder level	35%, with 3% increase for taxable income between $15 million and $18.33 million	35% (effective rate may be higher if exemptions are phased out and itemized deductions are limited)	Taxed at partner level	Taxed at member level
Use of tax credits	Passed through to shareholders to be applied against their tax	Used to offset corporate tax	Used to offset tax of the individual	Passed through to partners to be applied against their tax	Passed through to members to be applied against their tax
Use of NOLs	Passed through to shareholder; limits apply at shareholder level	Used to offset corporate income subject to certain limits	Used to offset individual's income subject to certain limits	Passed through to partner; limits apply at partner level	Passed through to members; limits apply at member level
At-risk rules	Limits apply at shareholder level	Only applicable to certain closely held corporations	Limits apply at proprietor level	Limits apply at partner level	Limits apply at member level
Charitable contributions	Passed through to shareholder; limits apply at shareholder level	Deductible by corporation subject to certain percentage limits	Deductible by individual subject to certain percentage limits	Passed through to partner; limits apply at partner level	Passed through to member; limits apply at member level
Self-employment income to owners	No	No	Yes	Yes, general partners; No, limited partners	Unclear
Cash accounting method	Unrestricted unless inventories are maintained or is a tax shelter[b]	Restricted	Unrestricted	Unrestricted unless inventories are maintained or is a tax shelter[b] or has a C corporation partner	Unrestricted unless inventories are maintained or is a tax shelter[b] or has a C corporation partner
Classes of stock/ownership interests	Restricted	Unrestricted	N/A	Unrestricted	Unrestricted
Number of investors	Limited to 100	Unlimited	N/A	At least two	At least two[c]
Eligible investors	Restricted	Unrestricted	N/A	Unrestricted	Unrestricted

Notes:

[a] Assumes the LLC is a multimember LLC treated as a partnership for tax purposes and not as an association taxable as a corporation.

[b] If a gross receipts test is met, the cash method may be used even if inventories are maintained.

[c] Reg. 301.7701-3(b)(1)(ii) disregards a single-member LLC as a separate entity.

MINUTES OF ORGANIZATIONAL MEETING

The organizational meeting of ------- LLC, an Iowa limited liability company, organized under the Iowa Revised Uniform Limited Liability Company Act, was held at ADDRESS (Law Office), in the City of --------, on the day of , 20, at --:00 o'clock -.M., pursuant to call by a majority of the organizers and waiver of notice by all members.

The following member of the Company was present, namely:

SMLLC MEMBER NAME

---- was chosen Chairman of the meeting, and ---- was chosen Secretary of the meeting.

Thereupon, the Secretary of the meeting presented an Operating Agreement prepared by counsel for the Company. The proposed Operating Agreement was reviewed and discussed, and the following resolution was thereupon adopted:

> **RESOLVED**, that the Operating Agreement prepared by counsel for the Company be, and is hereby, adopted as the Operating Agreement of this Company; and
>
> **FURTHER RESOLVED,** that the Operating Agreement so adopted or a true copy thereof be placed in the company record that is included in the record book of the Company.

The Chairman called for the nomination of officers. Thereupon the following persons were duly nominated and elected to serve as the officers of the Company for the term provided in the Operating Agreement:

President -
Vice President -
Secretary -
Treasurer -

The Chairman then stated that before the filing of the Certificate of Organization in the office of the Secretary of State, subscriptions to the membership units of the Company had been executed as follows:

Name	Address	No. of Units	Amount Subscribed

The Chairman stated that it was appropriate for the Members to accept such subscriptions on behalf of the Company and to determine the time and manner of payment of such subscriptions and to value any consideration other than money to be received therefor. Thereafter, the following resolutions were duly adopted:

> **RESOLVED,** that the aforesaid subscriptions to the membership units of the Company be and they are hereby accepted on behalf of the Company.
>
> **FURTHER RESOLVED,** that the subscribers to the membership units of this Company be and they are hereby required to pay for the same in full forthwith to the Treasurer of the Company.
>
> **FURTHER RESOLVED,** that a call be made by the Members for payments on all subscriptions by written notice to each subscriber in accordance with the above action of the Members.
>
> **FURTHER RESOLVED,** that the membership units subscribed for shall be issued for the consideration stated in the subscription agreements; and that when and as any subscriber makes full payment to the Treasurer of this Company for the membership units subscribed to by him in accordance with the subscription agreement heretofore accepted, the membership units of said subscriber shall be deemed fully paid and non-assessable.
>
> **FURTHER RESOLVED,** that when and as any subscriber shall make full payment for his membership units to the Treasurer of this Company, the proper officers of this Company, as provided in the Operating Agreement, shall execute and deliver to said subscriber a certificate or certificates representing said membership units.

Thereupon the following resolution was duly adopted:

> **RESOLVED,** that the officers of this Company be and they are hereby authorized and directed to pay all organization expenses of this Company out of the funds of this Company.

The Chairman then stated that it was appropriate to select a depository for the funds of the Company and adopt a resolution or resolutions establishing borrowing authority for the Company. A document, in the form of resolutions, supplied by in the city of , Iowa was presented. After full consideration, the resolutions contained in the blank form suggested by said bank was duly adopted. The Chairman directed that a copy of the form of resolutions as executed by the Company should be filed with these minutes.

The Secretary then presented to the meeting a form of certificate representing membership units of the Company. Thereupon, on motion duly made and seconded, the following resolution was unanimously adopted:

> **RESOLVED,** that certificates representing membership units of this Company be in the form of the specimen membership unit certificate presented to this meeting and that a specimen certificate in such form be inserted in the record book immediately following the minutes of this meeting.

There being no further business to come before the meeting, on motion duly made, seconded and carried, the meeting adjourned.

_____

Secretary of the meeting

OPERATING AGREEMENT BY THE MEMBER OF
NAME OF LLC

ARTICLE I
ORGANIZATION OF THE COMPANY

1.01 Formation. The party to this Agreement has agreed to the formation of , a limited liability company organized under the provisions of the Iowa Act. A certificate of organization has been filed with the Iowa Secretary of State. The Member may take such further actions as they deem necessary to permit the Company to conduct business as a limited liability company in any other jurisdiction.

1.02 Principal Office. The principal office of the Company shall be at ---- or such place as may be designated from time to time by the Member. The Member may establish additional places of business for the Company.

1.03 Purpose of the Company. The Company may engage in any activity with a lawful purpose as permitted by Iowa Law, regardless if for profit.

[Optional]

1.03 Business of the Company. The business of the Company is limited to unless the Member approves other business activities.

ARTICLE II
MEMBERS

2.01 Member. The name and address of the Member and his or her initial Capital Contribution is as follows:

Member	Address	Capital Contribution (See attached balance sheet)

2.02 Liability of the Member. The debts, obligations, or other liabilities of the Company, whether arising in contract, tort, or otherwise, belong solely to the Company and do not become the debts, obligations, or liabilities of a Member solely by reason of the Member acting as a Member.

ARTICLE III
MANAGEMENT OF THE COMPANY

3.01 Management by the Member.

(a) The Company is managed by the Member. The conduct of the Company's business and the management of its affairs will be exercised and

conducted solely by the Member. The member shall have the sole authority to bind the Company or authorize any other individual or entity to bind the Company. Any said authorization shall be in writing.

3.02 Statements of Authority. The Member is authorized on behalf of the Company to deliver to the Iowa Secretary of State for filing a statement of authority. The statement may provide the Member with the authority, or limitations on the authority, to do any of the following:

(a) Execute an instrument transferring real property held in the name of the Company; and

(b) Enter into other transactions on behalf of, or otherwise act for or bind, the Company.

With regard to real estate transactions, a Statement of Authority filed with the Secretary of State and the county recorder in which the real estate is located, shall serve as constructive notice to all third parties regarding who has the authority to transfer real estate on behalf of the Limited Liability Company.

3.03 Liability Limitation of the Member.

(a) The Member shall not be personally liable to the Company for money damages for any action taken, or any failure to take any action, except liability for any of the following:

(1) A breach of the duty of loyalty;

(2) A financial benefit received by the Member to which the Member is not entitled;

(3) Intentional infliction of harm on the Company; or

(4) An intentional violation of criminal law.

ARTICLE IV
RECORDS; FINANCIAL AND FISCAL AFFAIRS; TAX REPORTING

4.01 Records and Accounting.

(a) The books of account of the Company shall be maintained at the Company's principal office. The Company shall maintain correct and proper books and records, entering fully and properly all Company transactions, as reasonably determined by the Member.

4.02 Tax Returns. The Member shall cause income tax returns for the Company to be prepared and timely filed in accordance with applicable law.

4.03 Interim Closing of the Books. There shall be an interim closing of the books of account of the Company (i) at any time a taxable year of the Company shall end pursuant to the Internal Revenue Code; and (ii) at any other time determined by the Member to be required by good accounting practice or otherwise appropriate under the circumstances.

ARTICLE V
DISSOLUTION

5.01 Events Causing Dissolution. The Company is dissolved, and its activities must be wound up, upon the occurrence of any of the following:

(a) the direction of the Member;

(b) the passage of 90 consecutive days during which the Company has no Members; or

(c) the entry by a District Court of an Order dissolving the Company on the grounds that the conduct of all or substantially all of the Company's activities is unlawful; or it is not reasonably practicable to carry on the Company's activities in conformity with its Certificate and this Agreement certificate.

5.02 Distribution of Assets in Winding Up Company.

(a) In winding up its activities, the Company must apply its assets to discharge its obligations to creditors, including the Member if he or she is a creditor.

5.03 Business After Dissolution. After dissolution, the Company shall not engage in any business except what is necessary to wind up the Company's affairs pursuant to Iowa Code § 489.702 and to protect the value of and distribute the Company's assets.

5.04 Management of the Company After Dissolution. The Member shall continue to manage the Company after dissolution.

ARTICLE VI
MISCELLANEOUS

6.01 Entire Agreement. This Agreement is the sole Operating Agreement of the Company and constitutes the entire agreement among the parties relating to its subject matter; this Agreement supersedes any prior agreements or understandings between the parties, oral or written relating to its subject matter, all of which are hereby canceled.

6.02 Governing Law; Successors. This Agreement shall be governed by and construed in accordance with the laws of the State of Iowa and, subject to the restrictions on transferability set forth in this Agreement, shall bind and inure to the benefit of the heirs, executors, personal representatives, successors and assigns of the Members. The rights and liabilities of the Member under this Agreement shall be as provided by Iowa law.

6.03 Possible Restrictions. Notwithstanding anything to the contrary contained in this Agreement, in the event of (a) the enactment (or imminent enactment) of any legislation, (b) the publication of any temporary or final Treasury Regulations, (c) any ruling by the Internal Revenue Service; or (d) any judicial decision that, in any such case, in the opinion of counsel for the Company, would result in the taxation of the Company as an association taxable as a corporation or would otherwise result in the Company being taxed as an entity for federal income tax purposes, then the Member may impose such restrictions as may be required, in the opinion of counsel, to prevent the Company for federal income tax purposes from being taxed as an association taxable as a corporation or otherwise as an entity, including, without limitation, making any amendments to this Agreement as the Member in its sole discretion may determine to be necessary or appropriate to impose such restrictions.

ARTICLE VII
DEFINITIONS

As used in this Agreement, the following terms shall have the following meanings:

7.01 "Agreement" shall mean this Operating Agreement, as originally executed or as amended, modified, supplemented or restated from time to time.

7.02 "Capital Contribution" shall mean the aggregate amount of cash and fair market value of any non-cash property (net of any liabilities assumed by the Company or secured by such property) that the Member shall be credited with contributing, directly or by assignment, to the Company on or prior to such date.

7.03 "Internal Revenue Code" shall mean the Internal Revenue Code of 1986, as amended from time to time and any successor statute or subsequent codification or recodification of the federal income tax laws of the United States.

7.04 "Company" shall mean , as such limited liability company may from time to time be constituted.

7.05 "Iowa Act" shall mean the Iowa Revised Uniform Limited Liability Company Act, Chapter 489 of the Iowa Code, as amended.

7.06 "Fiscal Year" shall mean the twelve-month period ending December 31.

7.07 "Treasury Regulations" shall mean the regulations of the United States Department of the Treasury pertaining to the income tax, as from time to time in force

IN WITNESS WHEREOF, the Member has executed this Agreement effective as of the ---- day of ----, 20--.

_____

C or S Corporation Pitfall: Contributing Encumbered Property at Formation

Generally, an individual who transfers property in exchange for stock in a C (or S) Corporation usually is afforded tax-free treatment if 1) cash, property, or both is transferred solely in exchange for stock in the corporation; and 2) the contributing shareholder(s) are in control of the corporation immediately after the contribution.[7] "Control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock.[8]

However, where shareholder(s) contribute encumbered real property to a C (or S) Corporation, issues can arise. When real property is contributed to a C (or S) Corporation with an encumbrance that exceeds its tax basis and the Corporation assumes the encumbrance as part of the contribution, gain is recognized to the extent the encumbrance exceeds the tax basis of the contributed real property as taxable boot.[9] A shareholder would also recognize gain if an encumbered contribution was made to the Corporation to avoid federal income tax or made without a bona fide business purpose.[10]

Illustration:

A and B form a C Corporation under Iowa law on January 1, 2016. Both A and B are Iowa residents, individuals, and citizens of the United States. Shares are issued on the same day to A and B. Corporation, Inc. is formed to start a new business requiring a storefront in Perry, Iowa with hopes to later expand the number of stores. A contributes $100,000 cash in exchange for 50 shares of Corporation, Inc. to assist in capitalizing Corporation, Inc. B contributes Blackacre with a storefront in exchange for 50 shares of Corporation, Inc. Blackacre has a tax basis of $180,000, a fair market value of $200,000, and a mortgage of $200,000. If B contributes Blackacre to Corporation, Inc. with the attached encumbrance at formation, B will recognize a $20,000.00 gain on the contribution for his 50 shares in Corporation, Inc. and B's basis in his stock would be zero (basis + gain – debt assumed by Inc. = 0).

*For additional information on this pitfall, refer to Section J, Pages 21-22 of the 2015 Tax Manual.

---

[7] IRC § 351.
[8] IRC § 368(c).
[9] IRC §§ 357(c), 358(d).
[10] IRC § 357(b).

S Corporation Pitfall: Tax Attribute Allocation

Tax attributes of Small Business Corporations (S Corporations) are strictly allocated among shares of S Corporation stock, pro-rata, by default.[11] This is known as the per-share-per-day rule.[12] Tax attributes, including income, are allocated among the shareholders according to their ownership interests, per day.[13] In addition to the per-share-per-day allocation method, an interim closing of the books election can be made pursuant to Regulations.[14] In effect, if a closing of the books election is made, the pre-Closing and post-Closing books are treated as separate taxable years for allocation of tax attributes among shareholders.[15]

In order to make a valid terminating election (also known as a closing of the books election), particular requirements must be satisfied.[16] Specifically, (1) at least one shareholder's interest in the S Corporation must be completely terminated; (2) all affected shareholders must consent; and (3) the S Corporation must (i) affirmatively declare the election to close the books on Form 1120S, (ii) include a statement confirming all affected shareholders consent to the election, and (iii) detail information on how the shareholder's interest was entirely terminated by sale or gift.[17] For purposes of the terminating election, affected shareholders include (1) the shareholder whose interest is terminated, and (2) all shareholders to whom such shareholder has transferred shares during the taxable year.[18]

Illustration:

After making a valid election to be taxed as an S Corporation on February 1, 2016, A decides to sell her 50 shares of Corporation, Inc. to D for $100,000.00 on May 25, 2016; 145 days after the start of the tax year. From January 1, 2016 to May 25, 2016, Corporation, Inc. generated $145,000.00 of income. From May 26, 2016 to December 31, 2016, Corporation, Inc. generated $263,000.00 of income.

Under the default **per-share-per-day** method, the tax attribute allocation for A, B, and D is as follows:

---

[11] IRC § 1377(a)(1).
[12] *Id*.
[13] *Id*.
[14] IRC § 1377(a)(2).
[15] Treas. Reg. § 1.1377-1(b)(3).
[16] Treas. Regs. §§ 1.1377-1(b), 1.1377-1(b)(5).
[17] Treas. Reg. § 1.1377-1(b)(5)(i)(A)-(D).
[18] Treas. Reg. § 1.1377-1(b)(2).

Per-day income allocation				
Total Income in 2016				$408,000.00
Days in 2016				/365
Income per day in 2016				$ 1,117.81
Per-share-per-day income allocation				
Income per day in 2016				$ 1,117.81
Shares issued by Corp., Inc.				/100
Income per-share-per-day 2016				$ 11.18
2016 Shareholder Income Allocation				Total Annual
S/H	Shares	Days	Income/SH/Day	Allocation
A	50	145	$11.18	$81,055* (20%)
B	50	365	$11.18	$204,035* (50%)
C	50	220	$11.18	$122,980* (30%)

*Indicates an approximate annual allocation with rounding.

Using the **terminating election** to close the books, the tax attribute allocation for A, B, and D is as follows:

Per-day income allocation	Total 2016	1/1/16 to 5/25/16	5/26/16 to 12/31/16
Total Income	$408,000	$145,000	$263,000
Days	365	145	220
Income per day	$1,117.81	$1,000	$1,195.45
Shares	100	100	100
Income/share/day	$11.18	$10	$11.95

2016 Shareholder Income Allocation			1/1/16 to 5/25/16	
S/H	Shares	Days	Income/SH/Day	Allocation
A	50	145	$10	$72,500
B	50	145	$10	$72,500
C	0	0	$0	$0

2016 Shareholder Income Allocation			5/26/16 to 12/31/16	
S/H	Shares	Days	Income/SH/Day	Allocation
A	0	0	$0	$0
B	50	220	$11.95	$131,450
C	50	220	$11.95	$131,450

2016 Shareholder Income Allocation			Annual Total	
S/H	Shares	Days	% of Income	Total Allocation
A	50	145	18%	$72,500*
B	50	365	50%	$203,950*
C	50	220	32%	$131,450*

Without the election, A would be over allocated approximately $8,500.00 worth of income for Tax Year 2016. Depending on A's individual income tax situation, the terminating election may be a benefit to A to more equitably divide income based on ownership as opposed to the annual default attribute allocation structure.

*Note: It would be best practice to include a statement of any terminating election in any Shareholder Agreement that applies to all of the Shareholders of the S Corporation. In addition, a statement should be attached to Form 1120S for the year that a terminating election is being made.

*For a Statement example, refer to Chapter D, Page 78 of the 2015 Tax Manual.

NAME(S):	TIN:

**ELECTION TO APPLY SPECIFIC ACCOUNTING RULES
IN CONNECTION WITH TERMINATION OF A SHAREHOLDER'S
ENTIRE INTEREST
PURSUANT TO IRC §1377(a)(2) AND REG. 1.1377-1(b)**

The corporation hereby elects under IRC §1377(a)(2) to have the rules provided in IRC §1377(a)(1) regarding allocation of income, expense, etc. applied as if the corporate tax year consisted of two tax years. This election is made with respect to the termination of the entire interest of the following shareholder(s) during the tax year:

NAME	TERMINATION DATE	MANNER OF TERMINATION
_____		
_____		
_____		

CONSENT OF AFFECTED SHAREHOLDERS

The undersigned shareholders comprise all of the shareholders of the above corporation whose interest(s) were terminated on the above date and/or to whom corporate stock was transferred as a result of said termination. The undersigned hereby consent to the corporation's election under IRC §1377(a)(2). The undersigned hereby certify, under penalties of perjury, that to the best of their knowledge and belief the statements contained herein are true and correct.

SIGNATURE	ADDRESS	SSN
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

NOTE: **Unless this election is made, the per-share, per-day method of allocating income and expense is required to be utilized. Income and expense allocations may differ depending on the allocation rule the corporation and its shareholders choose to have applied.**

(Revised 11/15)

Bloethe Tax School

Employee Benefits – Flexible Spending, High Deductible Insurance Plans and Health Savings Accounts

3:15 p.m.-4:15 p.m.

Presented by
Dustin Petty
Base
601 Visions Parkway
Adel, IA 5003
Phone: 515-993-5033
Email: dpetty@BASEonline.com

THURSDAY, DECEMBER 8, 2016

Tax Saving Benefit Strategies & Compliance Options In ACA World

Going Beyond the Law – Solutions for Business Owners

Presented by

Dustin Petty

601 Visions Parkway, Adel IA 50003

Phone: 888-386-9680, ext. 256

Fax: (515) 993-5033

dpetty@BASEonline.com

Benefit Strategies & Compliance
Are you looking for new benefit strategies that keep business owners compliant with ACA?

- Section 105 HRA
- Integrated HRA
- 125 Cafeteria Plan (POP, FSA & DCAP)
- Excepted Benefits
- ERISA Wrap

Section 105 HRA
Do you work with self-employed business owners looking for ways to cover the cost of family medical expenses?

- ACA exempted/IRS approved benefit plan
- Average qualifying client saves $4,500 annually when taking this business deduction
- Deductible expenses include health insurance premiums, out-of-pocket non-insured medical expenses, dental, vision and more!

Section 105 HRA
Allows small business clients to deduct up to 100% of their family's qualifying medical expenses as a legitimate business deduction

- Health Insurance Premiums
- Deductibles
- Co-pays
- Eye Care
- Dental
- Prescriptions
- Orthodontia
- Many more

Section 105 HRA – 1 Employee Participant
- Health Insurance Premiums CAN BE reimbursed. However, if the client obtains coverage through the Federal or State Exchange/Marketplace and receives a subsidy these premiums are not eligible. But, can cover all non-premium expenses.
- Supplemental Premiums that qualify as indemnity policies
- Dental Premiums, Vision Premiums, Long Term Care Insurance Premiums, Medicare Premiums
- All other 213(d) medical expenses
- Plan must have a benefit limit *(plan maximum)*

Section 105 HRA – 2 or More Employees
- Health Insurance Premiums are NOT eligible, and this includes Medicare Part B
- Supplemental Premiums that qualify as indemnity policies
- Dental Premiums

- Vision Premiums
- Long Term Care Insurance Premiums
- All Section 213(d) medical expenses
- Plan must not have a benefit limit *(no plan maximum)*

Group Health Care vs Individual Plans

- In Iowa individual plans with Wellmark are going up 40%
- If you already have group options for premium savings – Integrated HRA
- Cafeteria Plans
  - POP
  - FSA
  - DCAP
- Excepted Benefits

Integrated HRA

Do you work with employers who are looking to reduce premium costs for group insurance plans?

- Self-funding with a safety net
- High deductible plan with low deductible
- Employee satisfies deductible and employer pays up to insured deductible

Integrated HRA

- Client must have a group insurance policy
- Employer selects what type of expenses to reimburse
- Deductibles, Coinsurance, Co-Pay, Rx
- Plan must have a benefit limit *(plan maximum)*

Integrated HRA

Example

Average Utilization of Integrated HRA funds equals 11%

- 11% HRA utilization means employer would pay $550 through the HRA
  - Company would **save $24,496**
- Even at 100% utilization the employer would pay $5,000 through HRA
  - Would still **save $20,046**

125 Cafeteria Plan

Do you work with employers who pay for any portion of their employee's health insurance premiums or are looking to assist with the cost of out-of-pocket or dependent care expenses?

- Pre-tax premiums, out-of-pocket medical or dependent care expenses *(employer saves FICA tax match)*
- Plan documentation & administration

- Premium Only Plan is option under 125 Cafeteria Plan – along with Flexible Spending Account & Dependent Care Assistance Plan

125 Cafeteria Plan

- Employer sponsors Section 125 Cafeteria Plan Flexible Spending Account (FSA)
- Employee directs employer to withhold premiums
    - Withheld from paycheck as a pre-tax benefit
- Employer can make **NO** contributions to employees individual premiums *(GROUP ONLY)*
- Employer **CAN** contribute to non-premium medical expenses

Premium Only Plan (POP)

Established by an employer to allow employees to set aside money from each paycheck on a pre-tax basis to pay for insurance premiums.

- Employer that sponsors a group underwritten plan and employees pay a portion of the premium.
- Employer saves FICA tax match on any premium withheld pre-tax from employee's paycheck.

Premium Only Plan (POP)

- If only a few employees choose to take advantage of ability to pay health insurance premiums with pre-tax dollars, the employer can still realize a net financial gain.
- With one quick payroll adjustment, the POP is an effective way for business owners to allow employees to pay for employer sponsored group health care by utilizing pre-tax dollars.
- Participating employees benefit from the ability to pay their share of employer-sponsored benefit premiums, including health, dental, and vision supplemental, with pre-tax dollars through salary reduction. This saves employees Federal, State and FICA taxes.
- Depending on an employee's family income, the amount of money that individuals can save by paying for health insurance this way is between 25 to 50% of their total insurance premium.

Flexible Spending Account (FSA)

Established by an employer to allow employees to set aside money from each paycheck on a **pre-tax basis** to pay for qualifying medical expenses, up to $2,600 annually.

- Non-insured medical expenses only
- Code §213(d) expenses
    - Dental
    - Vision
    - Co-pays
    - Deductible
    - Chiropractic
    - Prescriptions

Dependent Care Assistance Plan (DCAP)

Established by an employer to allow employees to set aside money from each paycheck on a pre-tax basis to pay for qualifying adult or child care expenses, up to $5,000 annually.

- Childcare or Daycare costs
- Adult daycare
- Before and after school programs
- Summer programs or camps in which care is provided while parents are working or at school

Excepted Benefits
Do you work with employers who are looking to assist employees with the payment of supplemental benefit plans?

Excepted Benefits HRA
- Employer Paid

Excepted Benefits 125
- Employee Paid

Excepted Benefits – HRA
EMPLOYER PAID
Protection of Funds – Funds are held by employer and only paid to employees once a qualifying excepted benefit has been adjudicated by BASE.

Reimbursement Control – Employers decide which excepted benefits will be reimbursed under the HRA.

Controlled Funding Limits – Employers determine their annual contribution amount for each employee, and are able to limit risk due to the annual rollover caps.

Excepted Benefits – 125
EMPLOYEE PAID
Financial Benefits – Employer does not pay Medicare and Social Security on the amounts that employees choose to have withheld from their paychecks on a pre-tax basis.

Limited Risk – Plan is 100% employee funded. Reimbursement is on an accrual basis at no risk to the employer.

Increase Take-Home Pay – Employees benefit from the ability to pay for supplemental coverage with pre-tax earnings, which in turn reduces total taxable income.

ERISA Wrap
Do your clients offer employee benefits?

- Federally required

- Plan document & SPD (not SBC)
- $110 per-day, per-employee penalty

ERISA Wrap
ERISA (the federal Employee Retirement Income Security Act) requires employers who are plan administrators of group health plans to comply with 2 important requirements or risk potential penalties and possible audits:

1. Maintain and distribute Summary Plan Descriptions (SPDs) to plan participants which accurately reflect the contents of the plan and which include specific information as required under federal law.
2. Group health plans must be administered in accordance with a written Plan Document which must be made available to plan participants and beneficiaries upon request.

ERISA Wrap
Employers are not aware of the ERISA requirements to distribute an SPD and maintain a Plan Document.

Many companies mistakenly assume that insurance contracts, certificates of insurance and benefits summaries fulfill the ERISA requirements for an SPD and Plan Document--but they don't include the required or recommended provisions that protect the plan and the employer.

Employers mistakenly think they are compliant by distributing benefits booklets and summaries. Plus, the SBC and SPD are often confused and employers think they are covered if they have the SBC in place.

ERISA Wrap
Compliance calls for an ERISA Wrap…virtually all employers who offer or sponsor benefits, regardless of size or number of participants.

- Lack of SPD could trigger a plan audit by the U.S. DOL.
- Failure to provide SPD or Plan Document within 30 days of receiving request from plan participant or beneficiary can result in penalty of up to $110/day per participant or beneficiary for each violation.
- DOL has increased audit staff and national enforcement initiatives to investigate employers' compliance with Health Care Reform, resulting in companies of all sizes being audited and being required to provide an SPD and Plan Document.

Only entities exempt are government employers and bona fide church groups.

ERISA Wrap
Penalty for Failure to Comply with ACA Market Reforms

- Failure to provide SPD or Plan Document within 30 days of receiving request from plan participant or beneficiary can result in penalty of up to $110/day per participant or beneficiary for each violation.
- Lack of SPD could trigger a plan audit by the U.S. DOL.
- DOL has increased audit staff and national enforcement initiatives to investigate employers' compliance with Health Care Reform, resulting in companies of all sizes being audited and being required to provide an SPD and Plan Document.

ERISA Wrap

Establishing ERISA Wrap provides documentation to wrap around existing certificates of insurance and benefit plan booklets to provide required provisions and information necessary to comply with ERISA.

- Customized Wrap SPD and Wrap Plan Document provide the required ERISA provisions and information to help achieve compliance.
- Distribution guidelines explain how and when to provide compliance documents to plan participants.
- Ability to keep documents current and updated should the federal government issue new amendments or if plan information needs to be changed.

Bloethe Tax School

Ethics: Cybersecurity and Cloud-based Databases

4:15 p.m.-5:00 p.m.

Presented by
Todd Scott
V.P. Risk Management
Minnesota Lawyers
Mutual Insurance Company
333 South Seventh Street
Suite 2200
Minneapolis, MN 55402

THURSDAY, DECEMBER 8, 2016

Ethical Applications of New Legal Technology: Conflict Checking, Cloud Computing, Electronic Use & Social Media **(IA Rules 2014)**

By Todd C. Scott, VP Risk Management
Minnesota Lawyers Mutual Ins. Co.

The purpose of a conflicts check is to ensure that your commitment to your client's matter will not be distracted by your commitment to any other person. "Loyalty and independent judgment are essential elements in the lawyer's relationship to a client." **Iowa Rules of Professional Conduct Rule 32:1.7: CONFLICT OF INTEREST CURRENT CLIENTS, Comment [1].** Many attorneys believe that this commitment of loyalty can be upheld by a brief moment of thought, comparing their client's circumstances to that of the firm's other clients, at the time they are being retained for their services.

Professional liability insurers and risk management professionals continually stress the importance of a conflict-checking system in law firms to help identify potential conflicts at the time the attorney-client relationship is established. Consistently, it has been shown that a check for conflicts-of-interest that does not include the use of a thorough list or database will leave the firm vulnerable to an embarrassing, and potentially negligent conflict-of-interest problem.

Establishing a reliable conflict-checking system in your firm can be a relatively easy thing to do. However, the system is only as good as the information that is put into it. Therefore, creating the conflict-checking system and maintaining it should be viewed as an ongoing and permanent commitment to securing your client's confidence and your devotion to their best interests will never be questioned.

The elements necessary for conducting an effective conflicts check in your law practice are:

- Establishing a thorough, well-maintained list of names;
- Ensuring that the conflict-checking procedure becomes a part of firm's routine;
- Everyone in the firm is trained in the procedure and involved in the system.

The best conflict-checking system is one that will work, and that the members of the firm will find easy to use and maintain. There is nothing inherent in a computer-based conflicts program that makes it superior to a well-maintained manual system. However, since a computer-based conflicts system can conduct a thorough check rather quickly, it is more likely to be used routinely by the firm, and it is less likely to overlook a single name buried in a large database.

Using Software to Search for Conflicts

One common misunderstanding involving law office software is that there is a category of software products called "conflict checking software." Although there are a handful of software programs that

purport to be used exclusively for conflicts checking, for the most part, there are no software titles available for lawyers to perform this exclusive task.

In the world of law office software, conflicts checking tools are commonly available in case management software programs. The connection between conflicts checking and case management software makes sense. After all, if you take the time to enter detailed information about your clients, former clients, witnesses, opposing counsel, interested parties and just about everyone else who has ever come in contact with the firm in a software program, what it starts to resemble is a large database of firm information that can be used for several purposes – including conflicts checking.

Since case management products became affordable for use in small law offices in the days of Windows 95, this category of software has rapidly secured its spot as the hub of a law firm's information system. Case management software performs two vital functions for a law practice: it is a comprehensive database of information concerning the firm's clients, and it also serves as a calendaring/docket-control system that can be accessed throughout the firm.

The manufacturers of case management software understand that lawyers want to have the ability to quickly and easily perform conflict checks across the program's entire database. Therefore, performing a conflict check in a case management program is usually as simple as pushing a single button after entering a name to search for within the system. The searches are so quick and so thorough, that after determining that the name "John Smith" was not found in the lists of current clients, former clients, and other parties, it will then search the calendars of the lawyers in the firm, and even the note pads within the electronic client files to see if someone has come in contact with the name in an informal way.

For those lawyers interested in the conflicts-checking features of case management software but don't have an interest in establishing a firm-wide database program, you may want to consider purchasing a single-user version of a case management application and use it exclusively for maintaining the conflicts database. With this type of set-up, the software program would be installed on one workstation within the firm, and the computer user would become the firm's designated conflicts checking clerk.

Case management software comes with many dynamic features for tracking client information all throughout the firm – but there is no requirement that the purchaser use the software for all that it can do. Just as many users logon to Microsoft's Outlook for nothing more than to send and receive e-mail, it would be okay if your firm purchased a case management software product simply for its conflict-checking abilities.

Managing Client Information in the Cloud

Cloud computing is shorthand for parking your client data on a third-party server out on the internet. Its attractiveness comes from the convenience of logging on from any computer to a third-party web site to get full access to your client data and the features that many of the new cloud computing legal products offer. More attorneys are willing to use the service as their comfort level with online security grows. An

added benefit to using cloud based services is the recognition that there are certain security benefits that come with using an online product that is immune from floods, fires, theft and other disasters that could affect their firm.

But cloud computing raises a longstanding question that has always been a concern for lawyers: should I be concerned about my client's confidential data on a third party's computer server?

When storing information relating to the representation of a client in a cloud environment, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this rule. **Iowa Rules of Professional Conduct Rule 32:1.6: CONFIDENTIALITY OF INFORMATION, Comment [17].**

If you are a lawyer considering a cloud-based service, here are some important things to consider when trying to decide if the vender will be a secure host for your confidential information:

- **Encryption** – The data that is being stored in the cloud-based environment should be adequately encrypted (256 bit) to protect the data from dissemination if the vender's server is ever hacked into or the data is ever accidentally distributed to an unsecure source while it is in the vender's hands. By having the data encrypted, you can be assured that if the data ever gets into the wrong hands it will be unusable, unreadable information to the hacker. Any good cloud-based vender will make sure that your data is encrypted while it is on their computer server.

- **Geographic distribution of web servers** – Your data can become vulnerable to permanent loss if the vender stores the data on a single server or multiple servers in a single location. For example, if the data is stored in a single location in Utah and the location experiences a significant disruption due to an earthquake, your data could be disrupted or permanently lost. Therefore, it is important to make sure that your off-site vender is storing your data in multiple geographic locations, so any disruption in one area may not affect the servers that are storing your data in other areas of the country. Software companies like Clio (www.goclio.com) that store legal data understand this issue and have their client's data mirrored on multiple servers throughout North America.

- **Promise of confidentiality** – Just as paper and file storage companies will provide you with assurances that they will maintain the confidentiality of your client's information and instruct their employees about the importance of maintaining strict confidentiality, a good web-based

data storage company will do the same. You should seek that assurance in writing from the cloud-based company whenever you contract with them to store your client's information.

- **If possible, request a back-up copy of your stored client information** – Some companies will provide the firm with an opportunity to also have a backup (on DVD disk or flash drive) of the client data that they are storing for you on your behalf. The purpose of the back-up is to have a full-copy of your client information on hand if ever the company that you are contracting with should unexpectedly go out of business leaving you with no opportunity to have access to your stored client data. These situations rarely, if ever, happen when you are contracting with a reputable web-based company that has been in business for some time, however it is understandable that attorneys would want to make sure that the data is always available – even in the extreme situation where the company they are working with has gone out of business. Not all web-based companies will offer you the opportunity to make your own back-ups of the data they are storing for you, but if the service is available it is recommended that you take advantage of it.

What advice is there for those lawyers shopping for a cloud computing product? Here are some questions you may want to consider asking the web-based service provider:

Question: How long have you been in business? Longevity is your best bet the company will stick around during hard economic times.

Question: Does the online software use Secure Sockets Layer (SSL) technology? Is the data being stored encrypted? SSL is a protocol that has been approved by the Internet Engineering Task Force as a standard for transmitting data securely.

Question: Is the host's server geographically redundant? Make sure the host's servers are in multiple locations so any disaster they have doesn't take you down as well.

Question: Can I back up locally? This is a must — saving the online data on a local device is your best hope if the provider unexpectedly goes out of business.

Policies for Keeping Technology Ethical & Safe in the Firm

For years, businesses and large organizations have turned to electronic use policies to define what is acceptable use of electronic equipment for employees, students, and other individuals with access rights. A good electronic use policy can prevent employee misconduct as well as thwart behavior that would typically corrupt a database.

Legal employers have found value in an electronic use policy to address several common concerns:

- **Acceptable use of e-mail.** E-mail messages designed to threaten, intimidate, or harass the recipient with racial slurs or sexual implications, or to forward information that is derogatory, defamatory, or obscene are disruptive to the workplace and may subject the employer to workplace liability.

- **Transporting confidential data off-site**. Data involving confidential client information and proprietary information essential to the organization's success can get into the wrong hands if it is transported off-site through the use of laptops, PDAs, and flash drives.

- **Password accountability**. Most hacking is done through the keyboard, and a simple but strong password can easily thwart it.

- **Adding or removing software.** The indiscriminate addition or removal of software increases the network's vulnerability to viruses, Trojan horses, worms, and spyware, and also exposes the organization to potential licensing violations.
- **Limitations on the Internet**. Sexually explicit and offensive websites may also subject the employer to liability concerns, and excessive personal use of the Internet generally affects overall employee productivity.

- **Copyright infringement**. File sharing or the unauthorized transfer of copyrighted materials such as movies, music, and games violates federal anti-piracy laws and exposes the computer owner to confiscation and seizure of the hardware.

- **Control of company property.** By engaging in private consulting and outside work, employees assigned electronic equipment may be engaging in personal use activities to an extent where the use comes in conflict with the organization.

- **Protecting the company image**. Employees accessing the Internet or sending e-mails containing the organization's domain address (e.g.,____@lawfirm.com) may be perceived as reflecting on the character and professionalism of the organization.

- **Accessing external e-mail accounts**. Websites hosting private e-mail accounts open a doorway through an otherwise secure firewall by allowing potentially damaging e-mail attachments into a firm's network or facilitating the unauthorized transfer of company data.

What to Include in the Electronic Use Policy

In a survey conducted in 2007 by the American Management Association (AMA) and the ePolicy Institute, 84 percent of responding organizations revealed they let employees know that the company is monitoring their computer activity. Previous surveys by AMA have revealed that only 31 percent of employers have a policy regarding instant messaging (IM) in the workplace, 27 percent have a policy

involving personal cell phone use at the office, and only 9 percent have a policy regarding the operation of personal blogs on company time.

Although many employers have acted upon and established policies addressing their concerns regarding e-mail and Internet usage, many other common forms of electronic usage that can disrupt employee workflow or corrupt company data are often ignored or forgotten.

Also, because technology innovations change so rapidly, what may have been a good and thorough electronic use policy two years ago is likely to be stale and out-of-date today. The sheer speed of change in communications and e-tools, including social networking formats, smart phones, and personal blogging sites, may be one major reason why so many employers that have electronic use policies don't address common technology matters found in the workplace today.

A good electronic use policy should address the acceptable use (and prohibitions) of all electronic tools, devices, and formats accessible to employees in the ordinary course of their workday. This is not easy to do, and the ever-changing nature of technology is one important reason why the policy should be reexamined every 12 to 24 months.

When writing an electronic use policy today, employers should consider including the following topics: business e-mail decorum, personal use of business e-mail, personal e-mail accounts, instant messaging, text messaging, business phone etiquette, personal use of business phones, personal use of business cell phones, use of personal cell phones, appropriate use of Internet, web posting, personal websites, blogging, mass storage devices (such as flash drives and iPods), portable computer equipment, adding and deleting software, security and password maintenance, and file sharing.

The policy should also clearly provide employee notice that the employer intends to review any and all traffic in the system including messages, attachments, websites visited, files downloaded, and cell phone records including text messages, and that such monitoring can occur at any time without prior notice.

Any specific technology that is prohibited by the company policy should also be listed in the document. For example, a common practice for organizations concerned with the unauthorized transfer of company information is to prohibit access to private e-mail servers such as AOL and Hotmail and to restrict the use of mass storage devices such as flash drives and portable transfer devices, including iPods.

It is important to craft an electronic use policy that is right for the firm. Many small law firm practitioners confess to never having an electronic use policy in place because the need for it never seemed apparent. Perhaps excessive personal use of the firm technology is something more likely to happen in a large firm environment where employee anonymity can sometimes exist.

Nevertheless, even the most basic electronic use policy that outlines prohibited activities is a good reminder to the staff that the firm's electronics belong to the firm. Moreover, it may prevent a difficult and painful experience if ever the firm is involved in employment litigation. Such a policy would be paramount to helping guide the firm through a difficult time.

Todd C. Scott is the VP of Risk Management at Minnesota Lawyers' Mutual Ins. Co. and he focuses on the difficult law firm management issues all lawyers struggle with such as dealing with difficult clients, financial problems, systems issues, and best practices. If you have questions about legal systems or other law practice management concerns contact Todd at tscott@mlmins.com or at 612-373-9667.

Cyber Liability & Protecting Confidential Client Information

Iowa State Bar Association
2016 Bloethe Tax School
December 7-9, 2016

Todd C. Scott
V.P. Risk Management
Minnesota Lawyers Mutual Ins. Co.

MINNESOTA LAWYERS MUTUAL INSURANCE COMPANY

Cyber liability & Protecting Information

Cyber Liability Exposure:

- Cyber liability claims
- Securing client data
- How data loss occurs
- Our ethical responsibilities

Cyber liability & Protecting Information

We lose data because it's portable

Cyber liability & Protecting Information

We lose data because it's portable

Toshiba Encrypted USB Flash Drive

16 GB

$39

Cyber liability & Protecting Information

1

Cyber liability claims

- Cause of action
- Defenses to claims
- Notification laws
- Insurance

Cyber liability & Protecting Information

Data we are trying to protect

- **Personally identifiable information (PII).**
- **Personal healthcare information (PHI).**
- **Credit card information.**
- **Confidential trade secrets.**

Cyber liability & Protecting Information

Exposure to financial loss

- **Third Party Liability:** Third party files suit or makes a claim to recover for damages associated with failure to protect private, sensitive or confidential information.
- **First Party Expenses:** Costs incurred as a result of a cyber event. i.e. notification, credit monitoring, cyber investigation, crises management.

Cyber liability & Protecting Information

Third-party cause of action

- **Negligence:** Claimant alleges firm had a duty to exercise reasonable care in protecting plaintiff's personal information, and by failing to properly safeguard the data or timely notify the client of the data loss, the firm breached its responsibilities to the client.

Cyber liability & Protecting Information

Target retail data breach

- **40 million stolen credit cards**
- **70 million data files (PII)**
- **Over 90 lawsuits filed**
- **Total cost of breach legal fees, credit monitoring, replacement cards: $290,000,000**

Cyber liability & Protecting Information

Defenses to claim of cyber liability

•**No damages:** At the time of the data breach, claimant has not suffered any actual damage and there is no guarantee that the lost or stolen data will be used against the claimant. Damages may be speculative. No quantifiable risk of damage in the future.

Cyber liability & Protecting Information

Notification laws

•**Iowa Code §§ 715C.1 -715C.2 Personal Information Security Breach Protection Statute; Notification Requirements:** Any person who owns or licenses computerized data that includes a consumer's personal information that is used in the course of the person's business… and that was subject to a breach of security shall give notice of the breach of security following discovery of such breach of security, or receipt of notification under subsection 2, to any consumer whose personal information was included in the information that was breached.

Cyber liability & Protecting Information

Notification laws

•**Iowa Code §§ 715C.1 -715C.2 Personal Information Security Breach Protection Statute; Notification Requirements: (Cont'd)**
The consumer notification shall be made in the most expeditious manner possible and without unreasonable delay, consistent with the legitimate needs of law enforcement… and consistent with any measures necessary to sufficiently determine contact information for the affected consumers, determine the scope of the breach, and restore the reasonable integrity, security, and confidentiality of the data.

Cyber liability & Protecting Information

Notification laws

•**Iowa Code §§ 715C.1 -715C.2 Personal Information Security Breach Protection Statute; Notification Requirements:** Notice be provided to the director of the consumer protection division of the office of the Iowa Attorney General regarding a breach of security affecting 500 or more Iowa residents no later than five business days after providing notice of the breach to any affected Iowa residents under the statute.

Cyber liability & Protecting Information

Insurance Coverage

•**Third Party Liability:** Some coverage can be picked up by standard LPL policy. Check policies carefully when coverage is "built in" because it may be sub-limiting your coverage.

•**First Party Liability:** Coverage for notification, credit monitoring and other first party expenses available in handful of separate, cyber specific insurance products.

Cyber liability & Protecting Information

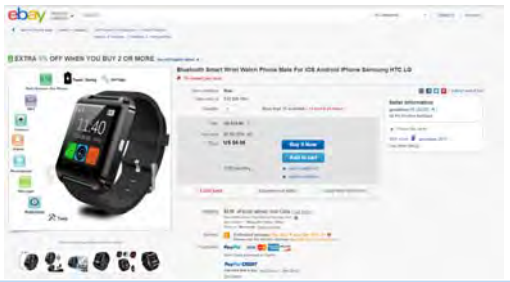
2

Securing your data

- Good security basics
- Weak links in the system
- Electronic use policies

Cyber liability & Protecting Information

Exposing data to threats



Cyber liability & Protecting Information

Exposing data to threats

Cyber liability & Protecting Information

Creating a security bubble

Cyber liability & Protecting Information

Critical systems for creating security

- Firewall hardware/software as gatekeeper
- Antivirus software kept up to date
- Strong passwords changed every 45-60 days
- Electronic use policy strictly enforced

Cyber liability & Protecting Information

Creating a security bubble

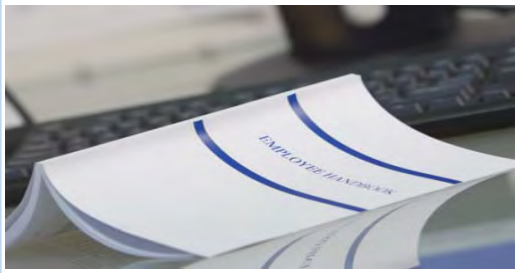
Cyber liability & Protecting Information

Common threats to your data security

- 2 Basic threats: viruses and worms
- 4 Modes of delivery:
  Trojan horse, email, spyware, rogueware
- All require you to introduce it the system

Cyber liability & Protecting Information

Why have an electronic use policy?



Cyber liability & Protecting Information

Why have an electronic use policy?

- Preserve the security of the firm's data.
- Protects the integrity of the firm.
- You can fire someone for violating it.

Cyber liability & Protecting Information

Why have an electronic use policy?

- It addresses the following:
  - Acceptable use of firm email.
  - Transporting confidential data.
  - Password accountability.
  - Adding or removing software.
  - Limiting the use of internets.

Cyber liability & Protecting Information

3

How data loss occurs:

- Lost devices
- Holes in the security
- Hacked or stolen data
- Scamming the user

Cyber liability & Protecting Information

Dispose data properly

Cyber liability & Protecting Information

Finding what you lost

Find

my iPhone

Cyber liability & Protecting Information

Disabling what you lost

Cyber liability & Protecting Information

Malware exposes data to threats

No such thing as a free flashlight.

Cyber liability & Protecting Information

Hacking 101: Wifi hacking.

WiFi Pineapple

$69.00

Cyber liability & Protecting Information

Cyber liability & Protecting Information

Hacking 101: Market for stolen data

Cyber liability & Protecting Information

Scamming for data: Ransomeware

Law firm paid $2,500 to get its data back

Cyber liability & Protecting Information

4

The ethics of cloud computing

- Ethics opinions re the cloud
- Ethics rules and guidance
- Terms of service

Cyber liability & Protecting Information

Using the cloud safely

Cyber liability & Protecting Information

Ethics Rules about the Cloud

IRPC 1.6: *Exercise Reasonable Care*

"When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy." **[Comment 17]**

Cyber liability & Protecting Information

Ethics Rules about the Cloud

IRPC 1.6: Exercise *Reasonable* Care

"Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this rule." **[Comment 17 Cont'd.]**

Cyber liability & Protecting Information

Terms of Service

Breaking it down:

- Transmission of confidential unencrypted information falls under implied authorization exception to Rule 1.6(b)(3)
- Duties of competence, confidentiality & safekeeping property require lawyers exercise reasonable care in selecting a provider.
- Implies a lawyer must have reasonable understanding of technology and available security.

Cyber liability & Protecting Information

Terms of Service

Case Example: Dropbox

- TOS provides Dropbox and "trusted third party companies and individuals" with the ability to use customer files to "provide, analyze, and improve" Dropbox.
- ABA lists Dropbox among more popular cloud services while declining to recommend it in light of security concerns.

Cyber liability & Protecting Information

Terms of Service

Case Example: Dropbox

- A cloud provider's use of trusted third parties may not be problematic , but the attorneys responsibilities to evaluate security would run to the third party.
- Problem: disclosures to improve and analyze Dropbox don't fall in the 1.6(b)(3) exception to confidentiality.

Dropbox

Cyber liability & Protecting Information

Interview your cloud vendors

- **Does the cloud-based service encrypt the stored data? 256 bit encryption recommended.**
- **Is there geographic distribution of the web servers?**
- **Does the vendor offer a promise of confidentiality?**

Cyber liability & Protecting Information

Requesting confidential data handling

Cyber liability & Protecting Information

Contact:

Todd C. Scott
VP Risk Management
Minnesota Lawyers Mutual
tscott@mlmins.com
612373-9667

Cyber Liability & Protecting Confidential Client Information

Iowa State Bar Association
2016 Bloethe Tax School
December 7-9, 2016

Todd C. Scott
V.P. Risk Management
Minnesota Lawyers Mutual Ins. Co.

MINNESOTA LAWYERS MUTUAL INSURANCE COMPANY

Cyber liability & Protecting Information

Cyber Liability Exposure:

- Cyber liability claims
- Securing client data
- How data loss occurs
- Our ethical responsibilities

Cyber liability & Protecting Information

We lose data because it’s portable

Cyber liability & Protecting Information

We lose data because it’s portable

Toshiba Encrypted USB Flash Drive

16 GB

$39

Cyber liability & Protecting Information

1

Cyber liability claims

- Cause of action
- Defenses to claims
- Notification laws
- Insurance

Cyber liability & Protecting Information

Data we are trying to protect

- Personally identifiable information (PII).
- Personal healthcare information (PHI).
- Credit card information.
- Confidential trade secrets.

Cyber liability & Protecting Information

Exposure to financial loss

- **Third Party Liability:** Third party files suit or makes a claim to recover for damages associated with failure to protect private, sensitive or confidential information.
- **First Party Expenses:** Costs incurred as a result of a cyber event. i.e. notification, credit monitoring, cyber investigation, crises management.

Cyber liability & Protecting Information

Third-party cause of action

- **Negligence:** Claimant alleges firm had a duty to exercise reasonable care in protecting plaintiff's personal information, and by failing to properly safeguard the data or timely notify the client of the data loss, the firm breached its responsibilities to the client.

Cyber liability & Protecting Information

Target retail data breach

- 40 million stolen credit cards
- 70 million data files (PII)
- Over 90 lawsuits filed
- Total cost of breach legal fees, credit monitoring, replacement cards: $290,000,000

Cyber liability & Protecting Information

Defenses to claim of cyber liability

- **No damages:** At the time of the data breach, claimant has not suffered any actual damage and there is no guarantee that the lost or stolen data will be used against the claimant. Damages may be speculative. No quantifiable risk of damage in the future.

Any person who owns or licenses computerized data that includes a consumer's personal information that is used in the course of the person's business, vocation,

Cyber liability & Protecting Information

Notification laws

- **Iowa Code §§ 715C.1 -715C.2 Personal Information Security Breach Protection Statute; Notification Requirements:** Any person who owns or licenses computerized data that includes a consumer's personal information that is used in the course of the person's business… and that was subject to a breach of security shall give notice of the breach of security following discovery of such breach of security, or receipt of notification under subsection 2, to any consumer whose personal information was included in the information that was breached.

Cyber liability & Protecting Information

Notification laws

- **Iowa Code §§ 715C.1 -715C.2 Personal Information Security Breach Protection Statute; Notification Requirements: (Cont'd)**

The consumer notification shall be made in the most expeditious manner possible and without unreasonable delay, consistent with the legitimate needs of law enforcement… and consistent with any measures necessary to sufficiently determine contact information for the affected consumers, determine the scope of the breach, and restore the reasonable integrity, security, and confidentiality of the data.

Cyber liability & Protecting Information

Notification laws

- **Iowa Code §§ 715C.1 -715C.2 Personal Information Security Breach Protection Statute; Notification Requirements:** Notice be provided to the director of the consumer protection division of the office of the Iowa Attorney General regarding a breach of security affecting 500 or more Iowa residents no later than five business days after providing notice of the breach to any affected Iowa residents under the statute.

Cyber liability & Protecting Information

Insurance Coverage

- **Third Party Liability:** Some coverage can be picked up by standard LPL policy. Check policies carefully when coverage is "built in" because it may be sub-limiting your coverage.
- **First Party Liability:** Coverage for notification, credit monitoring and other first party expenses available in handful of separate, cyber specific insurance products.

Cyber liability & Protecting Information

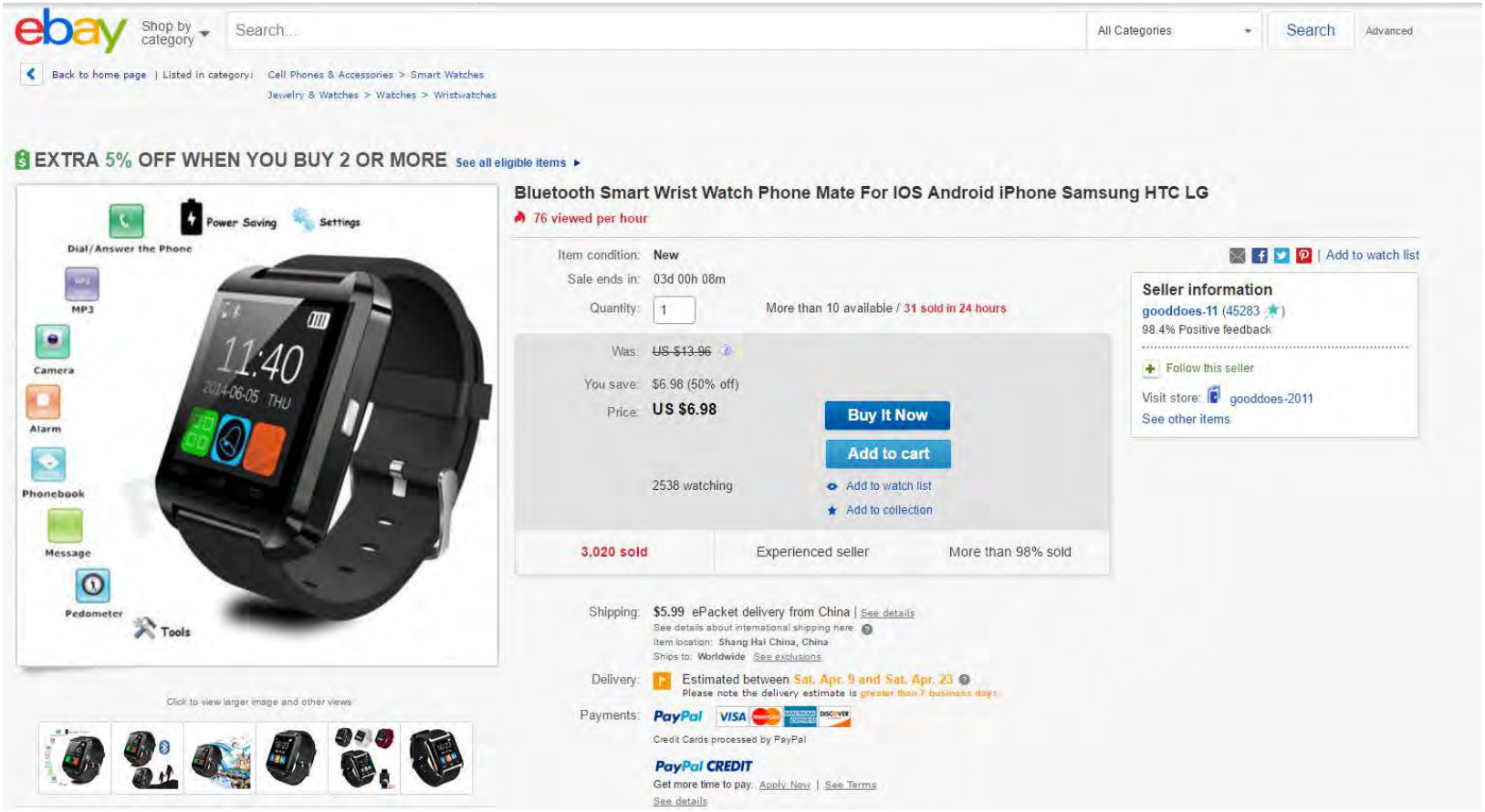
2

Securing your data

- Good security basics
- Weak links in the system
- Electronic use policies

Cyber liability & Protecting Information

Exposing data to threats



Cyber liability & Protecting Information

Exposing data to threats

DIGITAL JOURNAL Like 53K

10 must read articles

NEWS B2B NEWS TECHNOLOGY SCIENCE VIDEO INTERNET A&E LIFE S

TRENDING Politics | Windows 10 | Essure | Tampa Bay Rays | Hillary Clinton Judicial Watch | Si

6 Like Share Tweet in Share 3 G+1

1 COMMENT LISTEN PRINT

Shady $17 smartwatch sends your data to an unknown Chinese server

BY JAMES WALKER MAR 2, 2016 IN TECHNOLOGY

Smartwatches are usually quite pricey accessories but, as with most electrical products, cheap knockoffs can easily be found online. One such device is the "U8" $17 smartwatch, recently caught transmitting user data to an unknown Chinese server.

As The Register reports, the watch's suspicious connections were exposed by Mobile Iron research director Michael Raggo at the BSides San Francisco security conference this week. Raggo described the watch as a threat to

Cyber liability & Protecting Information

Creating a security bubble

Cyber liability & Protecting Information

Critical systems for creating security

- Firewall hardware/software as gatekeeper
- Antivirus software kept up to date
- Strong passwords changed every 45-60 days
- Electronic use policy strictly enforced

Cyber liability & Protecting Information

Creating a security bubble

Cyber liability & Protecting Information

Common threats to your data security

- 2 Basic threats: viruses and worms
- 4 Modes of delivery:
  Trojan horse, email, spyware, rogueware
- All require you to introduce it the system

Cyber liability & Protecting Information

Why have an electronic use policy?

Cyber liability & Protecting Information

Why have an electronic use policy?

- Preserve the security of the firm's data.
- Protects the integrity of the firm.
- You can fire someone for violating it.

Cyber liability & Protecting Information

Why have an electronic use policy?

- It addresses the following:
  - Acceptable use of firm email.
  - Transporting confidential data.
  - Password accountability.
  - Adding or removing software.
  - Limiting the use of internets.

Cyber liability & Protecting Information

3

How data loss occurs:

- Lost devices
- Holes in the security
- Hacked or stolen data
- Scamming the user

Cyber liability & Protecting Information

Dispose data properly

Cyber liability & Protecting Information

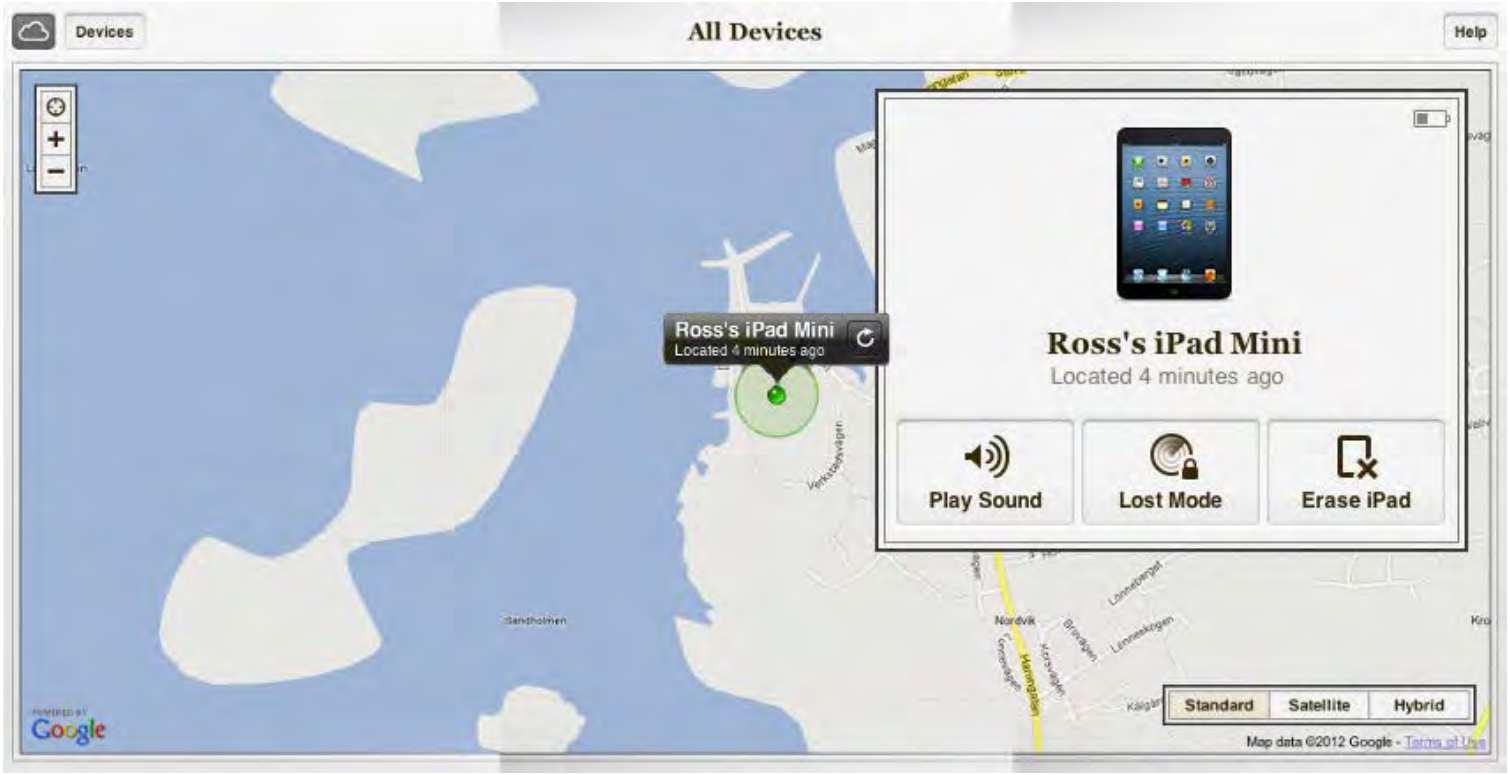
Finding what you lost

Find

my iPhone

Cyber liability & Protecting Information

Disabling what you lost



Cyber liability & Protecting Information

Malware exposes data to threats

No such thing as a free flashlight.

Cyber liability & Protecting Information

Hacking 101: Wifi hacking.

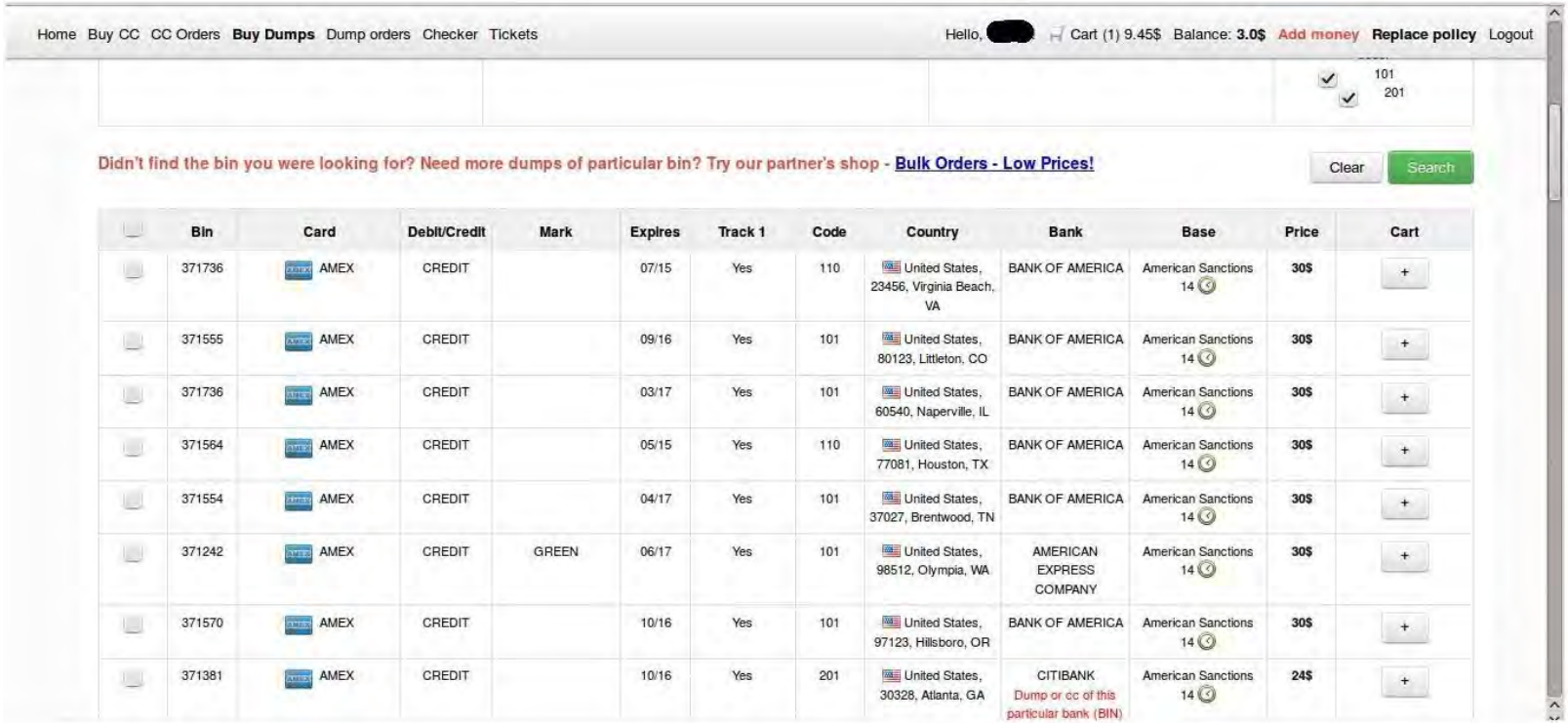
WiFi Pineapple

$69.00

Cyber liability & Protecting Information

Cyber liability & Protecting Information

Hacking 101: Market for stolen data



Home Buy CC CC Orders **Buy Dumps** Dump orders Checker Tickets

Hello, [redacted] Cart (1) 9.45$ Balance: **3.0$** Add money **Replace policy** Logout

101
201

Didn't find the bin you were looking for? Need more dumps of particular bin? Try our partner's shop - **Bulk Orders - Low Prices!**

Clear Search

Bin	Card	Debit/Credit	Mark	Expires	Track 1	Code	Country	Bank	Base	Price	Cart
371736	AMEX	CREDIT		07/15	Yes	110	United States, 23456, Virginia Beach, VA	BANK OF AMERICA	American Sanctions 14	30$	+
371555	AMEX	CREDIT		09/16	Yes	101	United States, 80123, Littleton, CO	BANK OF AMERICA	American Sanctions 14	30$	+
371736	AMEX	CREDIT		03/17	Yes	101	United States, 60540, Naperville, IL	BANK OF AMERICA	American Sanctions 14	30$	+
371564	AMEX	CREDIT		05/15	Yes	110	United States, 77081, Houston, TX	BANK OF AMERICA	American Sanctions 14	30$	+
371554	AMEX	CREDIT		04/17	Yes	101	United States, 37027, Brentwood, TN	BANK OF AMERICA	American Sanctions 14	30$	+
371242	AMEX	CREDIT	GREEN	06/17	Yes	101	United States, 98512, Olympia, WA	AMERICAN EXPRESS COMPANY	American Sanctions 14	30$	+
371570	AMEX	CREDIT		10/16	Yes	101	United States, 97123, Hillsboro, OR	BANK OF AMERICA	American Sanctions 14	30$	+
371381	AMEX	CREDIT		10/16	Yes	201	United States, 30328, Atlanta, GA	CITIBANK Dump or cc of this particular bank (BIN)	American Sanctions 14	24$	+

Cyber liability & Protecting Information

Scamming for data: Ransomeware

Home / Daily News / Law firm paid $2,500 to get its data back

LEGAL TECHNOLOGY

Law firm paid $2,500 to get its data back

POSTED FEB 16, 2016 02:02 PM CST

BY DEBRA CASSENS WEISS

Image from Shutterstock.com

A Florida law firm was unable to access any of its digital files in December after a hacker broke into its computer system.

Technology specialists working on the problem told the Brown Law Firm in Jacksonville it had two choices: Pay the hacker's ransom demand of $2,500, or lose access to all of its files, the Jacksonville Daily Record reports.

The firm paid the money—in bitcoins, as the hacker demanded. The files were unlocked for the firm.

Since the incident, the firm has improved computer firewalls and replaced passwords with pass phrases that are regularly changed, according to the article. The firm has also installed an isolated server that is used to back

Cyber liability & Protecting Information

4

The ethics of cloud computing

- Ethics opinions re the cloud
- Ethics rules and guidance
- Terms of service

Cyber liability & Protecting Information

Using the cloud safely

Cyber liability & Protecting Information

Ethics Rules about the Cloud

IRPC 1.6: *Exercise Reasonable Care*

"When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy." **[Comment 17]**

Cyber liability & Protecting Information

Ethics Rules about the Cloud

IRPC 1.6: Exercise *Reasonable* Care

"Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this rule." **[Comment 17 Cont'd.]**

Cyber liability & Protecting Information

Terms of Service

Breaking it down:

- Transmission of confidential unencrypted information falls under implied authorization exception to Rule 1.6(b)(3)
- Duties of competence, confidentiality & safekeeping property require lawyers exercise reasonable care in selecting a provider.
- Implies a lawyer must have reasonable understanding of technology and available security.

Cyber liability & Protecting Information

Terms of Service

Case Example: Dropbox

- TOS provides Dropbox and "trusted third party companies and individuals" with the ability to use customer files to "provide, analyze, and improve" Dropbox.
- ABA lists Dropbox among more popular cloud services while declining to recommend it in light of security concerns.

Cyber liability & Protecting Information

Terms of Service

Case Example: Dropbox

- A cloud provider's use of trusted third parties may not be problematic , but the attorneys responsibilities to evaluate security would run to the third party.
- Problem: disclosures to improve and analyze Dropbox don't fall in the 1.6(b)(3) exception to confidentiality.

Cyber liability & Protecting Information

Interview your cloud vendors

- Does the cloud-based service encrypt the stored data? 256 bit encryption recommended.
- Is there geographic distribution of the web servers?
- Does the vendor offer a promise of confidentiality?

Cyber liability & Protecting Information

Requesting confidential data handling

Cyber liability & Protecting Information

Contact:

Todd C. Scott
VP Risk Management
Minnesota Lawyers Mutual
tscott@mlmins.com
612373-9667

Bloethe Tax School

Presented by the ISBA Tax Section

FRIDAY, DECEMBER 9
Downtown Des Moines Marriott
Des Moines, Iowa

Bloethe Tax School

Presented by the ISBA Tax Section

Track 1

FRIDAY, DECEMBER 9
Downtown Des Moines Marriott
Des Moines, Iowa

Bloethe

Tax School

IOWA STATE BAR ASSOCIATION

Charitable Trusts and Foundation – Endow Iowa

Track One

9:00 a.m.-9:45 p.m.

Presented by
Sheila Kinman
Chief Advancement Officer
Community Foundation of
Greater Des Moines
1915 Grand Avenue
Des Moines, IA 50309
Phone: 515-447-4207

FRIDAY, DECEMBER 9, 2016

Live…Give…Better Together.

Charitable Case Studies

Sheila Kinman, CAP®
Chief Advancement Officer

Today's Agenda

- **What Is A Community Foundation?**
- **How do Advisors Work with Us?**
- **Charitable Gift Illustrations**
- **Questions**

Disclaimer

The content in this presentation is not intended to provide tax or legal advice. There are many wonderful professional advisors who can assist with your client's individual situations.

We are here to share stories of what can happen when proper planning and inspiring generosity come together to achieve a common goal.

COMMUNITY FOUNDATION
GREATER DES MOINES

Our Mission: improve quality of life for all by promoting charitable giving, connecting donors with causes they care about and providing leadership on important community issues…we're simply better together.

CONNECTING DONORS WITH CAUSES THEY CARE ABOUT

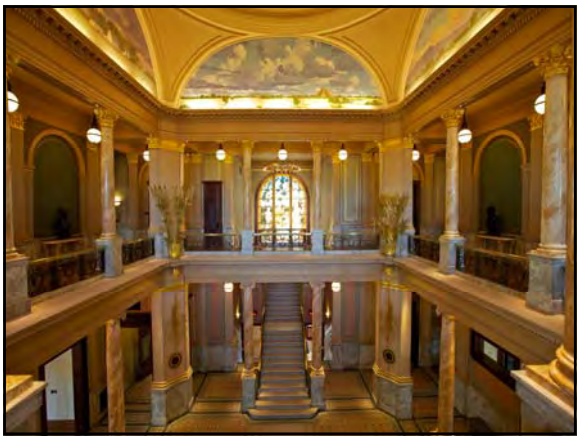
COMMUNITY FOUNDATION
GREATER DES MOINES

Cultivating Connections

Family Philanthropy

Inspiring Impact

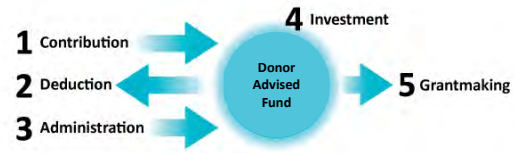
COMMUNITY LEADERSHIP
Better Together!



Promoting Charitable Giving

COMMUNITY FOUNDATION GREATER DES MOINES

DONOR ADVISED FUNDS



Endow Iowa

Three Requirements

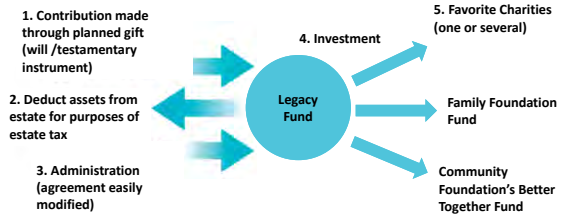
- Must be held at a qualified community foundation
- Iowa charitable causes
- No more than 5% annual spending/granting policy

Endow Iowa

Then donors can be eligible for

- 25% tax credit for contribution – in addition to federal deduction (can carry forward for up to 5 years)
- Limit each year, per taxpayer and also statewide
- Tax credit paperwork submitted; awarded on a first come-first served basis
- Tax Credit Letter/# sent by IEDA once awarded

LEGACY FUNDS



Donor Profile

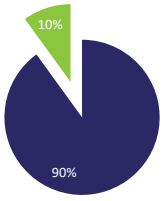
- **Charitably Inclined**– Median Fund Size is $52,000
- **Age** – Majority over age 55
- **Occupation**—many entrepreneurs
- **Estimated Household Income** –Very strong in $175k - $199k range and the over $250k range
- **Income Producing Assets** –over $1 million
- **Home Value** –$450k+
- **Length of Residence** – Strongest at 25+ years

Non-Cash Gift Types

- Appreciated Securities
- Real Estate
- Business Interests
- Tangible Personal Property
- Retirement Plans
- Life Insurance
- Grain

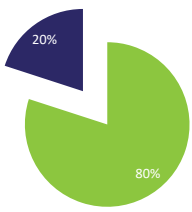
Non-Cash Assets Make Great Donations

Assets Owned



- Cash
- Non-Cash Assets

Assets Given



Observations about Non-Cash Gifts

- Increasing In Popularity as Capital Gains Taxes Goes Up
- Longer Planning Process

- Almost Always Occurs Due to An Advisor's Advice
- It's a Team Sport- The More Complex, the Bigger the Team

Shares of Privately Held Business Interest

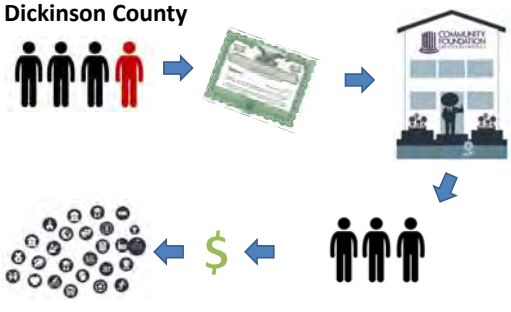
Dickinson County

Donor Has Four Goals:

1. Pre-fund his Charitable Giving
2. Utilize Endow Iowa to Offset Income Taxes
3. Avoid Capital Gains Taxes
4. Transfer Ownership of Shares to Employees

Shares of Privately Held Business Interest

Dickinson County



Estate Planning

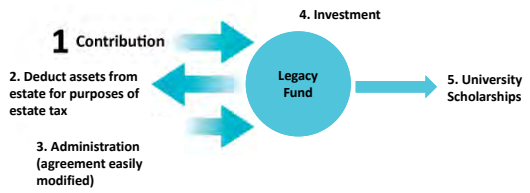
Warren County

Donor Had Three Goals:

1. Honor Her Husband's Charitable Intent
2. Ensure Accountability
3. Make a Meaningful Impact on Students

Estate Planning

Warren County



Bargain Sale

Clinton County

Donor Had Five Goals:

1. Benefit His Community
2. Donate An Asset No Longer Needed
3. Net $50,000 From the Sale
4. Wanted Endow Iowa Tax Credits
5. Avoid Capital Gains Taxes

Bargain Sale

Clinton County

Gift of Farmland-Outright

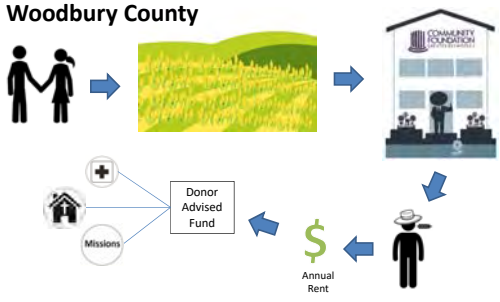
Woodbury County

Donors Had Five Goals:

1. Benefit Their Church
2. Wanted Endow Iowa Tax Credits
3. Avoid Capital Gains Taxes
4. Keep the Farmland In Production
5. Maintain Tenant Farmer Relationship

Gift of Farmland-Outright

Woodbury County



Charitable Lead Trusts

Cass County

Donors Had Three Goals:

1. Move Assets to Heirs at Passing
2. Support Favorite Charities During Lifetime
3. Take Advantage of Tax Benefits

Charitable Lead Trusts

Cass County

Private Foundation Conversion

Polk County

Donors Had Three Goals:

1. Relieve Administrative Burden on Heirs
2. Support Favorite Charities As A Family
3. Ensure Ongoing Legacy

Private Foundation Conversion

Polk County

	Private	Public
Set-Up Considerations	Legal, Accounting	None
Income Tax Considerations	30%/20% (2% excise)	50%/30%
Administration Considerations	Audit, compliance, legal	CF Handles
Privacy Considerations	Grants on 990	Private
Grantmaking Considerations	Flexible	Monitored

Questions

COMMUNITY FOUNDATION GREATER DES MOINES

Live…Give…Better Together.

Charitable Case Studies

Sheila Kinman, CAP®
Chief Advancement Officer

COMMUNITY FOUNDATION GREATER DES MOINES

Today's Agenda

- **What Is A Community Foundation?**
- **How do Advisors Work with Us?**
- **Charitable Gift Illustrations**
- **Questions**

Disclaimer

The content in this presentation is not intended to provide tax or legal advice. There are many wonderful professional advisors who can assist with your client's individual situations.

We are here to share stories of what can happen when proper planning and inspiring generosity come together to achieve a common goal.

COMMUNITY FOUNDATION GREATER DES MOINES

County Endowment Fund Program

(HF 2302) 2014-2015 Recipients by Affiliation

Community Foundation of Cedar County

Community Foundation of Louisa County

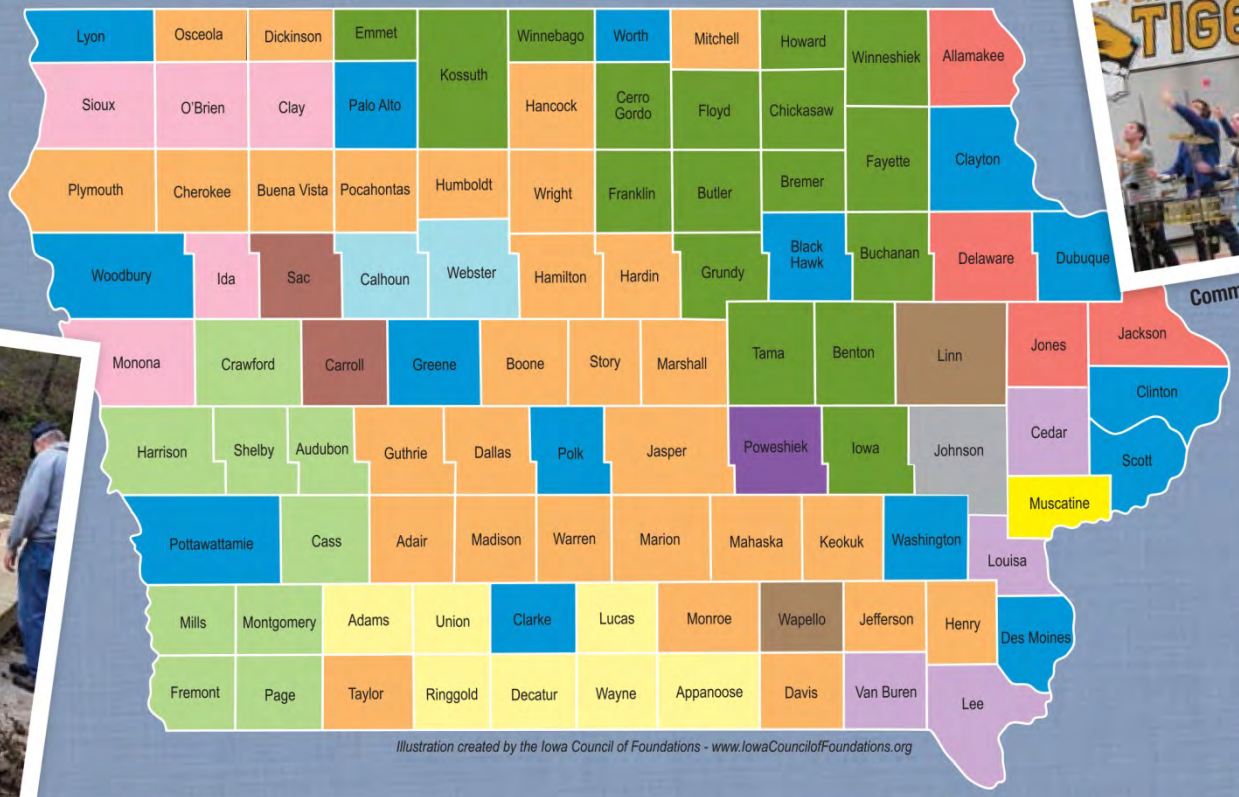


Illustration created by the Iowa Council of Foundations - www.IowaCouncilofFoundations.org

- Community Foundation of Carroll County
- Community Foundation of Greater Dubuque
- Community Foundation of Greater Muscatine
- Community Foundation of the Great River Bend
- Community Foundation of Johnson County
- Community Foundation of Northeast Iowa
- Fort Dodge Community Foundation & United Way
- Greater Cedar Rapids Community Foundation
- The Community Foundation of Greater Des Moines
- Omaha Community Foundation/ Community Foundations of Southwest Iowa
- Siouxland Community Foundation
- South Central Iowa Community Foundation
- Greater Poweshiek Community Foundation
- Counties with gaming licenses (not eligible for the County Endowment Fund Program)

COMMUNITY FOUNDATION GREATER DES MOINES

Our Mission: improve quality of life for all by promoting charitable giving, connecting donors with causes they care about and providing leadership on important community issues…we're simply better together.

CONNECTING DONORS WITH CAUSES THEY CARE ABOUT

COMMUNITY FOUNDATION
GREATER DES MOINES

COMMUNITY FOUNDATION
GREATER DES MOINES

Cultivating Connections

COMMUNITY FOUNDATION GREATER DES MOINES

Family Philanthropy

COMMUNITY FOUNDATION GREATER DES MOINES

Inspiring Impact

COMMUNITY LEADERSHIP
Better Together!

COMMUNITY FOUNDATION
GREATER DES MOINES


FOOD IS THE MORAL RIGHT OF ALL WHO ARE BORN INTO THIS WORLD


EVELYN K. DAVIS CENTER
FOR
WORKING FAMILIES

Promoting Charitable Giving

COMMUNITY FOUNDATION
GREATER DES MOINES

COMMUNITY FOUNDATION GREATER DES MOINES

DONOR ADVISED FUNDS

Endow Iowa

Three Requirements

- Must be held at a qualified community foundation
- Iowa charitable causes
- No more than 5% annual spending/granting policy

Endow Iowa

Then donors can be eligible for

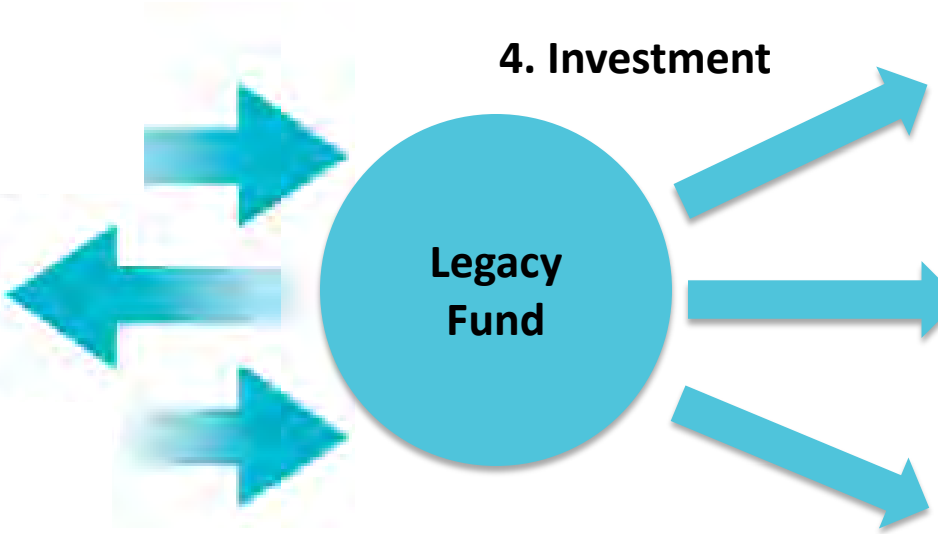
- 25% tax credit for contribution – in addition to federal deduction (can carry forward for up to 5 years)
- Limit each year, per taxpayer and also statewide
- Tax credit paperwork submitted; awarded on a first come-first served basis
- Tax Credit Letter/# sent by IEDA once awarded

LEGACY FUNDS

1. Contribution made through planned gift (will /testamentary instrument)

2. Deduct assets from estate for purposes of estate tax

3. Administration (agreement easily modified)



4. Investment

5. Favorite Charities (one or several)

Family Foundation Fund

Community Foundation's Better Together Fund

Donor Profile

- **Charitably Inclined**– Median Fund Size is $52,000
- **Age** – Majority over age 55
- **Occupation**—many entrepreneurs
- **Estimated Household Income** –Very strong in $175k - $199k range and the over $250k range
- **Income Producing Assets** –over $1 million
- **Home Value** –$450k+
- **Length of Residence** – Strongest at 25+ years

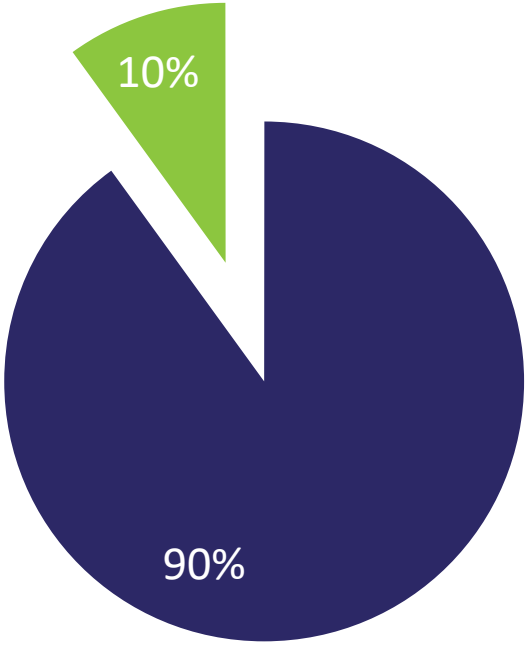
Non-Cash Gift Types

- Appreciated Securities
- Real Estate
- Business Interests
- Tangible Personal Property
- Retirement Plans
- Life Insurance
- Grain

Non-Cash Assets Make Great Donations

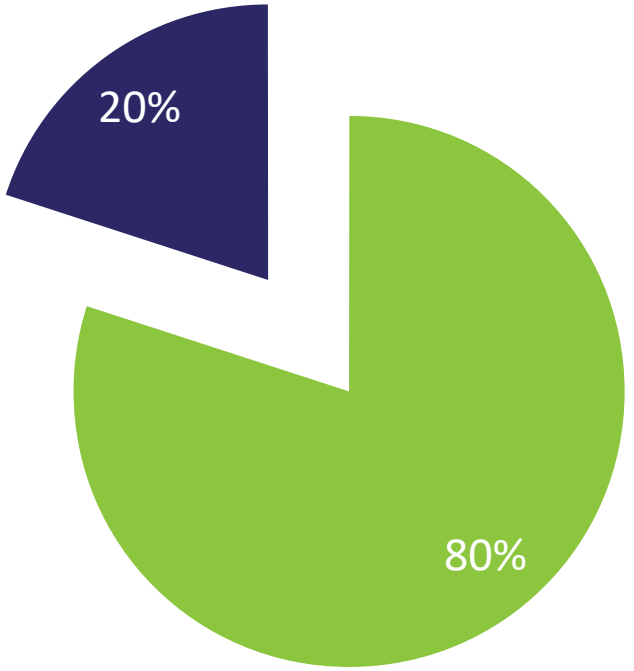
COMMUNITY FOUNDATION GREATER DES MOINES

Assets Owned



- Cash
- Non-Cash Assets

Assets Given



Observations about Non-Cash Gifts

- Increasing In Popularity as Capital Gains Taxes Goes Up

- Longer Planning Process

- Almost Always Occurs Due to An Advisor's Advice
- It's a Team Sport- The More Complex, the Bigger the Team

Shares of Privately Held Business Interest

COMMUNITY FOUNDATION GREATER DES MOINES

Dickinson County

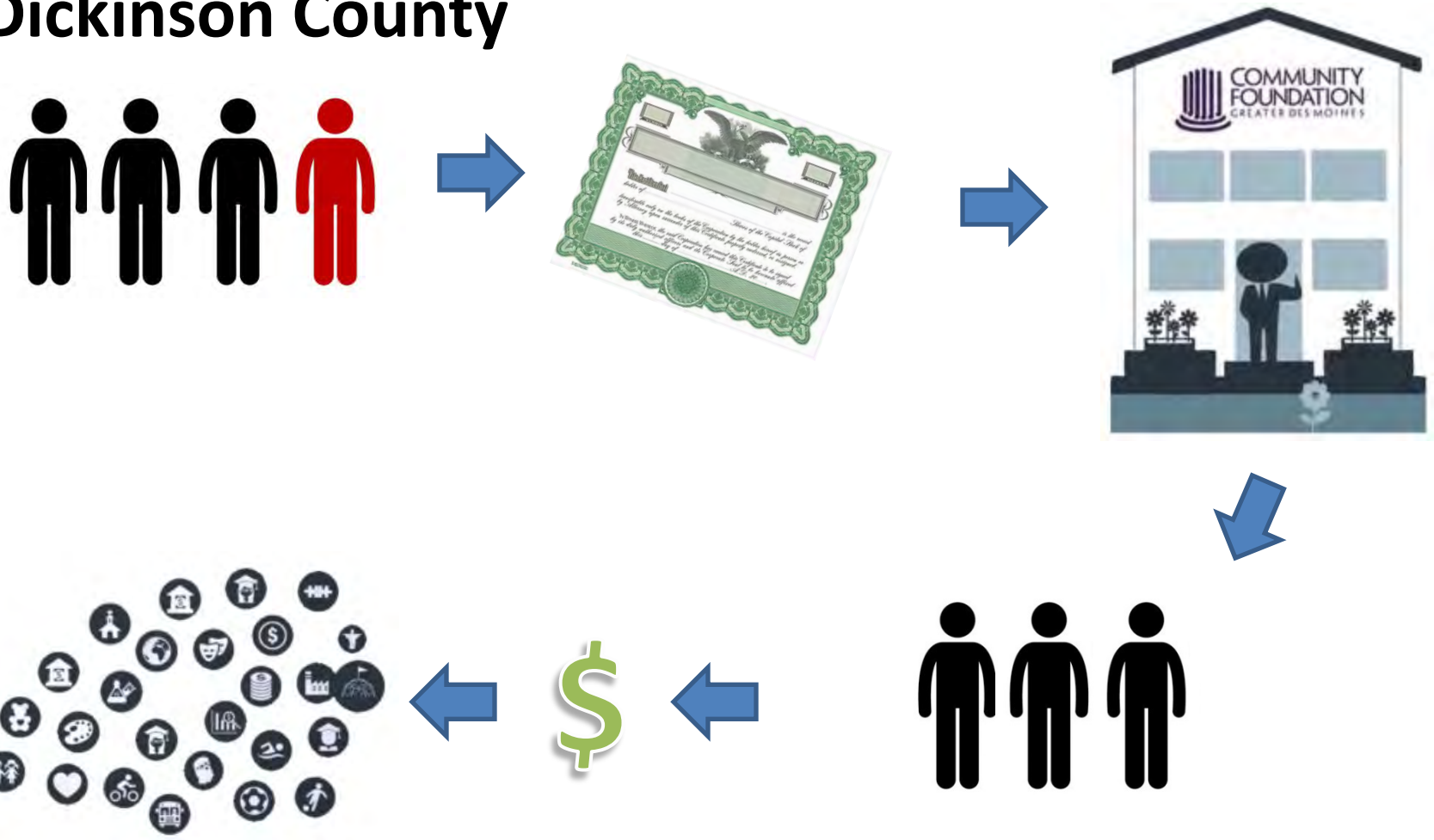
Donor Has Four Goals:

1. Pre-fund his Charitable Giving
2. Utilize Endow Iowa to Offset Income Taxes
3. Avoid Capital Gains Taxes
4. Transfer Ownership of Shares to Employees

Shares of Privately Held Business Interest

COMMUNITY FOUNDATION GREATER DES MOINES

Dickinson County



Estate Planning

COMMUNITY FOUNDATION GREATER DES MOINES

Warren County

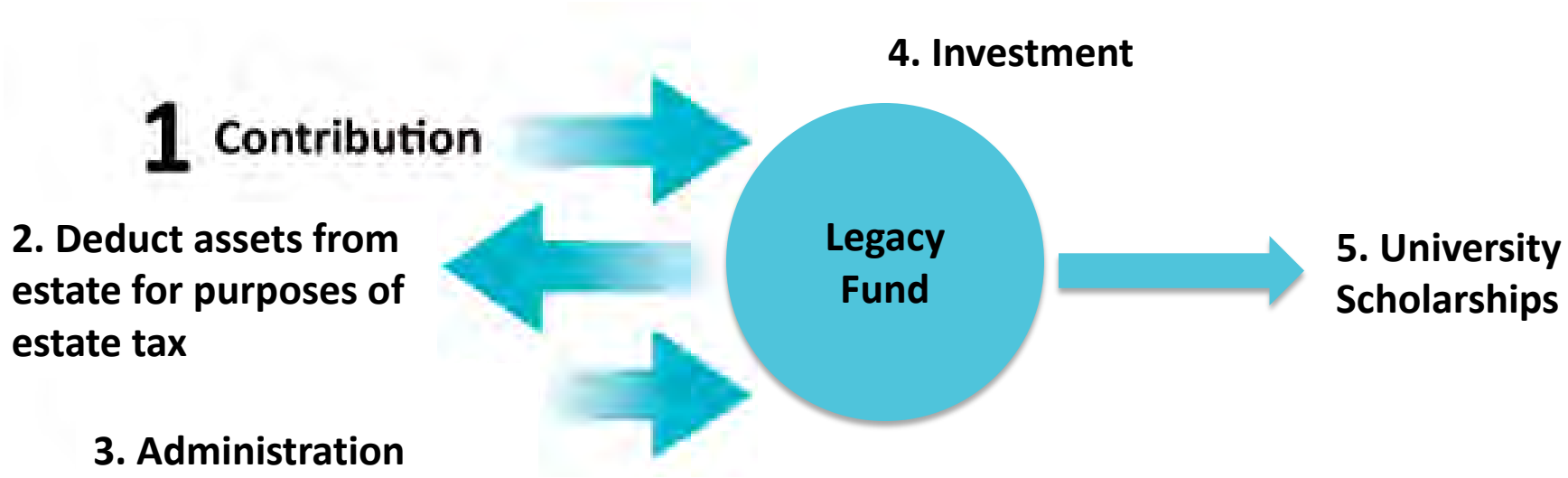
Donor Had Three Goals:

1. Honor Her Husband's Charitable Intent
2. Ensure Accountability
3. Make a Meaningful Impact on Students

Estate Planning

COMMUNITY FOUNDATION GREATER DES MOINES

Warren County



Bargain Sale

COMMUNITY FOUNDATION GREATER DES MOINES

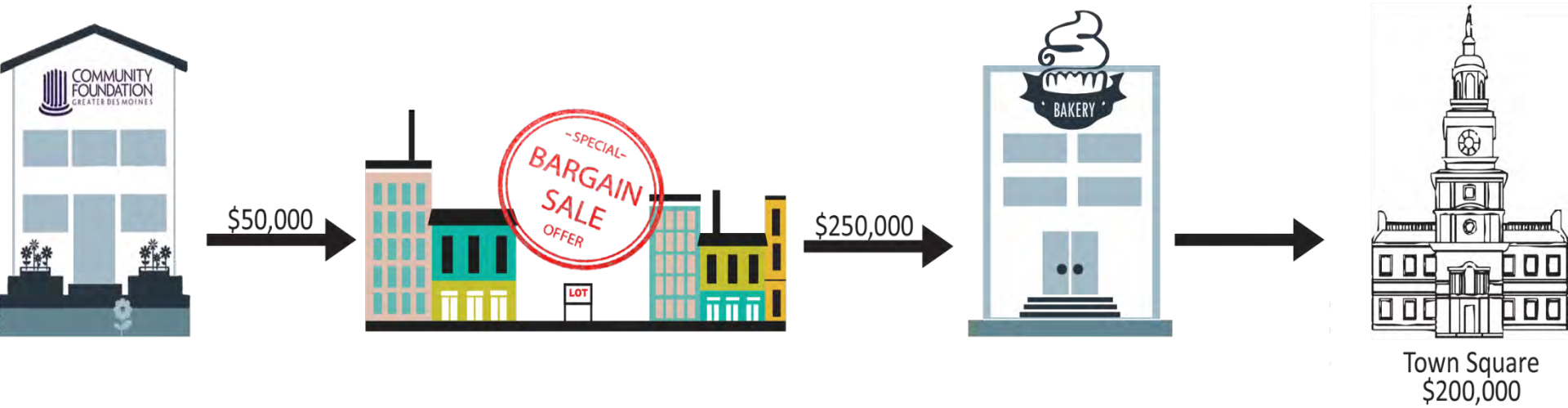
Clinton County

Donor Had Five Goals:

1. Benefit His Community
2. Donate An Asset No Longer Needed
3. Net $50,000 From the Sale
4. Wanted Endow Iowa Tax Credits
5. Avoid Capital Gains Taxes

Bargain Sale

Clinton County



Gift of Farmland-Outright

COMMUNITY FOUNDATION GREATER DES MOINES

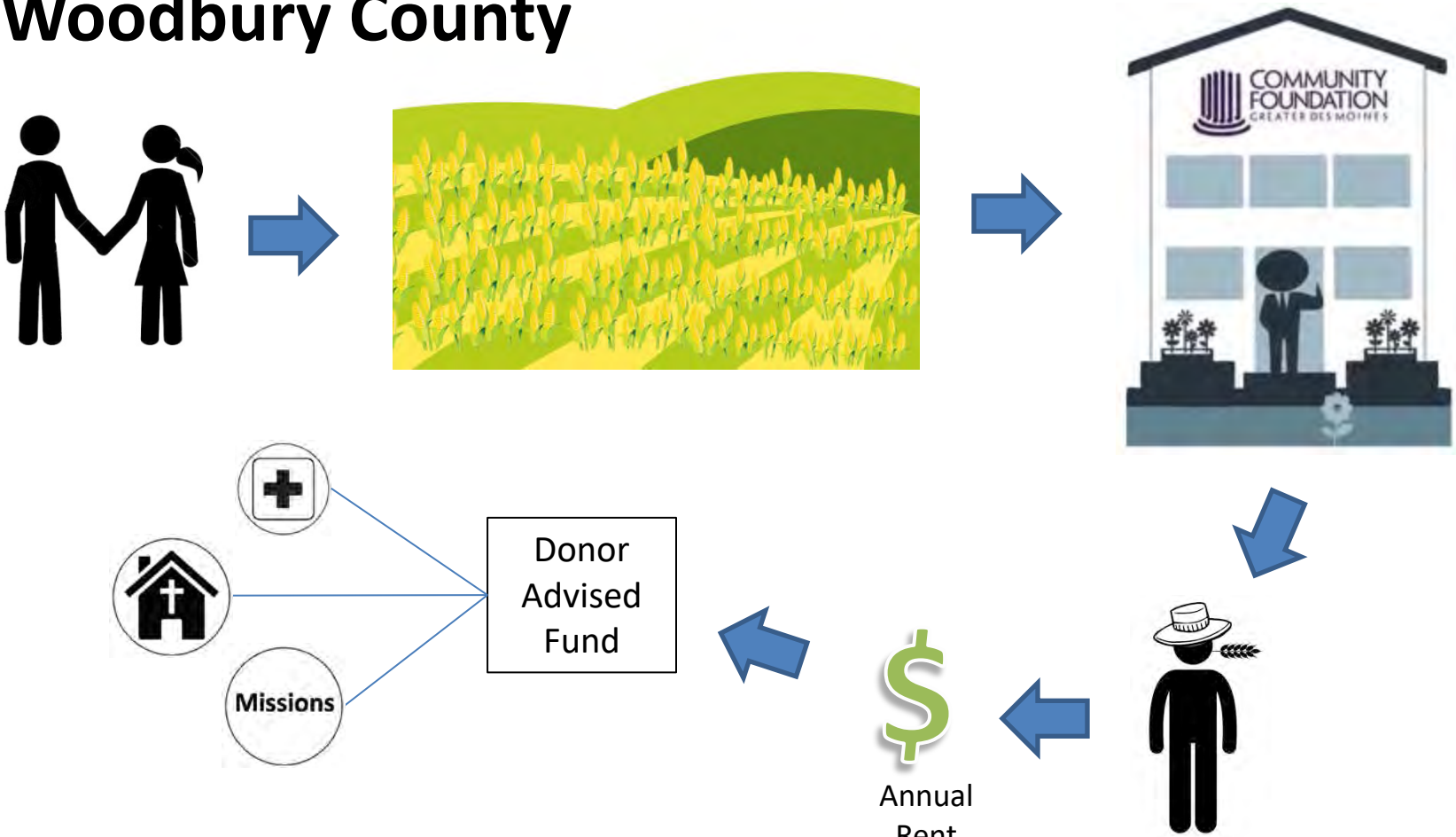
Woodbury County

Donors Had Five Goals:

1. Benefit Their Church
2. Wanted Endow Iowa Tax Credits
3. Avoid Capital Gains Taxes
4. Keep the Farmland In Production
5. Maintain Tenant Farmer Relationship

Gift of Farmland-Outright

Woodbury County



Charitable Lead Trusts

COMMUNITY FOUNDATION GREATER DES MOINES

Cass County

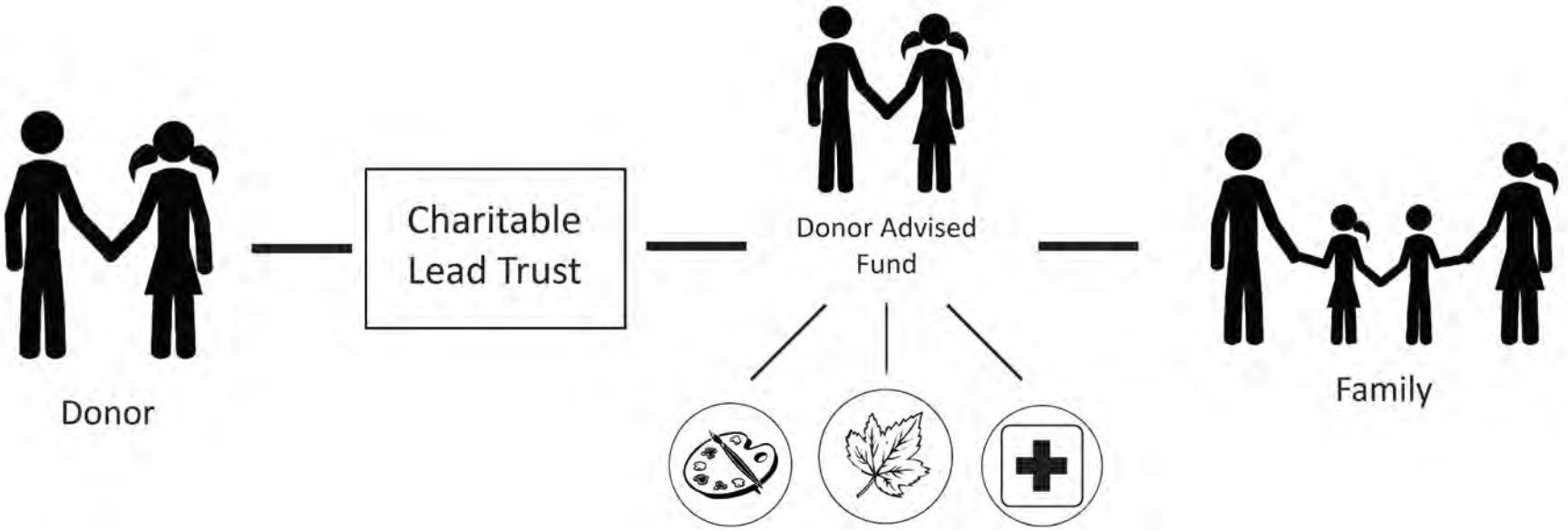
Donors Had Three Goals:

1. Move Assets to Heirs at Passing
2. Support Favorite Charities During Lifetime
3. Take Advantage of Tax Benefits

Charitable Lead Trusts

COMMUNITY FOUNDATION GREATER DES MOINES

Cass County



Private Foundation Conversion

COMMUNITY FOUNDATION GREATER DES MOINES

Polk County

Donors Had Three Goals:

1. Relieve Administrative Burden on Heirs
2. Support Favorite Charities As A Family
3. Ensure Ongoing Legacy

Private Foundation Conversion

COMMUNITY FOUNDATION GREATER DES MOINES

Polk County

	Private	Public
Set-Up Considerations	Legal, Accounting	None
Income Tax Considerations	30%/20% (2% excise)	50%/30%
Administration Considerations	Audit, compliance, legal	CF Handles
Privacy Considerations	Grants on 990	Private
Grantmaking Considerations	Flexible	Monitored

COMMUNITY FOUNDATION GREATER DES MOINES

Questions

Bloethe Tax School

2704 Discount Regulation Developments

10:00 a.m.-11:00 a.m.

Presented by
Gary Streit
Shuttleworth & Ingersoll, P.C.
115 Third Street SE Ste. 500
PO Box 2107
Cedar Rapids, IA 52406
Phone: 319-365-9461

FRIDAY, DECEMBER 9, 2016

Proposed Section 2704 Regulations
Iowa State Bar Association Tax School
December, 2016
Gary J. Streit
Shuttleworth & Ingersoll, P.L.C.
Cedar Rapids, Iowa

A. The Big Picture.

1. In the view of many commentators, the Proposed Regulations, if adopted, would essentially eliminate the long-honored practice of applying marketability and minority interest discounts in determining the value of interests in closely-held business interests for gift and estate tax purposes.

2. The 2704 proposed regulations were released on August 2, 2016, and were published in the Federal Register on August 4, 2016. A hearing on the proposed regulations was scheduled for December 1, 2016. The Internal Revenue Service has already received several thousand comments on the proposed regulations and forty-one (41) Republican Senators have signed a letter to Treasury Secretary Lew expressing their opposition to the proposed regulations. In addition, H.R. 6100, the Protect Family Farms and Businesses Act, includes a section which would provide that the proposed regulations published on August 4, 2016 "shall have no force or effect" and that "no federal funds may be used to finalize, implement, administer, or enforce such proposed regulations or any substantially similar regulations."

3. In all likelihood, the regulations will not be effective until 2017. In fact, the Internal Revenue Service estate and gift tax attorney, Catherine Hughes, has stated that Treasury does not intend to "ram these things through before the end of the year or the end of administration."

4. This is not a new issue. The Department of the Treasury and the Internal Revenue Service have been working on these regulations ever since 2003. These efforts included requests for legislative action that did not gather any type of support. Instead, the choice was made to approach this through the regulation process.

B. Statutory context.

1. Section 2704 of the Internal Revenue Code is part of Chapter 14 of the Internal Revenue Code which was enacted in 1990, the purpose of which was to impose special valuation rules in specific cases.

2. Section 2701 imposes special valuation rules in the case of transfers of certain interest in corporations or partnerships. These rules were designed to eliminate preferred "stock freezes" through junior and senior equity.

3. Section 2702 specifies special valuation rules in cases of transfers of interest in trusts. These rules were intended to eliminate the effectiveness of grantor retained interest trusts.

4. Section 2703 provides that certain rights and restrictions are disregarded. This section is designed to disregard limitations on valuation in buy-sell and similar agreements unless those agreements met specific conditions.

5. Section 2704 covers certain lapsing rights and restrictions. It is designed to treat the loss of value from a lapse of a voting or liquidation right as a transfer, and is also designed to disregard certain restrictions on liquidation that would reduce value. Finally, Section 2704 authorizes the issuance of regulations to disregard other restrictions that reduce value but do not ultimately reduce the value to the transferee.

   a. The anti-lapse provisions of Section 2704(a) apply only where an individual and the individual's family hold voting or liquidation control over a corporation or partnership.

   b. Similarly, Section 2704(b) is also limited in its application to a family-owned corporation or partnership.

C. Bad cases make bad law.

1. Section 2704(a) was originally intended to prevent a result similar to that in Estate of Harrison v. Commissioner, T.C. Memo, 1987-8. In this case, the decedent and two (2) of his children each held a general partnership interest in a partnership immediately before the decedent's death. The decedent also held all of the limited partnership interests in the partnership.

   Since any general partner could liquidate the partnership during the general partner's lifetime, each general partner could realize full value of that partner's partnership interest. However, a general partner's right to force the liquidation lapsed on that partner's death. In determining the estate tax value of the decedent's limited partnership interest, the Court concluded that the right of the decedent to liquidate the partnership (and thus obtain the full value of the limited partner interest) could not be taken into account because that right lapsed at death. As a result, the Court determined the value for transfer tax purposes of the limited partner interest to be approximately one-half (1/2) of its value even in the hands of the decedent immediately before death, or in the hands of the other general partners immediately after death.

Under the current regulations under Section 2704, the Court found that a lapse did not occur and that the lesser value was the appropriate value for estate tax purposes.

2. The other case which precipitated the Internal Revenue Service's efforts to revamp the regulations under §2704 was Kerr v. Commissioner, 113 T.C. 449 (1999), aff'd., 292 F. 3rd 490 (5th Cir. 2002). In the Kerr case, the partnership agreement provided that the partnership could not liquidate before the year 2043 without the consent of all partners, with one of the partners being a charity. The Internal Revenue Service argued that the restriction on liquidation was not an applicable restriction under Section 2704 and should be disregarded. The Tax Court held that:

   a. The restriction on liquidation was not more onerous than the default rule under state law which required consent of all partners as a default rule;

   b. Limiting a partner's right to redeem her interest was not an applicable restriction; and

   c. An applicable restriction only exists where restriction is on liquidation of the entire entity.

3. The 5th Circuit affirmed the Tax Court on different grounds: "For a restriction to be considered removable by the family, the Code specifies that '[t]he transferor or any member of the transferor's family, either alone or collectively,' must have the right to remove the restriction. Code Section 2407(b)(2)(B)(ii). The Code provides no exception allowing us to disregard non-family partners who have stipulated their probable consent to a removal of the restriction. The probable consent of [charity], a non-family partner, cannot fulfill the requirement that the family be able to remove the restrictions on its own."

4. The proposed regulations under Section 2704(b) attempt to change the outcome in Kerr in three ways:

   a. Eliminate the default rule concept so that a state law restriction on liquidation will be honored only where it is mandatory and the family members cannot vote to remove the restriction;

   b. Creating the concept of a disregarded restriction; and

   c. Disregarded restrictions cannot be avoided by giving nominal interest to non-family members.

D. Proposed Regulations under Section 2704(a).

1. The best way to understand the impact of the proposed regulations under Section 2704(a) is to look at example four (4) in the proposed regulations. In that example, a

parent owns eighty-four percent (84%) of an entity and gives forty-two percent (42%) of the entity in equal shares to three (3) children. The parent no longer holds enough shares to force liquidation of the entity, because the parent now owns less than fifty percent (50%) of the voting rights of the entity. This lapsed liquidation right amount (the loss of the ability to force the liquidation of the entity) is not included under Section 2704(a) because the rights associated with the transferred shares (the voting rights) were not eliminated by the terms of the transfer.

2. The proposed regulations introduce a three-year concept so that the provisions of the old regulations would continue to apply if the transfers described above occurred more than three (3) years before the decedent's death. If the transfer occurred within three (3) years of the decedent's death, the transfer should be treated as the lapse of the donor's liquidation right occurring at the donor's death. As a result, the lapsed liquidation amount will be included in the donor's gross estate, and this phantom value would not qualify for a marital or charitable deduction.

3. The mechanics of how to determine the amount of the lapsed value are unclear. The regulations state that you subtract the value of all interest after the lapse from the value of the interest immediately after the lapse. How is double taxation avoided if the disregarded restrictions discussed below is the liquidation value was taxed in the original transfer?

4. Another significant change under Section 2704(a) is that a transfer to an assignee is subject to Section 2704(a) even if the transferor can continue to exercise the voting or management rights associated with the interest transferred to the assignee. The concept here is that the transferor's voting rights "lapsed" as a result of the provisons of the governing instrument or state law that provide that the assignee only receives an economic interest and has no voting rights. Assignees would also be subject to the new "disregarded restrictions" rules of Section 2704(b) because they do not have a "put right". What this means is that the valuation of a transfer to an assignee has to be increased to reflect any diminution in value because the assignee does not have voting or liquidation rights.

E. Proposed Regulations under Section 2704(b).

1. It is very important to remember that Section 2704(b), as written, and the regulations at 25.2704-2 are written to deal with not taking into account "applicable restrictions" on the ability to liquidate the entity in determining the value of the transfer of an interest in an entity where members of a family control that entity immediately prior to the transfer.

2. Applicable restrictions are those imposed by the governing instruments of the entity (articles, bylaws, operating agreement, partnership agreement, a buy-sell agreement, a redemption agreement, etc. **and** state law restrictions on the ability to liquidate the entity. Prior to the proposed regulations, state law restrictions on the ability to

liquidate that could be overridden by the family were not deemed to be applicable restrictions. Under the proposed regulations, unless the state law restriction is mandatory (i.e., it cannot be overridden by agreement or otherwise), the state law restriction will treated as an applicable restriction. It is extremely unlikely that any state law will have mandatory restrictions that cannot be relieved by the shareholders or members or partners. No laws of any entity other than the United States or a state or District of Columbia can be given effect—you cannot pass a county ordinance to achieve a reduction in value by imposing restrictions on transfer.

3. The proposed regulations at 25.2704-3 introduce the concept of "disregarded restrictions". Disregarded restrictions are not to be taken into account in valuing the interest for transfer tax purposes when the interest is transferred to family members.

4. Disregarded restrictions are defined as those which limit the ability of the interest holder to compel liquidation or redemption of that interest on no more than six (6) months' notice for cash or property equal at least to a "minimum value", but only if the restriction will lapse at any time after the transfer or can be removed by family members.

    a. Minimum value is the interest's pro rata share of net value of the entity. Net value is defined as the fair market value of the assets of the entity determined under the §2512 and 2031 regulations reduced by debts of the entity, but only to the extent debts would be deductible under Section 2053 if they had been claims against the decedent's estate. For an operating entity, does this mean that you do not take into account contingent obligations or other unbooked exposures? What about built-in gains taxes for C corporations?

    b. For an operating entity, Regs. 20.2031-2(f)(2), 20.2031-3, 25.2512-2(f)(2) and 25.2512-3 apply—they refer to earning capacity and other factors. Net value of an ongoing business that does not intend to liquidate may be less than liquidation value. Giustina, T.C. Memo 2016-114.

    c. This net fair market value is then allocated pro rata across the ownership interests of the entity.

    d. The term "cash or property" does not include a note issued by the entity or its owners or related persons unless the entity is engaged in an active trade or business. This means at least sixty percent (60%) of the value of the entity consists of non-passive assets of trade or business, the liquidation proceeds (payments on the note) are not a treatable to passive assets, the note is adequately secured, the note requires periodic payments on a non-deferred basis, the note is issued at market interest rate (not AFRs), and the note has fair market value on the date of liquidation equal to liquidation proceeds.

e. It must be remembered that the disregarded restriction is disregarded only, if after the transfer, the restriction will lapse or can be removed by the transferor or any member or members of the transferor's family.

f. In determining whether the family can remove the disregarded restriction, an interest held by a non-family members that might give the non-family member the power to prevent the removal of a restriction is itself disregarded unless that interest has been held by the non-family member for at least three (3) years, represents at least ten percent (10%) of the entity, represents at least twenty percent (20%) of the entity when aggregated with other non-family members, and can be redeemed by the non-family holder on not more than six months' notice for cash or other property (as defined above). This limitation applies only to the newly-created concept of "disregarded restrictions" and not to "applicable restrictions".

g. The proposed regulations also do not seem to address a situation in which non-family board members, who own no ownership interests in the entity, must consent to the liquidation.

5. Please note the following language in the proposed regulations (Section 25.2704-3(d)(2)):

> "The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or other applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity or otherwise."

F. Key definitions and exceptions.

1. Entities which are covered are broadly defined to include limited liability companies and even disregarded entities. The definition may not be broad enough, however, to include tenants in common interests, but keep in mind a fairly broad interpretation of a partnership.

2. The definition of "family" includes an individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the forgoing. Presumably, does not include nieces and nephews. However, Section 2701defines a "family member" as any lineal descendant of any parent of the transferor or the transferor's spouse. The regulations under §2701 are referenced in Proposed Regulation §25.2704-2(c).

3. A commercially reasonable restriction on liquidation imposed by an unrelated party providing capital to the entity for the entity's trade or business operations is honored and can be taken into account for valuation purposes.

4. If a buy-sell agreement meets the requirements of Section 2703, those restrictions are not subject to the further limitations of Section 2704.

5. If every holder of interest in an entity has an actual right to put their interest back to the company for a price that meets the minimum value rules and is payable in cash or other property, restrictions that are imposed will not be disregarded. Proposed Reg. §27.2704-3(b)-5(v).

G. How do you value a transfer subject to Section 2704?

1. When dealing with disregarded restrictions, there are two (2) steps in the valuation process. The first is to determine the minimum value (a pro rata portion of the net value of the entity for purposes of the assumed six-month "put option"). The second step is to value the holder's interest in the entity under generally accepted valuation principals.
2. In other words, in the first step, one has to determine whether the interest hold will receive at least the "minimum value" for his or her interest in cash or property (remember limitations on promissory notes described above)

3. After assuming the interest holder has the right to receive the minimum value for appropriate consideration within an appropriate time frame, the appraiser can then apply traditional valuation principles.

4. There are many appraisers who take the position that the assumption that all holders of interests in the entity have put rights to receive a minimum value on 6 months notice could have a major depressive impact on the going concern value of the entity.

5. Some appraisers have suggested that a lack of control discount would still be available, even under the minimum value standard, for lack of control over day-to-day operations of the business (about ten percent (10%)) and for the six-month delay in receiving the liquidation payout (about five percent (5%)). In the case of Estate of Jameson v. Commissioner, T.C. Memo 1999-43, the marketability discount was allowed for valuing a ninety-eight percent (98%) interest in the corporation based on the nature and marketability of the corporation's assets.

6. Difficulties in liquidating the asset of the entity and the 6 month delay in payment are also factors that might have a depressing effect on value, even if the applicable restrictions are ignored or if disregarded restrictions are present.

H. Is there really a reason for concern.

1. One school of thought is that the proposed regulations mean that all interests are valued at the "minimum value", thereby eliminating virtually all discounts for minority ownership or marketability.

2. A second school of thought is that the minimum value requirement only means that the transferee will be deemed to have the right to redeem at whatever price he or she is able to negotiate with those who control the entity. In these instances, there are some statutes that require that the "fair value" standard apply. There is some support for this view in the preamble to the proposed regulations. In addition, Cathy Hughes, the IRS Estate and Gift Tax attorney who has spoken publicly on the proposed regs has said at an ABA meeting that the proposed regs are not intended to/do not eliminate minority and marketability discounts. According to her, certain restrictions are supposed to be ignored, but there are no implied put or redemption rights created by the proposed regulations. She went on to say that the proposed regs are intended to mean that if there are any rules in law or the governing documents that say if one redeems they receive a long term note or less than minimum value or if there is a restriction on redeming at all, those rules are to be ignored. (ACTEC list serve statements by David A. Handler on October 3, 2016.

I. Are the proposed regulations valid?

1. The regs appear to be a departure from the hypothetical willing seller/willing buyer concept, as embodied in Rev. Rul. 93-12, 1993-1 C.B. 202

2. Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837, establishes the general principle that courts will defer to the governing agency's interpretation of a statute, unless the agency's interpretation is unreasonable, arbitrary, or manifestly contrary to the statute. The Court must first determine if there is any ambiguity in the statute—if there is no ambiguity, the statute controls and no reference is made to the regulations. If there is an ambiguity, then the agency's interpretation will be judged on the standards outlined above—difficult standards to attain.

3. Mayo Foundation for Medical Education and Research v. United States. 562 U.S. 44, establishes that the Chevron analysis applies in evaluating tax statutes and regulations.

4. Section 2704(b)(4) authorizes the issuance of regulations to provide that other restrictions shall be disregarded in determining the value of the transfer of an interest in a corporation or a partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest but does not ultimately reduce the value of such interest to the transferee. The IRS may be clinging to the model of an "Ozzie and Harriet" family in assuming that the any limitation on the ability to redeem or liquidate an interest will not have the effect of reducing the actual value of the transferred interest—the IRS is assuming a

monolithic decision-making construct in a family. If the underlying premise is faulty, is there validity to the rest of the proposed regulation?

J. <u>What should you do now</u>.

1. Do not assume that the proposed regs will be invalidated.

2. Seriously consider gifts of minority interests in a closely-held business before the regulations take effect, but do not overlook the three year inclusion rule.

3. Will a sale to an IDGT (intentionally defective grantor trust) be covered—is that a transfer?

4. Make sure you have a solid valuation done before moving too far with the actual gifts.

5. Communicate with your clients.

6. Do not overlook basis considerations.

7. Be careful about tax apportionment clauses.

8. Avoid amending restrictions in place as of October 8, 1990. These are not affected by the new rules.

The following materials have been provided with permission by Mickey R. Davis, Davis & Willms, PLLC, Houston, Texas, an ACTEC fellow for many years. Included are the following:

1. Internal Revenue Code Section 2704
2. Treas. Reg. §25.2701-2 (redlined)
3. Treas. Reg. §25.2704-1 (redlined)
4. Treas. Reg. §25.2704-2 (redlined)
5. Treas. Reg. §25.2704-3 (new)
6. Treas. Reg. §25.2704-2 and 3 compared—Applicable versus Disregarded Restriction—examples not included
7. Flow chart for Treas. Reg. §§25.2704-2 and -3

§ 2704 Treatment of certain lapsing rights and restrictions.

(a) Treatment of lapsed voting or liquidation rights.

(1) In general.

For purposes of this subtitle, if-

(A) there is a lapse of any voting or liquidation right in a corporation or partnership, and

(B) the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity,

such lapse shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate of the decedent, whichever is applicable, in the amount determined under paragraph (2).

(2) Amount of transfer.

For purposes of paragraph (1), the amount determined under this paragraph is the excess (if any) of-

(A) the value of all interests in the entity held by the individual described in paragraph (1) immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing), over

(B) the value of such interests immediately after the lapse.

(3) Similar rights.

The Secretary may by regulations apply this subsection to rights similar to voting and liquidation rights.

(b) Certain restrictions on liquidation disregarded.

(1) In general.

For purposes of this subtitle, if-

(A) there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and

(B) the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity,

any applicable restriction shall be disregarded in determining the value of the transferred interest.

(2) Applicable restriction.

For purposes of this subsection , the term "applicable restriction" means any restriction-

(A) which effectively limits the ability of the corporation or partnership to liquidate, and

(B) with respect to which either of the following applies:

(i) The restriction lapses, in whole or in part, after the transfer referred to in paragraph (1).

(ii) The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.

(3) Exceptions.

The term "applicable restriction" shall not include-

(A) any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or

(B) any restriction imposed, or required to be imposed, by any Federal or State law.

(4) Other restrictions.

The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

(c) Definitions and special rules.

For purposes of this section -

(1) Control.

The term "control" has the meaning given such term by section 2701(b)(2).

(2) Member of the family.

The term "member of the family" means, with respect to any individual-

(A) such individual's spouse,

(B) any ancestor or lineal descendant of such individual or such individual's spouse,

(C) any brother or sister of the individual, and

(D) any spouse of any individual described in subparagraph (B) or (C).

(3) Attribution.

The rule of section 2701(e)(3) shall apply for purposes of determining the interests held by any individual.

§ 25.2701-2. Special valuation rules for applicable retained interests.

Effective: January 28, 1992.

(a)In general. In determining the amount of a gift under §25.2701-3, the value of any applicable retained interest (as defined in paragraph (b)(1) of this section) held by the transferor or by an applicable family member is determined using the rules of chapter 12, with the modifications prescribed by this section. See §25.2701-6 regarding the indirect holding of interests.

(1)Valuing an extraordinary payment right. Any extraordinary payment right (as defined in paragraph (b)(2) of this section) is valued at zero.

(2)Valuing a distribution right. Any distribution right (as defined in paragraph (b)(3) of this section) in a controlled entity is valued at zero, unless it is a qualified payment right (as defined in paragraph (b)(6) of this section). Controlled entity is defined in paragraph (b)(5) of this section.

(3)Special rule for valuing a qualified payment right held in conjunction with an extraordinary payment right. If an applicable retained interest confers a qualified payment right and one or more extraordinary payment rights, the value of all these rights is determined by assuming that each extraordinary payment right is exercised in a manner that results in the lowest total value being determined for all the rights, using a consistent set of assumptions and giving due regard to the entity's net worth, prospective earning power. and other relevant factors (the "lower of" valuation rule). See §§20.2031-2(f) and 20.2631-3 for rules relating to the valuation of business interests generally.

(4)Valuing other rights. Any other right (including a qualified payment right not subject to the prior paragraph) is valued as if any right valued at zero does not exist and as if any right valued under the lower of rule is exercised in a manner consistent with the assumptions of that rule but otherwise without regard to section 2701. Thus, if an applicable retained interest carries no rights that are valued at zero or under the lower of rule, the value of the interest for purposes of section 2701 is its fair market value.

(5)Example. The following example illustrates rules of this paragraph (a).

Example. P, an individual, holds all 1,000 shares of X Corporation's $1,000 par value preferred stock bearing an annual cumulative dividend of $100 per share and holds all 1,000 shares of X's voting common stock. P has the right to put all the preferred stock to X at any time for $900,000. P transfers the common stock to P's child and immediately thereafter holds the preferred stock. Assume that at the time of the transfer, the fair market value of X is $1,500,000, and the fair market value of P's annual cumulative dividend right is $1,000,000. Because the preferred stock confers both an extraordinary payment right (the put right) and a qualified payment right (i.e., the right to receive cumulative dividends), the lower of rule applies and the value of these rights is determined as if the put right will be exercised in a manner that results in the lowest total value being determined for the rights (in this case. by assuming that the put will be exercised immediately). The value of P's preferred stock is $900,000 (the lower of $1,000,000 or $900,000). The amount of the gift is $600,000 ($1,500,000 minus $900,000).

(b)Definitions.

(1)Applicable retained interest. An applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either-

(i) An extraordinary payment right (as defined in paragraph (b)(2) of this section), or

(ii) In the case of a controlled entity (as defined in paragraph (b)(5) of this section), a distribution right (as defined in paragraph (b)(3) of this section).

(2)Extraordinary payment right. Except as provided in paragraph (b)(4) of this section, an extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.

(3)Distribution right. A distribution right is the right to receive distributions with respect to an equity interest. A distribution right does not include-

(i) Any right to receive distributions with respect to an interest that is of the same class as, or a class that is

subordinate to, the transferred interest:

(ii) Any extraordinary payment right; or

(iii) Any right described in paragraph (b)(4) of this section.

(4)Rights that are not extraordinary payment rights or distribution rights. Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

(i) Mandatory payment right. A mandatory payment right is a right to receive a payment required to be made at a specific time for a specific amount. For example, a mandatory redemption right in preferred stock requiring that the stock be redeemed at its fixed par value on a date certain is a mandatory payment right and therefore not an extraordinary payment right or a distribution right. A right to receive a specific amount on the death of the holder is a mandatory payment right.

(ii) Liquidation participation rights. A liquidation participation right is a right to participate in a liquidating distribution. If the transferor, members of the transferor's family. or applicable family members have the ability to compel liquidation, the liquidation participation right is valued as if the ability to compel liquidation-

(A) Did not exist, or

(B) If the lower of rule applies, is exercised in a manner that is consistent with that rule.

(iii) Right to a guaranteed payment of a fixed amount under section 707(c). The right to a guaranteed payment of a fixed amount under section 707(c) is the right to a guaranteed payment (within the meaning of section 707(c)) the amount of which is determined at a fixed rate (including a rate that bears a fixed relationship to a specified market interest rate). A payment that is contingent as to time or amount is not a guaranteed payment of a fixed amount.

(iv) Non-lapsing conversion right

(A) Corporations. A non-lapsing conversion right, in the case of a corporation, is a non-lapsing right to convert an equity interest in a corporation into a fixed number or a fixed percentage of shares of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in voting rights), that is subject to proportionate adjustments for changes in the equity ownership of the corporation and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(B) Partnerships. A non-lapsing conversion right, in the case of a partnership, is a non-lapsing right to convert an equity interest in a partnership into a specified interest (other than an interest represented by a fixed dollar amount) of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in management rights or limitations on liability) that is subject to proportionate adjustments for changes in the equity ownership of the partnership and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(C) Proportionate adjustments in equity ownership. For purposes of this paragraph (b)(4), an equity interest is subject to proportionate adjustments for changes in equity ownership if, in the case of a corporation, proportionate adjustments are required to be made for splits, combinations, reclassifications, and similar changes in capital stock, or, in the case of a partnership, the equity interest is protected from dilution resulting from changes in the partnership structure.

(D) Adjustments for unpaid payments. For purposes of this paragraph (b)(4), an equity interest is subject to adjustments similar to those provided in section 2701(d) if it provides for-

(1) Cumulative payments;

(2) Compounding of any unpaid payments at the rate specified in §25.2701-4(c)(2); and

(3) Adjustment of the number or percentage of shares or the size of the interest into which it is convertible to take account of accumulated but unpaid payments.

(5)Controlled entity.

(i) In general. For purposes of section 2701, a controlled entity is a corporation ~~or~~, partnership, or any other

entity or arrangement that is a business entity within the meaning of §301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the ~~transferor's~~transferor's spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized. See §25.2701-6 regarding indirect holding of interests.

(ii) Corporations

(A) In general. In the case of a corporation, control means the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.

(B) Voting rights. Equity interests that carry no right to vote other than on liquidation, merger, or a similar event are not considered to have voting rights for purposes of this paragraph (b)(5)(ii). Generally, a voting right is considered held by an individual to the extent that the individual, either alone or in conjunction with any other person, is entitled to exercise (or direct the exercise of) the right. However, if an equity interest carrying voting rights is held in a fiduciary capacity, the voting rights are not considered held by the fiduciary, but instead are considered held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. A voting right does not include a right to vote that is subject to a contingency that has not occurred, other than a contingency that is within the control of the individual holding the right.

(iii) Partnerships. In the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership. Any right to a guaranteed payment under section 707(c) of a fixed amount is disregarded in making this determination. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner. See §25.2701-2(b)(4)(iii) for the definition of a right to a guaranteed payment of a fixed amount under section 707(c).

(iv) Other business entities. In the case of any entity or arrangement that is not a corporation, partnership, or limited partnership, control means the holding of at least 50 percent of either the capital interests or the profits interests in the entity or arrangement. In addition, control means the holding of any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

(6)Qualified payment right.

(i) In general. A qualified payment right is a right to receive qualified payments. A qualified payment is a distribution that is-

(A) A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate;

(B) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or

(C) Any distribution right for which an election has been made pursuant to paragraph (c)(2) of this section.

(ii) Fixed rate. For purposes of this section a payment rate that bears a fixed relationship to a specified market interest rate is a payment determined at a fixed rate.

(c)Qualified payment elections.

(1)Election to treat a qualified payment right as other than a qualified payment right. Any transferor holding a qualified payment right may elect to treat all rights held by the transferor of the same class as rights that are not qualified payment rights. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made.

(2)Election to treat other distribution rights as qualified payment rights. Any individual may elect to treat a distribution right held by that individual in a controlled entity as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made. An election under this paragraph (c)(2) will not cause the value of the applicable retained interest conferring the distribution right to exceed the fair market value of the applicable retained interest (determined without regard to section 2701). The election is effective only to the extent-

(i) Specified in the election, and

(ii) That the payments elected are permissible under the legal instrument giving rise to the right and are consistent with the legal right of the entity to make the payment.

(3)Elections irrevocable. Any election under paragraph (c)(1) or (c)(2) of this section is revocable only with the consent of the Commissioner.

(4)Treatment of certain payments to applicable family members. Any payment right described in paragraph (b)(6) of this section held by an applicable family member is treated as a payment right that is not a qualified payment right unless the applicable family member elects (pursuant to paragraph (c)(2) of this section) to treat the payment right as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made.

(5)Time and manner of elections. Any election under paragraph (c)(1) or (c)(2) of this section is made by attaching a statement to the Form 709, Federal Gift Tax Return, filed by the transferor on which the transfer is reported. An election filed after the time of the filing of the Form 709 reporting the transfer is not a valid election. An election filed as of April 6, 1992, for transfers made prior to its publication is effective. The statement must-

(i) Set forth the name, address, and taxpayer identification number of the electing individual and of the transferor, if different;

(ii) If the electing individual is not the transferor filing the return, state the relationship between the individual and the transferor;

(iii) Specifically identify the transfer disclosed on the return to which the election applies;

(iv) Describe in detail the distribution right to which the election applies;

(v) State the provision of the regulation under which the election is being made; and

(vi) If the election is being made under paragraph (c)(2) of this section-

(A) State the amounts that the election assumes will be paid, and the times that the election assumes the payments will be made;

(B) Contain a statement, signed by the electing individual, in which the electing individual agrees that-

(1) If payments are not made as provided in the election, the individual's subsequent taxable gifts or taxable estate will, upon the occurrence of a taxable event (as defined in §25.2701-4(b)), be increased by an amount determined under §25.2701-4(c), and

(2) The individual will be personally liable for any increase in tax attributable thereto.

(d)Examples. The following examples illustrate provisions of this section:

Example (1). On March 30, 1991, P transfer's non-voting common stock of X Corporation to P's child, while retaining $100 par value voting preferred stock bearing a cumulative annual dividend of $10. Immediately before the transfer, P held 100 percent of the stock. Because X is a controlled entity (within the meaning of paragraph (b)(5) of this section), P's dividend right is a distribution right that is subject to section 2701. See §25.2701-2(b)(3). Because the distribution right is an annual cumulative dividend, it is a qualified payment right. See §25.2701-2(b)(6).

Example (2). The facts are the same as in Example 1, except that the dividend right is non-cumulative. P's

dividend right is a distribution right in a controlled entity, but is not a qualified payment right because the dividend is non-cumulative. Therefore, the non-cumulative dividend right is valued at zero under §25.2701-2(a)(2). If the corporation were not a controlled entity, P's dividend right would be valued without regard to section 2701.

Example (3). The facts are the same as in Example 1. Because P holds sufficient voting power to compel liquidation of X, P's right to participate in liquidation is an extraordinary payment right under paragraph (b)(2) of this section. Because P holds an extraordinary payment right in conjunction with a qualified payment right (the right to receive cumulative dividends), the lower of rule applies.

Example (4). The facts are the same as in Example 1, except that immediately before the transfer, P, applicable family members of P, and members of P's family, hold 60 percent of the voting rights in X. Assume that 80 percent of the vote is required to compel liquidation of any interest in X. P's right to participate in liquidation is not an extraordinary payment right under paragraph (b)(2) of this section, because P and P's family cannot compel liquidation of X. P's preferred stock is an applicable retained interest that carries no rights that are valued under the special valuation rules of section 2701. Thus, in applying the valuation method of §25.2701-3, the value of P's preferred stock is its fair market value determined without regard to section 2701.

Example (5). L holds 10-percent non-cumulative preferred stock and common stock in a corporation that is a controlled entity. L transfers the common stock to L's child. L holds no extraordinary payment rights with respect to the preferred stock. L elects under paragraph (c)(2) of this section to treat the noncumulative dividend right as a qualified payment right consisting of the right to receive a cumulative annual dividend of 5 percent. Under §25.2701-2(c)(2), the value of the distribution right pursuant to the election is the lesser of-

(A) The fair market value of the right to receive a cumulative 5-percent dividend from the corporation, giving due regard to the corporation's net worth, prospective earning power, and dividend-paying capacity; or

(B) The value of the distribution right determined without regard to section 2701 and without regard to the terms of the qualified payment election.

Reg § 25.2701-8. Effective dates.

Effective: January 28, 1992.

(a) Except as provided in paragraph (b) of this section, §§25.2701-1 through 25.2701-4 and §§25.2701-6 and 25.2701-7 are effective as of January 28, 1992. * * *

(b) The first six sentences of §25.2701-2(b)(5)(i) and (iv) are effective on the date these regulations are published as final regulations in the Federal Register.

§ 25.2704-1. Lapse of certain rights.

Effective: January 28, 1992.

(a)Lapse treated as transfer.

(1)In general. ~~The~~For purposes of subtitle B (relating to estate, gift, and generation- skipping transfer taxes), the lapse of a voting ~~right~~ or a liquidation right in a corporation or a partnership (an ~~"~~entity~~")~~), whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the ~~"~~holder~~")~~) to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and ~~members of the holder's family immediately before and after the lapse.~~/or members of the holder's family immediately before and after the lapse. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes. The amount of the transfer is determined under paragraph (d) of this section. If the lapse of a voting right or a liquidation right occurs during the holder's lifetime, the lapse is a transfer by gift. If the lapse occurs at the holder's death, the lapse is a transfer includible in the holder's gross estate.

(2)Definitions. The following definitions apply for purposes of this section.

(i) Control. Control has the meaning given it in § 25.2701-2(b)(5). For purposes of determining whether the group consisting of the holder, the holder's estate and members of the holder's family control the entity, a member of the group is also treated as holding any interest held indirectly by such member through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

(ii) Member of the family. Member of the family has the meaning given it in §25.2702-2(a)(1).

~~(iii) Directly or in directly held. An interest is directly or indirectly held only to the extent the value of the interest would have been includible in the gross estate of the individual if the individual had died immediately prior to the lapse.~~

~~(iv~~(iii) Voting right. Voting right means a right to vote with respect to any matter of the entity. In the case of a partnership, the right of a general partner to participate in partnership management is a voting right. In the case of a limited liability company, the right of a member to participate in company management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and is not treated as a voting right.

(~~v~~iv) Liquidation right. Liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.

(~~vi~~iv) Subordinate. Subordinate has the meaning given it in § 25.2701-3(a)(2)(iii).

(3)Certain temporary lapses. If a lapsed right may be restored only upon the occurrence of a future event not within the control of the holder or members of the holder's family, the lapse is deemed to occur at the time the lapse becomes permanent with respect to the holder, i.e. either by a transfer of the interest or otherwise.

(4)Source of right or lapse. A voting right or a liquidation right may be conferred by ~~and may~~or lapse by reason of ~~a State~~local law, the ~~corporate charter or bylaws~~governing documents, an agreement, or ~~other means~~otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs voting or liquidation rights.

(5) *Assignee interests.* A transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has

nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest. (b)Lapse of voting right. A lapse of a voting right occurs at the time a presently exercisable voting right is restricted or eliminated.

(c)Lapse of liquidation right.

(1)In general. A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Except as otherwise provided, a transfer of an interest occurring more than three years before the transferor's death that results in the lapse of a voting or liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. However, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest. The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a).

(2)Exceptions. Section 2704(a) does not apply to the lapse of a liquidation right under the following circumstances.

(i) Family cannot obtain liquidation value

(A) In general. Section 2704(a) does not apply to the lapse of a liquidation right to the extent the holder (or the holder's estate) and members of the holder's family cannot immediately after the lapse liquidate an interest that the holder held directly or indirectly and could have liquidated prior to the lapse.

(B) Ability to liquidate. Whether an interest can be liquidated immediately after the lapse is determined under the ~~State~~local law generally applicable to the entity, as modified by the governing ~~instruments~~documents of the entity, but without regard to any restriction ~~described (in section 2704(b). Thus, if, after any restriction~~the governing documents, applicable local law, or otherwise) described in section 2704(b) and the regulations thereunder. The manner in which the interest may be liquidated is ~~disregarded, the remaining requirements~~irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, revising the governing documents, merging the entity with an entity whose governing documents permit liquidation of the interest, terminating the entity, or otherwise. For purposes of making this determination, an interest held by a person other than a member of the holder's family (a nonfamily- member interest) may be disregarded. Whether a nonfamily-member interest is disregarded is determined under ~~the governing instruments are less restrictive than the State law~~§25.2704-3(b)(4), applying that ~~would apply in the absence of the governing instruments, the ability~~section as if, by its terms, it also applies to the question of whether the holder (or the holder's estate) and members of the holder's family may liquidate ~~is determined by reference to the governing instruments~~an interest immediately after the lapse.

(ii) Rights valued under section 2701. Section 2704(a) does not apply to the lapse of a liquidation right previously valued under section 2701 to the extent necessary to prevent double taxation (taking into account any adjustment available under §25.2701-5).

(iii) Certain changes in State law. Section 2704(a) does not apply to the lapse of a liquidation right that occurs solely by reason of a change in State law. For purposes of this paragraph, a change in the governing instrument of an entity is not a change in State law.

(d)Amount of transfer. The amount of the transfer is the excess, if any, of-

(1) The value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over

(2) The value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual).

(e)Application to similar rights. [Reserved]

(f)Examples. The following examples illustrate the provisions of this section:

Example (1). Prior to D's death, D owned all the preferred stock of Corporation Y and D's children owned all the common stock. At that time, the preferred stock had 60 percent of the total voting power and the

common stock had 40 percent. Under the corporate by- laws, the voting rights of the preferred stock terminated on D's death. The value of D's interest immediately prior to D's death (determined as if the voting rights were nonlapsing) was $100X. The value of that interest immediately after death would have been $90X if the voting rights had been nonlapsing. The decrease in value reflects the loss in value resulting from the death of D (whose involvement in Y was a key factor in Y's profitability). Section 2704(a) applies to the lapse of voting rights on D's death. D's gross estate includes an amount equal to the excess, if any, of $90X over the fair market value of the preferred stock determined after the lapse of the voting rights.

Example (2). Prior to D's death, D owned all the preferred stock of Corporation Y. The preferred stock and the common stock each carried 50 percent of the total voting power of Y. D's children owned 40 percent of the common stock and unrelated parties own the remaining 60 percent. Under the corporate by-laws, the voting rights of the preferred stock terminate on D's death. Section 2704(a) does not apply to the lapse of D's voting rights because members of D's family do not control Y after the lapse.

Example (3). The by-laws of Corporation Y provide that the voting rights of any transferred shares of the single outstanding class of stock are reduced to ½ vote per share after the transfer but are fully restored to the transferred shares after 5 years. D owned 60 percent of the shares prior to death and members of D's family owned the balance. On D's death, D's shares pass to D's children and the voting rights are reduced pursuant to the by-laws. Section 2704(a) applies to the lapse of D's voting rights. D's gross estate includes an amount equal to the excess, if any, of the fair market value of D's stock (determined immediately after D's death as though the voting rights had not been reduced and would not be reduced) over the stock's fair market value immediately after D's death.

Example (4). D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. More than three years before D's death, D ~~gives~~transfers one-half of ~~D's~~D's stock in equal shares to ~~D's~~D's three children~~,~~ (14 percent ~~to~~ each). Section 2704(a) does not apply to the loss of ~~D's~~D's ability to liquidate Y~~,~~ because the voting rights with respect to the ~~corporation~~transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

Example (5). D and D's two children, A and B, are partners in Partnership X. Each has a 3⅓ percent general partnership interest and a 30 percent limited partnership interest. Under State law, a general partner has the right to participate in partnership management. The partnership agreement provides that when a general partner withdraws or dies, X must redeem the general partnership interest for its liquidation value. Also, under the agreement any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest. D dies, leaving his limited partnership interest to D's spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of D's liquidation right because after the lapse, members of D's family could liquidate D's limited partnership interest. D's gross estate includes an amount equal to the excess of the value of all D's interests in X immediately before D's death (determined immediately after D's death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all D's interests in X immediately after D's death.

Example (6). The facts are the same as in Example 5, except that under the partnership agreement D is the only general partner who holds a unilateral liquidation right. Assume further that the partnership agreement contains a restriction described in section 2704(b) that prevents D's family members from liquidating D's limited partnership interest immediately after D's death. ~~Under State law, in the absence of the restriction in the partnership agreement, D's family members could liquidate the partnership.~~ The restriction on the family's ability to liquidate is disregarded and the amount of D's gross estate is increased by reason of the lapse of D's liquidation right.

Example (7). D owns all the stock of Corporation X, consisting of 100 shares of non-voting preferred stock and 100 shares of voting common stock. Under the by-laws, X can only be liquidated with the consent of at least 80 percent of the voting shares. More than three years before D's death, D transfers 30 shares of common stock to ~~D's~~D's child. The transfer is not a lapse of a liquidation right with respect to the common

stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. The transfer is not a lapse of a liquidation right with respect to the retained preferred stock because the preferred stock is not subordinate to the transferred common stock. However, had the transfer occurred within three years of

D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death.

Example (8). D owns all of the single class of stock of Corporation Y. D recapitalizes Y, exchanging D's common stock for voting common stock and non-voting, non-cumulative preferred stock. The preferred stock carries a right to put the stock for its par value at any time during the next 10 years. D transfers the common stock to D's grandchild in a transfer subject to section 2701. In determining the amount of D's gift under section 2701, D's retained put right is valued at zero. D's child, C, owns the preferred stock when the put right lapses. Section 2704(a) applies to the lapse, without regard to the application of section 2701, because the put right was not valued under section 2701 in the hands of C.

Example (9). A and A's two children are equal general and limited partners in Partnership Y. Under the partnership agreement, each general partner has a right to liquidate the partnership at any time. Under State law that would apply in the absence of contrary provisions in the partnership agreement, the death or incompetency of a general partner terminates the partnership. However, the partnership agreement provides that the partnership does not terminate on the incompetence or death of a general partner, but that an incompetent partner cannot exercise rights as a general partner during any period of incompetency. A partner's full rights as general partner are restored if the partner regains competency. A becomes incompetent. The lapse of A's voting right on becoming incompetent is not subject to section 2704(a) because it may be restored to A in the future. However, if A dies while incompetent, a lapse subject to section 2704(a) is deemed to occur at that time because the lapsed right cannot thereafter be restored to A.

§ 25.2704-2. Transfers subject to applicable restrictions.

Effective: January 28, 1992.

(a) In general. ~~If~~ For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), if an interest in a corporation or a partnership (an "entity")), whether domestic or foreign, is transferred to or for the benefit of a member of the ~~transferor's~~transferor's family, ~~any applicable restriction is disregarded in valuing the transferred interest. This section applies only if~~ and the transferor and/or members of the ~~transferor's~~transferor's family control the entity immediately before the transfer. ~~For the definition of control, see §25.2701-2(b)(5). For the definition~~, any applicable restriction is disregarded in valuing the transferred interest. For purposes of ~~member of the family, see §25.2702-2(a)(1).~~this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) Applicable restriction defined. ~~An--~~(1) In general. The term applicable restriction ~~is~~means a limitation on the ability to liquidate the entity ~~(~~, in whole or in part~~) that is more restrictive than the limitations that would apply under the State law generally applicable to~~ (as opposed to a particular holder's interest in the entity), if, after the ~~entity in~~transfer, that limitation either lapses or may be removed by the ~~absence of~~transferor, the ~~restriction~~transferor's estate, and/or any member of the transferor's family, either alone or collectively. See §25.2704-3 for restrictions on the ability to liquidate a particular holder's interest in the entity.

(2) Source of limitation. An applicable restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section.

(3) Lapse or removal of limitation. A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the ~~transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer. Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instruments of the entity. See § 25.2704-1(c)(1)(B) for a discussion of the term "State law."~~restriction may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. For purposes of determining whether the ability to remove the restriction is held by any member(s) of this group, members are treated as holding the interests attributed to them under the rules contained in §25.2701-6, in addition to interests held directly. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

(4) Exceptions. A restriction described in this paragraph (b)(4) is not an applicable restriction.

(i) Commercially reasonable restriction. An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the ~~entity's~~entity's trade or business operations, whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b~~) of the Internal Revenue Code,~~), provided that for purposes of this section the

term "fiduciary of a trust" as used in section 267(b) does not include a bank as defined in section 581 ~~of the Internal Revenue Code.~~ A that is publicly held.

(ii) Imposed by federal or state law. An applicable restriction does not include a restriction imposed or required to be imposed by ~~Federal or State law is not~~ federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

(iii) Certain rights under section 2703. An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction.

~~(c)~~(iv) Put right of each holder. Any restriction that otherwise would constitute an applicable restriction under this section will not be considered an applicable restriction if each holder of an interest in the entity has a put right as described in §25.2704-3(b)(6).

(c) Other definitions. For the definition of the term controlled entity, see §25.2701-2(b)(5). For the definition of the term member of the family, see §25.2702-2(a)(1).

(d) Attribution. An individual, the individual's estate, and members of the individual's family are treated as also holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

(e) Effect of disregarding an applicable restriction. If an applicable restriction is disregarded under this section, the fair market value of the transferred interest is ~~valued~~determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist ~~and as if the rights of the transferor are determined under the State law that would apply but for the restriction~~. For example, an applicable restriction with respect to preferred stock will be disregarded in determining the amount of a transfer of common stock under section 2701.

~~(d)~~(f) Certain transfers at death to multiple persons. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are not members of the decedent's family, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (e) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) Ex. 4 of §25.2704-3.

(g) Examples. The following examples illustrate the provisions of this section:

Example (1). D owns a 76 percent interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. On D's death, D's partnership interest passes to D's child, C. The requirement that all the

partners consent to liquidation is an applicable restriction. Because A, B and C (all members of D's family), acting together after the transfer, can remove the restriction on liquidation, D's interest is valued without regard to the restriction; i.e., as though D's interest is sufficient to liquidate the partnership.

Example (2). D owns all the preferred stock in Corporation X. The preferred stock carries a right to liquidate X that cannot be exercised until 1999. D's children, A and B, own all the common stock of X. The common stock is the only voting stock. In 1994, D transfers the preferred stock to D's child, A. The restriction on D's right to liquidate is an applicable restriction that is disregarded. Therefore, the preferred stock is valued as though the right to liquidate were presently exercisable.

Example (3). D owns 60 percent of the stock of Corporation X. The corporate by-laws provide that the corporation cannot be liquidated for 10 years after which time liquidation requires approval by 60 percent of the voting interests. In the absence of the provision in the by-laws, State law would require approval by 80 percent of the voting interests to liquidate X. D transfers the stock to a trust for the benefit of D's child, A, during the 10-year period. The 10-year restriction is an applicable restriction and is disregarded. Therefore, the value of the stock is determined as if the transferred block could currently liquidate X.

Example (4). D and D's children, A and B, are partners in Limited Partnership Y. Each has a 3.33 percent general partnership interest and a 30 percent limited partnership interest. Any general partner has the right to liquidate the partnership at any time. As part of a loan agreement with a lender who is related to D, each of the partners agree that the partnership may not be liquidated without the lender's consent while any portion of the loan remains outstanding. During the term of the loan agreement, D transfers one- half of both D's partnership interests to each of A and B. Because the lender is a related party, the requirement that the lender consent to liquidation is an applicable restriction and the transfers of D's interests are valued as if such consent were not required.

Example (5). D owns 60 percent of the preferred and 70 percent of the common stock in Corporation X. The remaining stock is owned by individuals unrelated to D. The preferred stock carries a ~~put~~ right to liquidate X that cannot be exercised until 1999. In 1995, D transfers the common stock to D's child in a transfer that is subject to section 2701. The restriction on D's right to liquidate is an applicable restriction that is disregarded in determining the amount of the gift under section 2701.

§ 25.2704-~~2.~~3 Transfers subject to ~~applicable~~disregarded restrictions.

~~Effective: January 28, 1992.~~

(a) *In general.* For purposes of subtitle B (relating to estate, gift~~,~~ and generation-skipping transfer taxes), and notwithstanding any provision of §25.2704-2, if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any ~~applicable~~ restriction described in paragraph (b) of this section is disregarded ~~in valuing~~, and the transferred interest~~.~~ is valued as provided in paragraph (f) of this section. For purposes of this section, a corporation is any business entity described in §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of §301.7701-2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) ~~Applicable restriction~~ *Disregarded restrictions defined.*~~—~~(1) In general. The term ~~applicable~~disregarded restriction means a restriction that is a limitation on the ability to redeem or liquidate ~~the entity~~an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) this section, if the restriction, in whole or in part ~~(as opposed to a particular holder's interest in the entity), if,~~ either lapses after the transfer~~, that limitation either lapses~~ or ~~may~~can be removed by the transferor ~~, the transferor's estate, and/~~or any member of the transferor's family~~,~~ (subject to paragraph (b)(4) of this section), either alone or collectively. ~~See §25.2704-3 for restrictions on the~~

(i) The provision limits or permits the limitation of the ability of the holder of the interest to ~~liquidate~~compel liquidation or redemption of the interest.

(ii) The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a ~~particular~~minimum value. The term minimum value means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate. For example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of §20.2031-2(f)(2) or §20.2031-3 of this chapter apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or §25.2512-3 apply in the case of an inter vivos transfer. The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. For this purpose, the interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. If the property held by the entity directly or indirectly includes an interest in another entity, and if a transfer of an interest in that other entity by the same transferor (had that transferor owned the interest directly) would be subject to section 2704(b), then the entity will be treated as owning a share of the property held by the other entity, determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder.

(iii) The provision defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder's intent to have the holder's interest ~~in the entity~~liquidated or redeemed.

(iv) The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property. Solely for this purpose, except as provided in the following sentence, a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity, is deemed not to be property. In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of

the non- passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See §25.2512-8. For purposes of this paragraph (b)(1)(iv), a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in section 267(b), provided that for this purpose the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(2) Source of limitation. ~~An applicable~~A disregarded restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, ~~that~~which governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(~~4)(ii~~5)(iii) of this section.

(3) Lapse or removal of limitation. A restriction is ~~an applicable~~a disregarded restriction only to the extent that ~~either~~ the restriction either will lapse by its terms ~~will lapse~~ at any time after the transfer~~,~~ or ~~the restriction~~ may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. For purposes of determining whether the ability to remove the restriction is held by any ~~member(s)~~ one or more members of this group, members are treated as holding ~~the~~ interests attributed to them under the rules contained in §25.2701-6, in addition to interests held directly. See also paragraph (b)(4) of this section. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

~~(4) Exceptions. A restriction described in this paragraph (b)(4) is not an applicable restriction.~~

~~(i)~~ (4) Certain interests held by nonfamily members disregarded--(i) In general. In the case of a transfer to or for the benefit of a member of the transferor's family, for purposes of determining whether the transferor (or the transferor's estate) or any member of the transferor's family, either alone or collectively, may remove a restriction within the meaning of this paragraph (b), an interest held by a person other than a member of the transferor's family (a nonfamily-member interest) is disregarded unless all of the following are satisfied:

(A) The interest has been held by the nonfamily member for at least three years immediately before the transfer;

(B) On the date of the transfer, in the case of a corporation, the interest constitutes at least 10 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of §301.7701-2(a) of this chapter other than a corporation, the interest constitutes at least a 10-percent interest in the business entity, for example, a 10-percent interest in the capital and profits of a partnership;

(C) On the date of the transfer, in the case of a corporation, the total of the equity interests in the corporation held by shareholders who are not members of the transferor's family constitutes at least 20 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of §301.7701-2(a) of this chapter other than a corporation, the total interests in the entity held by owners who are not members of the transferor's family is at least 20 percent of all the interests in the entity, for example, a 20-percent interest in the capital and profits of a partnership; and

(D) Each nonfamily member, as owner, has a put right as described in paragraph (b)(6) of this section.

(ii) Effect of disregarding a nonfamily-member interest. If a nonfamily-member interest is disregarded under this section, the rules of this section are applied as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.

(iii) Attribution. In applying the 10-percent and 20-percent tests when the property held by the corporation or other business entity is, in whole or in part, an interest in another entity, the attribution rules of paragraph (d) of this section apply both in determining the interest held by a nonfamily member, and in measuring the interests owned through other entities.

(5) Exceptions. A restriction described in this paragraph (b)(5) is not a disregarded restriction.

(i) Applicable restriction. A disregarded restriction does not include an applicable restriction on the liquidation of the entity as defined in and governed by §25.2704-2.

(ii) Commercially reasonable restriction. ~~An applicable~~A disregarded restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations~~,~~ whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term fiduciary of a trust as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(ii) ~~Imposed by~~iii) Requirement of federal or state law. ~~An applicable~~A disregarded restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is ~~an applicable~~a disregarded restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in §25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

(iii) ~~iv)~~ Certain rights ~~under~~described in section 2703. An option, right to use property, or agreement that is subject to section 2703 is not ~~an applicable~~a restriction~~.~~ for purposes of this paragraph (b).

(iv) ~~Put right of each holder.~~v) Right to put interest to entity. Any restriction that otherwise would constitute ~~an applicable~~ a disregarded restriction under this section will not be considered ~~an applicable~~a disregarded restriction if each holder of an interest in the entity has a put right as described in ~~§25.2704-3~~paragraph (b)(6)~~.~~) of this section.

(6) Put right. The term put right means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash

and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs liquidation or redemption rights with regard to interests in the entity. For purposes of this paragraph (b)(6), the term other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), the term other property does include a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See §25.2512-8. The minimum value of the interest is the interest's share of the net value of the entity, as defined in paragraph (b)(1)(ii) of this section.

(c) *Other definitions.* For the definition of the term controlled entity, see §25.2701-2(b)(5). For the definition of the term member of the family, see §25.2702-2(a)(1).

(d) *Attribution.* An individual, the individual's estate, and members of the individual's family, as well as any other person, also are treated as ~~also~~ holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6.

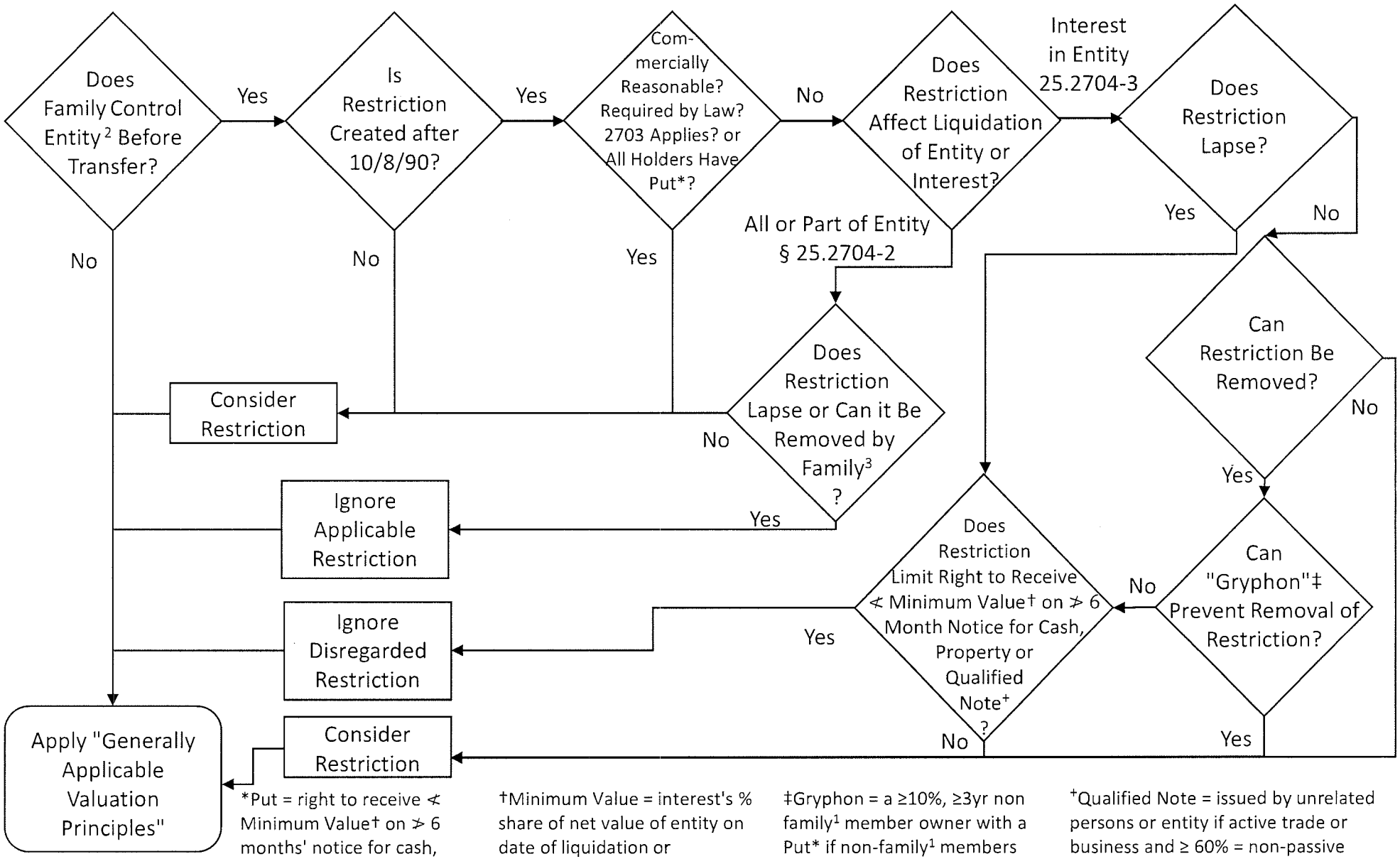
~~(e) Effect of disregarding an applicable restriction. If an applicable restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist. For example, an applicable restriction with respect to preferred stock will be disregarded in determining the amount of a transfer of common stock under section 2701.~~

~~(f)~~ (e) *Certain transfers at death to multiple persons.* Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are ~~not~~nonfamily members of the ~~decedent's family~~decedent, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (~~e~~f) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) ~~Ex.~~Example 4 of ~~§25.2704-3~~this section.

(f) *Effect of disregarding a restriction.* If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.

(g) *Examples.* The following examples illustrate the provisions of this section~~:~~.

Decision Tree for Sections 25.2704-2 and 25.2704-3 Proposed Regulations
Transfers of Interests to Family Members[1]



*Put = right to receive ≮ Minimum Value† on ≯ 6 months' notice for cash, property or Qualified Note+

†Minimum Value = interest's % share of net value of entity on date of liquidation or redemption

‡Gryphon = a ≥10%, ≥3yr non family[1] member owner with a Put* if non-family[1] members own ≥20% of business

+Qualified Note = issued by unrelated persons or entity if active trade or business and ≥ 60% = non-passive assets; adequately secured, periodic payments, market interest, FMV = liquidation proceeds

[1] Family Member = transferor/spouse, ancestor/descendant of transferor or spouse, sibling of transferor, or spouse of foregoing

[2] Controlled Entity = control by Family Members *and/or* descendants of parent of transferor or transferor's spouse

[3] Includes Family Members[1] and transferor's estate

Bloethe Tax School

Presented by the ISBA Tax Section

Track 2

FRIDAY, DECEMBER 9
Downtown Des Moines Marriott
Des Moines, Iowa

Bloethe Tax School

C to S Corporations

Track Two
8:45 a.m.-9:45 a.m.

Presented by
David Bibler
Buchanan, Bibler, Gabor & Meis
111 N. Dodge Street
P.O. Box 617
Algona, IA 50511
Phone: 515-295-3565

FRIDAY, DECEMBER 9, 2016

2016
Bloethe Tax School

"C" TO "S" CORPORATE CONVERSIONS – CORPORATE TAX ISSUES

Prepared by: A. David Bibler
Buchanan, Bibler, Gabor & Meis
111 North Dodge Street
Algona, Iowa 50511
Ph.: (515) 295-3565
Fax: (515) 295-2158
E-mail: adb@buchlaw.com
www.northiowalaw.com

CONVERSION FROM "C" CORPORATION TO "S" CORPORATION (FARM EXAMPLE)

FACTS: Your clients are the majority shareholders of a cash basis "C" corporation (current retained earnings = $236,000) who have reached retirement age. They have no on-farm heirs to take over the farming operation and anticipate the corporation, which includes low basis farmland, will be liquidated at their deaths. Following retirement, they wish to rent all corporate farmland on a cash rental basis to simplify their involvement.

According to their current wills, at the death of the first spouse, a portion of the corporate stock will transfer to a by-pass trust which will meet qualified subchapter "S" trust (QSST) eligibility. The trust provides for the remainder of trust assets to pass equally to your clients children upon the death of the surviving spouse.

The following is intended to provide some insight into the various tax related problems involved with a conversion from a "C" corporation to a "S" corporation, followed by liquidation of the corporation or passage of the assets to family members, considering the above fact pattern. It is not intended to be a complete recitation of tax law. Alternative courses of action are discussed which could provide significant tax savings; however, the unwinding of a "C" corporation is usually complicated, time-consuming and fraught with pitfalls for the unwary.

PROBLEM -- EVENTUAL LIQUIDATION OF CORPORATION/BUILT-IN GAINS (IRC §1374)

The 1986 Tax Reform Act substantially changed corporate tax law in the area of corporate liquidations. Generally, the liquidation of a "C" corporation will result in double taxation (corporate and shareholder level) as a result of appreciation in value of corporate assets from the inception of the corporation through the date of liquidation.

RECOMMENDATION -- "S" CORPORATION ELECTION (BUILT-IN GAIN RULE): The corporation should consider electing "S" corporate status (if less than 100 shareholders) in an attempt to lock in and limit the total amount of gain that would be realized upon a corporate liquidation. The election of "S" corporate status will freeze the corporate built-in gain at a level that will not exceed the difference between the cost basis in the farm real estate/improvements and the fair market value as of the effective date of the "S" election. **Following this election, the corporation and shareholders could avoid double taxation (corporate and shareholder level) on any additional appreciation in the fair market value of farm real estate/improvements. As an additional benefit, if the corporation continued its corporate existence for a period of five (5) years following the "S" corporate election, the corporation and its shareholders could avoid double taxation (corporate and shareholder levels) on the appreciation in value of farm real estate/improvements arising under the built-in gain rule.**

CAUTION - BUILT-IN GAIN ON LIQUIDATION OF GRAIN/EQUIPMENT: Built-in gain will be created if the corporation has zero basis grain and/or farm equipment and machinery on hand at the time of the conversion from "C" corporate status to "S" corporate status because these assets will be, or are likely to be, liquidated within the 5-year built-in-gain recognition period. Consider liquidating grain inventories and any farm equipment/machinery likely to be sold within the next 5 years prior to a conversion. Otherwise, the corporation may incur gain at the highest corporate rate (currently 35%) when these assets are sold.

APPRAISAL OF ASSETS TO DETERMINE NET UNREALIZED BUILT-IN GAIN AT DATE OF "S" CORPORATION CONVERSION: Following an "S" election, the corporation and its shareholders bear the burden of determining what appreciation in fair market

value occurred on subject assets. An appraisal of all corporate assets (farm real estate/improvements, etc.) should be **completed at the "S" corporation conversion date** so that measurement issues with IRS will be avoided if assets are liquidated during the 5-year built-in gain recognition period.

NOTE – TIMING OF CONVERSION: For farm corporations, it is usually best to consider an "S" corporation election after harvest and before planting to avoid any growing crop issues. However, growing crops which will ultimately be sold as inventory during the 5-year recognition period should not constitute separate assets on the conversion date; and, thus, should not be subject to the IRC §1374 built-in gain rules. See: Rev. Rul. 2001-50 (which dealt with timber, coal & iron ore sales during the built-in gain recognition period).

PERMANENT 5-YEAR RECOGNITION PERIOD: The PATH Act of 2015 permanently changed the built-in gain recognition period from 10 years to 5 years. Thus, for tax years beginning in 2015, and for assets held by the "S" corporation as of the beginning of its first tax year, **the recognition period is now the 5-year period beginning with the first day of the first tax year for which the corporation was an "S" corporation.** IRC §1374(d)(7). See discussion regarding prior temporary reductions in the original 10-year built-in gain recognition period below.

TAXATION OF BUILT-IN GAINS: A corporate level tax is imposed by IRC §1374 on any net recognized built-in gain occurring in any taxable year during the 5-year recognition period. The built-in gain tax is **in addition to regular taxation** that would occur upon sale of the asset. As denoted above, the tax is equal to the highest corporate rate (currently 35%).

The built-in gains tax applies to any asset carried over from "C" corporate status that is disposed of within the 5-year recognition period. The built-in gain for each asset liquidated is limited to its net unrealized gain (FMV - adjusted tax basis) as measured on the date on which the "S" election takes effect. Any built-in gains tax liability is treated as a reduction in the "S" corporation's taxable income for the year of recognition. IRC §1366(f)(2) & IRC Reg. §1.1366-4(b).

EXAMPLE: Assume that zero basis grain on hand (FMV $200,000) was not liquidated prior to electing a change to "S" corporate status. Upon sale of the grain, the "S" corporation will be required to pay built-in gains tax of $70,000 ($200,000 x 35%). The shareholders will then pay federal and state income taxes on the remaining $130,000 of sale price ($200,000 - $70,000 built-in gains tax). If one assumes a shareholder level federal marginal tax rate of 25% and state marginal tax rate of 8%, the combined tax rate pertaining to the liquidation of the corporation's grain is **56.45%** ($112,900 of the $200,000 sale price).

AUTHOR'S NOTE: For a discussion of Form 1120S reporting requirements involving built-in gains taxation, see 1999 Farm Income Tax School's (pgs. 272-288) Board of Trustees of the University of Illinois (Nov., 1999).

NOTE – NOL AND/OR CAPITAL LOSS CARRYOVERS: Recognized built-in gains may be offset by "C" corporate NOL carryovers or capital loss carryovers which had not been used at the date of "S" corporate conversion subject to normal carryover timeframe limitations (i.e. current 20-year carryover for NOLs). IRC §1374(b)(2).

NOTE - SPECIAL RULE (INSTALLMENT SALES): Generally, if an "S" corporation sells built-in gains property within the recognition period and the sale qualifies for the installment method, **the recognition period for that sale continues until the last installment is collected**, even if the collection period extends beyond the corporation's normal 5-year recognition period. IRC Reg. §1.1374-10(b)(4).

TAX PLANNING NOTE: A 2016 installment sale of all remaining "S" corporation assets subject to the built-in gain tax avoids built-in gain taxation for "S" corporate elections effective January 1, 2011 or prior, even for those installment payments deferred to later tax years. The 5-year recognition period would have expired 12/31/15.

ALTERNATIVES TO SALE OF ASSETS WITHIN THE 10-YEAR BUILT-IN GAIN RECOGNITION PERIOD: If shareholders must liquidate some or all of the corporation's property within the 5-year recognition period, the following avoidance alternatives should be considered:

(1) **Sale of corporate stock in lieu of liquidation of assets:** A sale of corporate stock in lieu of liquidation of assets will **not** trigger the built-in gains tax. However, the assets of the corporation would continue to be subject to built-in gains taxation rules for the remainder of the 5-year recognition period and the new purchaser of the stock would be responsible for any built-in gains taxation.

NOTE: A buyer of corporate stock subject to a built-in gains recognition period will likely require a significant discount from fair market value in negotiating the purchase price of the stock.

(2) **Like-kind exchange of property to avoid triggering built-in gain upon liquidation:** Property acquired in a like-kind exchange whose basis is determined, in whole or in part, by reference to the basis of an asset that was held by a "C" corporation when it became an "S" corporation is treated as being held by the corporation at the time of conversion. IRC §1374(d)(6). Thus, assets subject to the 5-year built-in gain recognition rule can be exchanged for similar "like-kind" assets without triggering the built-in gain tax (e.g. farm real estate exchanged for apartment building or other urban rental real estate; farm equipment exchanged for like-kind farm equipment; etc.). The exchanged asset will continue to be subject to built-in gains taxation for the remainder of the 5-year recognition period.

(3) **Long-term lease of assets to avoid triggering built-in gain tax on liquidation:** Shareholders may be able to enter into a long-term lease of corporate assets with an option to the buyer for purchase of the assets subsequent to the expiration of the 5-year built-in gain recognition period. If this alternative is being considered, care should be taken in drafting the lease agreement so that it does not constitute a sale for federal income tax purposes and to avoid exposure to various passive income tax problems discussed below.

ALTERNATIVES TO PAYMENT OF BUILT-IN GAINS TAX DURING THE 5-YEAR RECOGNITION PERIOD: Net recognized built-in gain for any taxable year is the **lowest** of the following three amounts:

(1) The total **remaining** net unrealized built-in gain resulting from the "S" corporate conversion;

(2) The amount of **recognized** built-in gain during the taxable year (pre-limitation amount); **and**

(3) The "S" corporate **taxable income for the tax year**.

Thus, if shareholders must liquidate some or all of the corporation's assets within the 5-year built-in gains recognition period, the corporation may still avoid payment of the built-in gains tax if the "S" corporation's taxable income can be reduced to $0 for the year of recognition and each subsequent remaining tax year during the 5-year recognition period. **The tax that would otherwise be paid on net recognized built-in gain is limited to the "S" corporation's taxable income.** IRC §1374(d)(2)(A)(ii).

If the "S" corporation has net recognized built-in gain during a taxable year, steps should be taken to attempt to reduce the "S" corporate taxable income to $0 to defer payment of the built-in gains tax (**e.g. deferral of income; salary**

increases or bonuses; accelerated expenses). Any net recognized built-in gain upon which tax is not paid during a taxable year will carry over to each subsequent taxable year during the 5-year recognition period. Thus, the net recognized built-in gains tax will be paid in a subsequent year unless "S" corporate taxable income can also be lowered to $0 for those tax years. If an "S" corporation's taxable income can be reduced to $0 for each taxable year during the 5-year recognition period, the built-in gains tax that would apply to recognized built-in gains carried over from prior taxable years will be eliminated forever.

EXCEPTION: See discussion for recognized built-in gains under installment sales discussed above.

Once the net recognized built-in gain has been established for a taxable year and the built-in gain tax has been computed, there is a limited ability to offset the tax with any business credit carryforward and/or alternative minimum tax credit that remains available and unused from a "C" corporate tax year. IRC 1374(b)(3). The "S" corporation must observe any limitations (e.g. carryover limitations, etc.) that apply to these two credits. No other credit is available to offset the built-in gains tax (except gas tax credits – Form 4136) for the "S" corporate year. All other credits pass through to "S" corporate shareholders.

▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶

NOTE – PRIOR YEAR TEMPORARY REDUCTIONS OF THE 10-YEAR BUILT-IN GAINS TAX RECOGNITION PERIOD – (7 YEARS – 2009/2010) – (5 YEARS – 2011-2014): The American Recovery and Reinvestment Act of 2009 temporarily shortened the original 10-year recognition period for built-in gains to 7 years for tax years beginning in 2009 or 2010 (**calendar or fiscal**). The Small Business Jobs Act of 2010 further shortened the original 10-year recognition period (on a temporary basis) to 5 years **for tax years beginning in 2011 (calendar or fiscal)**. Subsequent extender bill legislation extended the 5-year recognition period (on a temporary basis) **for tax years beginning in 2012-2014 (calendar or fiscal), until the PATH Act of 2015 permanently changed the built-in gain recognition period to 5 years for tax years beginning in 2015**. IRC §1374(d)(7).

Thus, for a tax year beginning in 2009 or 2010, no tax was imposed on an "S" corporation's net recognized built-in gain **if the completion of the 7th tax year in the 10-year recognition period preceded the beginning of the current tax year**. Similarly, for a tax year beginning in 2011-2014 no tax was imposed on a "S" corporation's net recognized built-in gain **if the completion of the 5th tax year in the 10-year recognition period preceded the beginning of the current tax year**.

For 2011-2014 these changes effectively terminated the built-in gains recognition period for any "C" to "S" corporate conversions that took place **prior to January 1, 2006**. Otherwise the provisions provided a window of opportunity for "C" corporations that converted to "S" corporate status during the 2006-2009 tax years. For these entities, during 2011-2014, if the 5th anniversary of the "C" to "S" corporate conversion date had been reached **prior to the beginning of the current tax year**, any sales of assets that would otherwise been subject to the built-in gains rules avoided built-in gains taxation for the year of sale. IRC §1374(d)(8).

EXAMPLE: ABC, Ltd., a calendar year taxpayer, elected to convert from a "C" corporation to an "S" corporation on **January 2, 2009**. Since the 5th anniversary of its 10-year recognition period would **not** have expired by the start of its 2014 calendar year, ABC, Ltd. would be subject to built-in gains taxation for any sale in 2014.

If the "C" to "S" corporate conversion had been made effective January 1, 2009, the 5th year of the corporation's recognition period **would have expired on December 31, 2013 and any 2014 sales would not be subject to built-in gains taxation**.

▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶▶

PROBLEM -- RETENTION OF "C" CORPORATION EARNINGS & PROFITS

(A) ACCUMULATED EARNINGS PENALTY (GREATER THAN $250,000 "C" CORPORATION EARNINGS & PROFITS): A corporation may be liable for an accumulated earnings penalty tax if the IRS determines that the corporation is preventing the imposition of income tax upon shareholders by permitting old profits to accumulate instead of being distributed. IRC §532. Prior to 2003, the penalty tax imposed on improper accumulations was 38.6% of "accumulated taxable income" (the highest federal individual tax rate imposed). Effective for tax years beginning after 2002 through December 31, 2012, the accumulated earnings penalty tax rate was reduced to 15% of "accumulated taxable income". This reduction was due to the maximum tax rate for qualified dividends being reduced to 15% under the 2003 Tax Act. **Since the maximum tax rate for qualified dividends was increased to 20% for tax years beginning after December 31, 2012 by the American Taxpayer Relief Act of 2012 (ATRA), the accumulated earnings penalty tax rate has also been increased to 20% for tax years beginning after December 31, 2012.**

NOTE: An underpayment of accumulated earnings tax may be subject to negligence penalties. Rev. Rul. 75-330. Interest would be imposed on an accumulated earnings tax underpayment from the due date of the corporation's tax return, determined without regard to extensions. IRC §6601(b)(4).

ACCUMULATED EARNINGS CREDIT: A minimum amount of accumulated earnings and profits **($250,000 ($150,000 for personal service corporations))** is allowable before a corporation can be subject to the accumulated earnings tax penalty. IRC §535(c).

If a corporation's accumulated earnings and profits exceed $250,000, care should be taken in drafting annual minutes for the corporation to specify the various corporate business purposes for which earnings are being retained and not paid out as dividends. A corporation may retain earnings and profits for repayment of debt (non-shareholder loans), expansion of business (purchase of additional farm real estate, grain storage facilities), working capital needs, etc.). IRC Reg. §1.537-1(b)(1) states that the corporation must have **specific, definite and feasible plans** for the use of accumulated earnings and profits.

> **EXAMPLE MINUTES:** A discussion followed as to whether it would be appropriate for the corporation to consider declaring a cash dividend to the shareholders at this time. The President stated that it would not be wise for the Board of Directors to declare a dividend at this time as the corporation anticipated acquiring an additional 80 acres of farm real estate in the near future and the majority of available cash proceeds would be needed for this acquisition.

While the corporation in our example does not have accumulated earnings and profits in excess of the $250,000 threshold, the retention of earnings and profits may cause havoc if the corporation has significant passive income, as discussed below.

(B) PASSIVE INCOME/RETENTION OF "S" CORPORATE STATUS: An "S" corporation that has previously been a "C" corporation **and** has "C" corporate earnings and profits is only eligible to retain "S" corporate status for **three years** if more than 25% of its gross receipts are from passive sources (**cash rent**, interest, etc.). IRC §1362(d)(3). If the corporation were to rent all farmland it owned under a cash rental arrangement, virtually 100% of corporate income would be derived from "passive" income sources. The corporation would be in danger of losing its "S" corporate status (reverts back to a "C" corporation again) immediately at the **end of the third taxable year** in which this condition existed following the "S" corporate election.

(C) PASSIVE NET INCOME/FEDERAL "STING" TAX: Even though the corporation could utilize a cash rental lease arrangement for a limited time after making an "S" election and avoid losing its "S" status, **a "sting" tax (35% rate) is imposed on any "excess net" passive income in the meantime if the corporation has "C" corporate earnings and profits at the end of the taxable year and greater than 25% of its gross receipts are from passive income.** IRC §1375. Since the corporation in our example currently has "C" corporate earnings and profits, if the shareholders wish to cash rent corporate farmland after the "S" election is made, they can only avoid the "sting" tax in one of the following ways:

(1) **Avoid reporting any "excess net" passive income.** This can be accomplished only if the corporation is able to **prepay sufficient farm expenses** to offset all passive investment income (as defined by IRC §1362(d)(3)(C)) **and/or** create negative "net" passive income.

(2) **Distribute all accumulated "C" corporate earnings and profits to shareholders prior to the end of the first "S" corporate year-end.** IRC §1375(a)(1). **NOTE: Tax rate on qualified dividends is 0%/15%/20% for tax years beginning after 12-31-12.** In order to make a distribution of accumulated "C" corporation earnings and profits, the "S" corporation, with the consent of all of its shareholders, must elect under IRC §1368(e)(3) to treat these distributions as taxable dividends to the corporation's shareholders.

DEEMED DIVIDEND ELECTION: If the corporation did **not** have sufficient cash to pay out the entire accumulated "C" corporation earnings and profits, the corporation may make a deemed dividend election under IRC Reg. §1.1368-1(f)(3). Under this election, the corporation can be treated as having distributed all of its accumulated "C" corporate earnings and profits to the shareholders as of the **last day of its taxable year**. The shareholders, in turn, are deemed to have contributed the amount back to the corporation **in a manner that increases stock basis**. With the increased stock basis, the shareholders will be able to extract these proceeds in future years without additional taxation, as "S" corporate cash flow permits. **NOTE: The consent of all affected shareholders is also required to make this election.**

The election for a deemed dividend is made by attaching an election statement to the "S" corporation's **timely filed original or amended** Form 1120S. The election must state that the corporation is electing to make a deemed dividend under Reg. §1.1368-1(f)(3). Each shareholder who is deemed to receive a distribution during the tax year must consent to the election. Furthermore, the election must include the amount of the deemed dividend that is distributed to each shareholder. IRC Reg. §1.1368-1(f)(5). **See election forms following**.

DISCUSSION NOTE: "S" corporation distributions are normally taxed to the shareholders as an ordinary income dividends to the extent of accumulated earnings and profits (AE&P) after the accumulated adjustments account (AAA) and previously taxed income (PTI -- pre-1983 "S" corporation undistributed earnings) have been distributed. **Deemed dividends issued proportionately to all shareholders are not subject to one-class-of-stock issues and do not require payments of principal or interest.**

NAME(S):	TIN:

DIVIDEND ELECTION -- ELECTION TO TREAT CURRENT TAX YEAR DISTRIBUTIONS AS BEING FROM ACCUMULATED "C" CORPORATION RETAINED EARNINGS PURSUANT TO IRC §1368(e)(3) AND REG. §1.1368-1(f)(2)(i)

The corporation hereby elects under IRC §1368(e)(3) and Reg. §1.1368-1(f)(2)(i) to treat **all** current tax year distributions as being from accumulated "C" corporation retained earnings and not from the accumulated adjustments account (AAA) of the corporation. It is understood that this election is irrevocable when made and is only effective for the current tax year.

CONSENT OF AFFECTED SHAREHOLDERS

The undersigned shareholders comprise all of the shareholders of the above corporation to whom a distribution was made during the current taxable year. The undersigned hereby consent to the corporation election under IRC §1368(e)(3) and Reg. §1.1368-1(f)(2)(i) to treat all current tax year distributions as being from accumulated "C" corporation retained earnings and not from the accumulated adjustments account (AAA) of the corporation.

The undersigned hereby certify, under penalties of perjury, that to the best of their knowledge and belief the statements contained herein are true and correct.

SIGNATURE	ADDRESS	SSN
_____	_____ _____ _____	_____
_____	_____ _____ _____	_____
_____	_____ _____ _____	_____
_____	_____ _____ _____	_____
_____	_____ _____ _____	_____
_____	_____ _____ _____	_____

NOTE: "S" corporation distributions are normally taxed to the shareholders as an ordinary income dividends to the extent of accumulated earnings and profits (AE&P) after the accumulated adjustments account (AAA) and previously taxed income (PTI -- pre-1983 "S" corporation undistributed earnings) have been distributed. **If the corporation became a "S" corporation prior to 1983, a separate election will need to be made to avoid having the distributions herein treated as first coming from previously taxed income (PTI) to the extent thereof.**

FILING: **File with original Form 1120S for the year during which distributions were made.**

(Revised 11/16)

NAME(S):	TIN:

DEEMED DIVIDEND ELECTION -- ELECTION TO TREAT PART OR ALL OF ACCUMULATED "C" CORPORATION RETAINED EARNINGS AS DISTRIBUTED DURING THE CURRENT TAX YEAR PURSUANT TO IRC §1368(e)(3) AND REG. §1.1368-1(f)(3)

The corporation hereby elects under IRC §1368(e)(3) and Reg. §1.1368-1(f)(3) to treat part or all of accumulated "C" corporation retained earnings as deemed distributed during the current tax year. It is understood that under this election the deemed dividend is considered to have been distributed in cash to the shareholders, in proportion to their stock ownership, on the last day of the tax year. Upon receipt, the shareholders are deemed to have immediately contributed the cash back to the corporation in a manner that increases stock basis. It is understood that this election is irrevocable when made.

CONSENT OF AFFECTED SHAREHOLDERS

The undersigned shareholders comprise all of the shareholders of the above corporation to whom a distribution was deemed made during the current taxable year. The undersigned hereby consent to the corporation election under IRC §1368(e)(3) and Reg. §1.1368-1(f)(3) to treat part or all of accumulated "C" corporation retained earnings as deemed distributed during the current tax year.

The undersigned hereby certify, under penalties of perjury, that to the best of their knowledge and belief the statements contained herein are true and correct.

SIGNATURE	ADDRESS	SSN	DIVIDEND AMOUNT
_____	_____ _____	_____	_____
_____	_____ _____	_____	_____
_____	_____ _____	_____	_____
_____	_____ _____	_____	_____
_____	_____ _____	_____	_____
_____	_____ _____	_____	_____
_____	_____ _____	_____	_____

NOTE: "S" corporation distributions are normally taxed to the shareholders as an ordinary income dividends to the extent of accumulated earnings and profits (AE&P) after the accumulated adjustments account (AAA) and previously taxed income (PTI -- pre-1983 "S" corporation undistributed earnings) have been distributed. **If the corporation became a "S" corporation prior to 1983, a separate election will need to be made to avoid having the distributions herein treated as first coming from previously taxed income (PTI) to the extent thereof.**

FILING: **File with original Form 1120S for the year during which distributions were made.**

(Revised 11/16)

RETENTION OF "C" CORPORATION EARNINGS & PROFITS
(TAX PLANNING ALTERNATIVES)

ALTERNATIVE RECOMMENDATION -- CROP SHARE LEASE: Internal Revenue Code regulations provide that rents will not constitute passive investment income if the "S" corporation **provides significant services or incurs substantial costs in conjunction with rental activities.** Whether significant services are performed or substantial costs are incurred is a **facts and circumstances determination**. IRC Reg. §1.1362-2(c)(5)(ii)(B)(2). The significant services test can be met by entering into a lease format (generally crop-share) that requires **significant management involvement** by the corporate officers with regard to crop production decision-making (e.g. what/where to plant and timing thereof, tillage methods, type of seed, fall fertilization practices, chemical application, etc.).

NET-CROP SHARE LEASE: The corporation may wish to consider entering into a "net" crop share lease (while retaining significant management decision-making authority) upon making the "S" corporate election, as an alternative to a cash rent lease or a 50/50 crop share lease. Some form of bonus bushel clause is usually added to a "net" crop share lease in case a bumper crop is experienced or high crop sale prices result within a particular crop year. "Net" crop leases in the Midwest, for example, normally provide the landlord with approximately 30% to 33% of the corn and 38% to 40% of the beans grown on the subject real estate.

Since crop share income is generally **not** considered "passive" (if the significant management involvement test can be met), a "net" crop share lease should allow the corporation to limit involvement in the farming operation and avoid passive investment income traps unless the corporation has significant passive investment income from other sources (interest, dividends, etc.) such that passive investment income still exceeds 25% of gross receipts.

NOTE -- "C" CORPORATION EARNINGS AND PROFITS: Corporate shareholders will always have to deal with the problem of income tax liability that will be incurred upon the distribution of "C" corporate earnings and profits unless the corporation is liquidated. Generally, distributions of "C" corporate earnings and profits should occur when income taxation to the shareholders can be minimized.

For 2013 and after, high income taxpayers experienced an increase in their effective tax rate for qualified dividends from 15% to 23.8%. A 20% tax rate now applies for qualified dividends if AGI is greater than $450,000 (MFJ), $400,000 (single), $425,000 (HOH) and $225,000 (MFS). In addition, the 3.8% Medicare surtax on net investment income (NIIT) applies to qualified dividends if AGI exceeds $250,000 (MFJ) and $200,000 (single/HOH). However, if accumulated "C" corporate earnings and profits can be distributed while minimizing shareholder tax rates (keeping total AGI below the net investment income tax (NIIT) thresholds and avoiding AMT) this may be a good time to make these distributions.

TAX PLANNING EXAMPLE: If total AGI can be maintained below the net investment income tax (NIIT) thresholds and below those levels where AMT taxation would apply, the highest effective federal tax rate for 2013 and after "C" corporate dividends would be 27.75% if all corporate net income had been previously taxed at a 15% federal rate (i.e. 15% -- corporate income tax rate + (85% x 15% -- dividend rate)= **27.75%** effective federal (double) tax rate to shareholders). At a 25% corporate income tax rate, the effective federal (double) tax rate to shareholders equals **36.25%** (25% + (75% x 15% -- dividend rate)).

CAUTION - TAXATION OF SOCIAL SECURITY BENEFITS: Be sure to give consideration to the effect distribution of these earnings and profits will have upon the taxability of social security benefits for older shareholders, etc.

TAX PLANNING - GIFTING: Gifts of stock to children or grandchildren could be considered so that dividends paid are taxed to those in lower tax brackets. However, tax benefits may be negated for children and grandchildren up to the age of 18-23 (for 2008 and after) if they receive sufficient dividends to cause the "kiddie" tax rules to be invoked.

IRC §303 STOCK REDEMPTIONS: A corporation may redeem a portion of the stock held by a deceased shareholder and treat such redemption as a capital gain redemption to the extent that **the amount of the redemption does not exceed the sum of estate taxes, inheritance taxes and the amount of administration expenses of the estate**. The capital gain reported is usually small or non-existent due to step-up in basis of a shareholder's stock at date of death.

NOTE: IRC §303 does **not** operate any differently with an "S" corporation than a "C" corporation.

POSSIBLE PROBLEM -- "S" CORPORATE STATUS BY QSST TRUST

Once "S" corporate status has been elected, this classification can only be retained by a corporation having appropriate shareholders. After the death of the first spouse, the portion of corporate stock held by a by-pass trust could **only qualify** as an acceptable "S" corporate shareholder if the Trust met the definition of a QSST trust (Qualified Subchapter "S" Trust), as follows:

(1) All of the trust's income be either distributed or required to be distributed currently to **only one beneficiary** who is a citizen or resident of the United States;

(2) During the life of the current income beneficiary, there can be only **one** income beneficiary;

(3) Corpus distributions during the current income beneficiary's life can only be made to that beneficiary;

(4) The current income beneficiary's income interest must terminate on the earliest of the current beneficiary's death, or the termination of the trust; **and**

(5) If the trust terminates during the current income beneficiary's life, the trust assets are all distributed to the current income beneficiary. IRC §1361(d)(3) & (4).

Since the Trust, in our example, does meet the definition of a QSST an appropriate "S" corporate election under IRC §1361(d)(2) should be made. **See election form following.**

TO: Internal Revenue Service
Ogden, Utah 84201-0013

RE: _____
TIN: _____

ELECTION TO TREAT QUALIFIED SUBCHAPTER S TRUST (QSST) AS AN ELIGIBLE SUBCHAPTER S SHAREHOLDER PURSUANT TO INTERNAL REVENUE CODE §1361(d)(2) AND REG. §1.1361-1(j)(6)

The undersigned hereby elects to have the _____ Trust treated as a Qualified Subchapter S Trust (QSST) for purposes of eligibility as a Subchapter S Shareholder pursuant to IRC §1361(c)(2). The undersigned also elects to be treated as the owner of the portion of said Trust that consists of the S corporation stock for purposes of IRC §678.

The undersigned states that the Trust meets the definition of a qualified subchapter S trust as the terms of the Trust provide that (1) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust; (2) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary; (3) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust; and (4) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary. The undersigned is a citizen and/or resident of the United States.

In addition, the undersigned states that (1) the Trust is required to distribute (or the Trustee agrees to distribute) all of its income currently to the current income beneficiary; and (2) that no distributions of income or corpus will be in satisfaction of the grantor's legal obligations to support and maintain the income beneficiary.

The taxpayer understands that this election, once made, shall be irrevocable.

CURRENT INCOME BENEFICIARY INFORMATION

NAME	ADDRESS	SSN

TRUST INFORMATION

NAME	ADDRESS	SSN

SUBCHAPTER S CORPORATE INFORMATION

NAME	ADDRESS	SSN

The effective date of this election is the ____ day of _____, 201___.

_____
(Current Income Beneficiary)

Note: This election may not be filed any earlier than 2 months and 15 days before the effective date of the "S" corporate election; and no later than 2 months and 16 days from the date the stock is transferred to the Trust. This election form is mailed to IRS by separate mail. For late elections, generally follow the procedures outlined in Rev. Proc. 2003-43 and/or Rev. Proc. 2007-62.

Note: This election shall be effective for each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election by filing such refusal with the Service Center with which the corporation files its income tax return pursuant to IRC Reg. §1.1361-1(j)(9).

(Revised 11/16)

ISSUE – WHEN TO LIQUIDATE THE "S" CORPORATION

If one ignores the "C" corporate earnings and profits issue, taxation **will generally be minimized** by waiting to liquidate until **the later of (1) the death of the shareholder(s); or (2) the expiration of the 5-year built-in gain rule**.

At death, a decedent's stock ownership interest generally receives a step-up in basis to fair market value. This basis adjustment coupled with the basis increase that results from gain recognition inside the corporation upon liquidation of corporate assets (e.g. sale/distribution of assets, real estate, etc.) and the pass-through of the taxation of this gain to the shareholder (on Schedule K-1), results in only one level of taxation being incurred on liquidation (shareholder level). Since stock basis has been increased by death and pass-through of income, **no actual realization of gain results when cash or property is distributed to the decedent's estate/heirs (in exchange for stock) to complete the liquidation**, since the pass-through gain (Schedule K-1) to the estate/heirs will be offset by a matching loss from liquidation of the stock.

CAUTION IRC §1239 – ORDINARY INCOME TREATMENT: IRC §1239 was enacted to put an end to the practice of selling or exchanging depreciable assets to a controlled corporation in order to establish a higher depreciation basis at the expense of the capital gain provisions. **Accordingly, IRC §1239 requires ordinary income treatment of any gain recognized from the sale or exchange of property, directly or indirectly, between related persons, if the property is of a character subject to depreciation in the hands of the transferee.**

NOTE: Property of a character subject to the allowance for depreciation includes amortization of IRC §197 intangibles. IRC §197(f)(7).

Related persons for purposes of IRC §1239 include the following:

- A person and all entities which are controlled entities with respect to such person (i.e. the individual directly or indirectly owns more than 50% of the value of the outstanding stock of the corporation);
- A taxpayer and any trust in which such taxpayer is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest; and
- Except in the case of a **sale or exchange** in satisfaction of a pecuniary bequest, **an executor of an estate and a beneficiary of such estate. For this purpose, related beneficiaries would include those individuals defined as related parties under IRC §267(c)(4).**

Under IRC §1239, when depreciable property is involved in a liquidation (tile, grain bins, farm buildings, etc.), a shareholder who is a related party to the liquidating corporation will realize ordinary income upon sale or exchange to the extent of any depreciation recapture.

TAX RESULT: If the assets of a corporation are being liquidated upon the death of a decedent (or at any other time when related parties are involved), ordinary income will be realized and recognized upon sale or exchange of certain depreciable property. This ordinary income will **not** be completely offset by a Schedule D capital loss recognized upon the liquidation of corporate stock.

NOTE: See example liquidation comparison computations for "C" and "S" corporations that follow this section when no depreciable property is involved.

▶ ▶

TAX PROBLEM -- Distributions of Property in Liquidation of Deceased Shareholder's "S" Corporation Stock When Corporation Had More Than One Shareholder:
Distributions of property (other than cash) are treated as though the corporation sold the property to the shareholder for its fair market value, pursuant to IRC §311(b). The corporation recognizes gain to the extent the property's fair

market value exceeds its adjusted basis. When appreciated property is distributed to an "S" corporate shareholder in exchange for stock, the gain recognized at the corporate level passes through to **all** shareholders (via Schedule K-1) based on their percentage ownership in the corporation.

If the "S" corporation **only** had **one shareholder** whose interest is liquidated at death, gain recognition does not cause taxation problems due to a matching loss offset resulting from the stock basis adjustments discussed above. However, if the "S" corporation has **more than one shareholder**, a distribution of property to a single shareholder (deceased or otherwise) in liquidation of their stock interest will result in a taxation event for **all** corporate shareholders.

> **EXAMPLE:** Assume Farm Corp. has four equal shareholders. Mary, a shareholder who owns 25% of the "S" corporation's stock dies. The corporation distributes farm real estate to Mary's estate in liquidation of her stock interest. Mary's estate would report 25% of any gain at distribution and would be able to offset this taxable gain through a matching capital loss created by the liquidation of her stock in Farm Corp. **Unfortunately, the other shareholders would be responsible for paying tax on the remaining 75% of any gain.**
>
> An alternative to avoid this taxation problem when there are multiple shareholders in an "S "corporation is to simply have the remaining shareholders purchase the stock of the deceased shareholder. Implementing a corporate **buy-sell agreement** among the shareholders might be advantageous to accomplish the desired result.

FURTHER TAX PROBLEM – NEW CAPITAL GAINS HOLDING PERIOD FOR PROPERTY DISTRIBUTED PURSUANT TO A STOCK REDEMPTION: A shareholder's income tax basis in property distributed to him or her by the corporation is the property's fair market value at the date of distribution. **Unfortunately, the distributee shareholder's holding period begins when the shareholder actually or constructively receives the property**, because the distribution is treated as if the property were sold to the shareholder at its fair market value on that date. Since the shareholder's basis in the property is its fair market value (rather than a carryover of the corporation's basis), the corporation's **holding period does not tack** on to the shareholder's holding period. Thus, the redeeming shareholder would need to hold distributed property for 12 months (1 year) after distribution prior to sale to achieve capital gain income tax treatment on a subsequent sale.

ALTERNATIVE TO LIQUIDATION – DIVISIVE REORGANIZATION: An alternative to liquidating the "S" corporation at the death of the surviving spouse is a divisive reorganization under IRC §355. In a divisive reorganization, part of the assets of a parent corporation are split-off to one or more (former) shareholders through a new corporation. A divisive reorganization typically involves three major steps:

(1) Formation of a new corporation (functions like a subsidiary);

(2) Transfer of part of the parent corporation's assets to the subsidiary (usually tax-free); **and**

(3) Distribution of the stock in the subsidiary to some of the parent corporation's shareholders in exchange for their stock in the parent corporation.

A divisive reorganization can be used to divide a single, functionally integrated business (e.g. farming operation) into two separate businesses and will allow surviving shareholders to postpone income recognition that would otherwise occur through corporate liquidation at the death of the first generation shareholders.

IRC Regs. §§1.355-1(b) & 1.355-3(c), Examples 4 & 5. See also, Rev. Rul. 75-160, 1975-1 CB 112; Coady v. Commissioner, 33 T.C. 771 (1960, acq., 1965-2 C.B. 4, nonacq., 1960-2 C.B. 8 (withdrawn), aff'd, 289 F.2d 490 (6th Cir. 1961); United States v. Marett, 325 F.2d 28 (5th Cir. 1963).

For a divisive reorganization to be tax-free, five tests under IRC §355 must be met: (1) control test; (2) "active conduct of a business" test; (3) distribution of "solely stock or securities"; (4) parent corporation must distribute all of the stock in the subsidiary (or enough for control); and (5) reorganization must not be used "primarily as a device for distribution of earnings and profits." However, there are only two tests/requisites that generally create issues which prevent consideration of this planning alternative. The two problematic requisites/tests restated are as follows:

(1) **Active conduct of trade or business requirement (5-year pre-distribution/2 or more year post-distribution)**; **and**

(2) **Trade or business purpose requirement.**

▶ ▶

ACTIVE CONDUCT OF TRADE OR BUSINESS
(5-YEAR PRE-DISTRIBUTION/2 OR MORE YEAR POST-DISTRIBUTION)

For purposes of IRC §355, a trade or business must have been actively conducted by the distributing parent corporation **throughout the 5-year period** ending on the date of distribution. The regulations under IRC §355 expand this requirement and require continued operation of the business or businesses existing prior to the implementation of the divisive reorganization. Accordingly, a transitory continuation of one of the active businesses would not satisfy the active trade or business test provided by these regulations. IRC §355(b)(1)(A) and Regs. §1.355-3(a)(1).

EXAMPLES: The holding of stock and securities for investment purposes will **not** constitute the active conduct of a trade or business. **Also, the ownership and rental of real or personal property (e.g. farm real estate) will not constitute the active conduct of a trade or business unless the owner performs significant services with respect to the operation and management of the property. IRC Regs. §1.355-3(b)(2)(iv).**

See Rev. Rul. 73-234 and Rev. Rul. 86-126, for corporate farming examples where the active conduct of a trade or business was met (Rev. Rul. 73-234) and not met (Rev. Rul. 86-126).

Rev. Rul. 73-234, 1973-2 C.B 180: (Livestock share lease with active involvement) – "the fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions".

Rev. Rul. 86-126, 1986-2 C.B 58: Corporation cash rented farmland, with sharing of expenses, to tenant who planted, raised, harvested and sold crops using tenant's equipment. Activities of corporate officers in leasing land, providing advice and reviewing accounts **not** substantial enough to meet active business requirement.

NOTE: It does **not** appear that the use of a farm manager (agent) to perform these services for the corporation necessarily impairs the active conduct of a trade or business requirement. Webster Corp., 25 T.C. 55 (1955), acq. 1960-2 Cum. Bull. 7, aff'd 240 F 2d 164 (2nd Circ. 1957). **However, the officers and directors must be active in directing the activities of the agent, not mere spectators.**

CAUTION - TAX PLANNING: The corporation's officers and directors activities for the pre-distribution (5 yr.) and post-distribution (2 or more yr.) time frames should be well documented before a divisive reorganization is undertaken. Also, officers/directors should be paid reasonable salaries for services performed.

▶ ▶

TRADE OR BUSINESS PURPOSE:

IRC Regs. §1.355-2(b)(2) provides that a **corporate business purpose** must be a real and substantial non-federal tax purpose germane to the business of the distributing corporation, as well as, the controlled corporation. A **shareholder purpose** (e.g. accomplishing personal estate planning objectives) by itself, is **not** a corporate business purpose. However, the regulations go on to explain that a shareholder purpose may be so nearly co-extensive with a corporate business purpose as to preclude any distinction between them, in which case the transaction meets the corporate business purpose requirement. **A transaction motivated in substantial part by a corporate business purpose will not fail the business purpose requirement merely because it is motivated in part by non-federal tax shareholder purposes.**

Within this guidance, the business purpose test generally is readily ascertainable (e.g. shareholder disputes or potential therefore, etc.). See examples below.

EXAMPLES: **Rev. Rul. 2003-52**, involved a family farming corporation owned by a father, mother and their two adult children, with active operation and management largely conducted by the two adult children. One child intended to focus on the livestock aspect of the corporate business; the other preferred to operate the grain farming enterprise. To allow each to devote their full attention to a single business strategy, the corporation reorganized into two corporations, with the son receiving the stock of the livestock business and the daughter receiving the stock of the grain enterprise. **The IRS approved the reorganization taking the position that it was motivated by substantial non-tax business reasons even though the reorganization advanced the personal estate planning goals of the mother and father and promoted family harmony.**

PLR 200323041 (3-11-03): (Separation of grain farming business (land, etc.) between brother and sister following father's death). A corporate split-off undertaken to avoid shareholder disputes in a family-owned grain farming corporation (engaged in a single line of business) will constitute an IRC §368(a)(1)(D) reorganization and the stockholders of the split-off corporation will **not** recognize gain or loss pursuant to IRC §355.

PLR 200425033 (3-4-04): Split-offs designed to resolve shareholder disputes having adverse effect on corporation's business.

PLR 200422040 (2-13-04): Family owned "S" corporation split-off to avoid disputes and accomplish parental estate planning.

LTR 201219003 (2-3-12): Related party "S" corporation (two (2) shareholders) split-off to avoid future management disputes between shareholders and among their family members and prolong life of corporation.

LTR 201402002 (1-10-14): Single business "S" corporation (4 equal shareholders) equal split-off into 4 separate corporations to allow each shareholder to independently own and manage a separate business according to his/her own goals and priorities.

NOTE: The IRS has ruled that the post-distribution business purpose requirement

of IRC Reg. 1.355-2(b) remained satisfied even though the business purpose could not be achieved due to an unexpected change in circumstances following the divisive reorganization. In so ruling, the IRS noted that the "regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution." **Rev. Rul. 2003-55.**

OTHER CONSIDERATIONS

NOTE – DE MINIMUS RULE - (LESS THAN 5% NONQUALIFYING ASSETS): While IRC §355 requires that the corporation seeking a divisive reorganization be engaged in the active conduct of a trade or business it does not require that all of the assets of the corporation be devoted to or used in an active trade or business. The corporation may hold non-qualifying assets (generally less than 5% of total – hunting cabin, etc.) as long as it is engaged in the active conduct of a trade or business. IRC Reg. §1.355-(3)(a)(ii).

TAX/BUSINESS PLANNING RECOMMENDATION – INDEMNITY AGREEMENT: It may be advisable to have the various shareholders enter into an agreement providing that any shareholder who violates the post-distribution active trade or business rule agrees to pay **all** taxes incurred by all shareholders if the divisive reorganization fails to pass IRS scrutiny.

CAPITALIZATION OF REORGANIZATION COSTS: Courts have regularly held that amounts incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses under IRC §162(a) but rather capital expenditures under IRC §263(a). Thus, costs incurred to facilitate tax-free corporate reorganizations under IRC §368 are generally required to be capitalized. IRC Reg. §1.263(a)-5(a)(4).

NOTE – ADVANCE IRS RULINGS: In Rev. Proc. 2003-48 the IRS stated that, for ruling requests after 8/8/03, it would no longer rule on whether (1) a distribution of stock of a controlled corporation is carried out for business purposes, (2) the transaction is used principally as a device, or (3) a distribution and an acquisition are part of a plan under IRS §355(e). In Rev. Proc. 2013-32, the IRS announced a change in its letter ruling policy for the tax-free treatment of corporate spin-offs, reorganizations, and other nonrecognition transactions. For transactions submitted after August 23, 2013, the IRS would no longer issue so-called "comfort rulings" on whether transactions qualify for nonrecognition treatment under IRC §355 or on whether transactions constitute a reorganization within the meaning of IRC §368, regardless of whether the transaction presents a significant issue or is part of a larger transaction that involves issues upon which the IRS could rule.

However, the IRS further explained that it would rule on one or more issues, under the "nonrecognition provisions", that it determined to be "significant." The IRS defined a "significant issue" as an issue of law, the resolution of which was not essentially free from doubt and that is germane to determining the tax consequences of the transaction. The IRS also decided that it would restrict its rulings to tax consequences that result from application of the nonrecognition provisions to the extent that a significant issue was presented under a related IRC provision that addresses such tax consequences.

Recently, in Rev. Proc. 2016-45, the IRS announced that it would change its "no-rule" position regarding the first two issues above, namely:

a. The corporate business purpose requirement under Reg. 1.355-2(b); **and**

b. Whether a transaction is used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both under §355(a)(1)(B) and Reg. §1.355-2(d).

The IRS noted that the policy change was only for significant legal issues and not for issues that are inherently factual in nature.

Before submitting a letter ruling request, the IRS recommends that the taxpayer call the Office of Associate Chief Counsel (Corporate) at (200) 622-7700 to discuss whether the Service will entertain such a letter ruling request.

TAX CONSEQUENCES OF CORPORATE LIQUIDATIONS

The following are numerical examples of the tax cost difference between the current liquidation of a "C" corporation versus current liquidation of an "S" corporation versus liquidation of an "S" corporation following the death of a shareholder.

The liquidation of a corporation is a taxable event, at **both** the corporation and shareholder levels. The same general rules apply to both C and S corporations, although the incidence of tax may be quite different due to **double taxation** on C corporation distributions and **single taxation** on S corporation distributions.

A. Complete Liquidation of C Corporation:

Farms, Inc. has two equal shareholders, John and Ann. The fair market value of the corporation's assets (all unimproved real estate – no depreciation taken) is $2,000,000; adjusted basis is $1,000,000. John and Ann each have $200,000 basis in their stock. The shareholders would like to liquidate the corporation and distribute its assets equally.

Tax on corp.:	
FMV of assets	$2,000,000
Adj. basis of assets	(1,000,000)
Gain on liquidating distribution (**all gain taxed at ordinary income rates**)	1,000,000
Corp. tax on gain (assuming flat 34%)	$ 340,000
Distributions to shareholders:	
Corporation's assets (pretax)	$2,000,000
LESS: Corp. tax liability	(340,000)
Amt. dist. to shareholders (total)	1,660,000
Amt. dist. per shareholder	830,000
LESS: Shareholder basis (each)	(200,000)
Gain recognized per shareholder	630,000
Tax per shareholder (fed-15%/23.8%; state-8%)	$ 168,340
Total tax liability	
Tax on corporation	$ 340,000
Tax on John	168,340
Tax on Ann	168,340
Total tax	$ 676,680

- The shareholder's basis of the property received in a liquidation is its fair market value at the date of the distribution. IRC §334(a).

- The liquidating corporation recognizes all gains and losses on distribution of property in liquidation. IRC §336.

  - Losses may be limited on recently acquired property if not related to the corporation's business. IRC §336(d)(2).

  - Losses would be disallowed if property is distributed to the controlling shareholder or a related party, if the property was received as a contribution to capital or received in a IRC §351 exchange within 5 years, or if the distribution of loss property is not pro rata. IRC §336(d)(1).

- Shareholders report all gains and losses on the disposition of their shares in a complete liquidation (IRC §331). Different rules could govern if a shareholder was a corporation that owned at least 80% of the shares in the liquidated corporation (IRC §§332 and 337).

B. Complete Liquidation of S Corporation:

The same general liquidation rules apply to an S corporation as to a C corporation. However, the tax cost is significantly smaller **unless** the S corporation is subject to built-in gains taxation.

Assume the same facts as above, except that Farms, Inc. has always been an S corporation. Thus, it is exempt from the built-in gains tax. **If the corporation completely liquidates, there would be no tax at the corporate level.** The shareholders would, however, be required to recognize the corporation's gains and losses on the liquidating distribution which passes through to the shareholders.

Tax on corp.:		
FMV of assets		$ 2,000,000
Adj. basis of assets		(1,000,000)
Gain on liquidating dist.		1,000,000
Gain passed through per shareholder (50%)		500,000
Tax on pass-through gain (fed-15%/23.8%; state-8%)		$ 127,000
Distributions to shareholders:		
Corporation's assets		$2,000,000
Amt. dist. to each shareholder		1,000,000
LESS: Shareholder's basis (each):		
Basis before liquidating dist.	$200,000*	
Add gain passed through from corp.	500,000	(700,000)
Gain recognized per shareholder		300,000
Tax per shareholder (fed-23.8%; state-8%)		$ 95,400
Total tax liability		
Gain pass-through from corp. (127,000 x 2)		$ 254,000
Dist. to shareholders (95,400 x 2)		190,800
Total		$ 444,800

*If shares are retained until death, a "step-up" to fair market value generally would be obtained. This would materially reduce any tax consequences.

C. Complete Liquidation of S Corporation (At Death of Shareholder):

To illustrate the tax benefits of retention of stock until the death of a shareholder, consider the following example:

Agco, Inc. was incorporated in 1983 as a C corporation. This corporation was converted to S corporate status in 1987.

Agco, Inc. has one shareholder, Albert. Albert died in 2016 at a time when the fair market value of the corporation's assets were $2,000,000; adjusted basis was $1,000,000 (all unimproved real estate – no depreciation taken).

Prior to Albert's death, his basis in Agco Inc.'s stock (outside basis) was $0. At his death, Albert's basis in the Agco, Inc. stock receives a step-up to fair market value. Therefore, Albert's basis in the Agco, Inc. stock to his heirs is $2,000,000. The corporation is liquidated following Albert's death.

Tax on corp.:	
FMV of assets	$ 2,000,000
Adj. basis of assets (inside basis)	(1,000,000)
Gain on liquidating dist. (passed through to Albert's heirs)	$1,000,000
Distributions to shareholders:	
Corporation's assets	$2,000,000

LESS: Shareholder's basis:		
Basis before liquidating distribution	$2,000,000*	
Add gain passed through from corp.	1,000,000	(3,000,000)
Loss recognized (Albert's heirs on liquidation)		(1,000,000)

Total Gain/Loss on Liquidation	
Gain pass-through from corp.	$1,000,000
Loss recognized by Albert's heirs on liquidation	(1,000,000)
Total gain/loss on liquidation	$ -0-

***Step-up in basis at date of death**

CAUTION – TAX PLANNING – LIQUIDATE IN SAME TAX YEAR AS SALE OF ASSETS: A corporation must be liquidated in the same tax year as the sale/distribution of assets to produce the desired tax result. If a sale/distribution of assets was accomplished in one tax year and the liquidation of the corporation in the following year, the capital loss produced upon liquidation would not offset the capital gain generated by the sale of assets.

In such a case, the capital loss produced upon liquidation would only offset other long-term capital gains for the tax year of the liquidation, plus $3,000 of ordinary income. The remaining long-term capital loss would be carried forward to subsequent tax years, but does not survive any particular heirs death.

Bloethe Tax School

Sales, Gifts & Devises of LLC Interest – Special Problems

Track Two
10:50 a.m.-11:40 p.m.

Presented by
David Repp
Dickinson, Mackaman, Tyler & Hagen, P.C.
699 Walnut Street, Suite 1600
Des Moines, Iowa 50309-3986
Phone: 515-246-4556

FRIDAY, DECEMBER 9, 2016

DICKINSONLAW

SALES, GIFTS & DEVISES OF LLC INTERESTS—SPECIAL PROBLEMS

77th Annual Bloethe Tax School
December 9, 2016
By: David M. Repp

Atticus Finch always arrived at the office each morning promptly at 8:15 and would eat a muffin in the break room while glancing over the day's headlines in the newspaper. Today was different because it was Monday. "Triage Monday," he called it. That morning, the phone was already ringing as he stepped into his office. Atticus set his muffin down and answered. A woman caller disclosed that her husband had not filed their tax returns for seven years and wondered what the penalties might be. Atticus wondered what set of events must have occurred for them to suddenly realize, after seven years, that they needed to file their tax returns.

Atticus glanced at the clock on the lower right corner of his computer screen. "9:45 and I haven't billed a single minute," he uttered to himself. Thirty-three emails, two faxes, three meeting reminders and a half-finished bar association seminar article awaited Atticus's attention. A subtle rumble emerged from Atticus's stomach. No sooner had he reached for his muffin than the phone rang again. The caller ID listed a name he did not recognize, but the number was within the local calling area. He hesitated, but set the muffin back down and answered.

> "Mr. Finch?"
> **"Yes, may I help you?"**
> "I own 200 units of Farmland Ethanol, LLC, that I bought 5 years ago for $200,000. My Schedule K-1s show that it's lost more than $300,000. How is that possible? It's lost so much money that I figure that with the money I saved from the Schedule K-1 tax losses and all the tax credits I got from it, I'm actually ahead!"
> **"Uh, that's too bad, or I mean that's good to hear. Ah, so how may I help you?"**
> "Well, I've been told ethanol's making a lot of money this year. Since I'm already money ahead, I want to dump it before I have to start reporting all that income. If I can't sell it, I want to give it to my nephew. Hey, what if I gave it to charity; can I take a tax deduction? What do you think, . . . can you help me?"
> **"Damn, I don't know a thing about partnership taxation."**[1]

[1] My apologies to Harper Lee, author, "To Kill a Mockingbird" (1962).

DICKINSONLAW

TABLE OF CONTENTS

I. TAXATION OF SALES OF LLC INTERESTS

A. Distinguishing Capital Accounts and Basis

Partnership tax law is an accountant's dream (or nightmare depending on the context). Multiple sets of books and records are required to be kept for the same partnership assets:

- The fair market value and tax basis of appreciated property contributed by a partner must be accounted for separately in case it is later sold.[2]

- If a 754 election is in place, each new partner that has succeeded to the interest of a former partner will have a separate basis in the partnership assets (called the "**inside basis**") equal to the new partner's basis in the partnership interest (called the "**outside basis**").[3]

Accountants must also keep track of a partner's interest in the partnership using a modified historical cost system and tax basis system.

Capital Accounts. Capital accounts are used to keep track of a partner's equity in the partnership. Tax law requires capital accounts to be maintained.[4] Partner capital accounts are increased or decreased for partner contributions and distributions. Likewise, capital accounts are increased or decreased for a partner's share of partnership income or loss.[5]

> **KNOWELEDGE POINT: Capital accounts represent the amount each partner would receive if the partnership sold all of its assets at book value, paid off its creditors, and distributed the remainder to the partners.**

Illustration 1: A and B form a partnership with A contributing $400 and B contributing equipment with a tax basis of $100 and a value of $400. Book capital accounts are blind to tax consequences. So, the $100 tax basis in the

---

[2] IRC § 704(c)(1)(A). The contributing partner is first allocated the gain equal to the built in gain that was present when the property was contributed to the partnership. The remaining gain is allocated among the partners in accordance with the partnership agreement.

[3] IRC § 743(b). This Section only applies to transfers of partnership interests. A transfer in this context includes a sale, exchange or a transfer at death, but it does not include a transfer by gift. IRC § 743(a). Transfers do not include either the admission of a new partner or the liquidation of an old partner. *Id.*

[4] Treas. Reg. § 1.704-1(b)(2)(iv).

[5] Treas. Reg. § 1/704-1(b)(2)(iv)(b)

equipment is not relevant for capital account maintenance purposes. The partnership's balance sheet and capital accounts are as follows:

Assets		***Liabilities & Capital***
	Book	
Cash	$400	
equip	$400	
	$800	

Capital Accounts

	Book
A	$400
B	$400
	$800

Unfortunately, capital accounts alone are insufficient to monitor and keep track of the 704(c) problem. Under IRC § 704(c), if appreciated or depreciated property is contributed to a partnership, the built-in gain or loss (when realized by the partnership) must be taken into account for tax purposes by the contributing partner. Thus, separate accounts to reflect the tax basis for the partnership's assets must be created as well as separate accounts for the partners to reflect their share of the tax basis in the partnership assets contributed by the partners.[6]

Assets			***Liabilities & Capital***
	basis	Book	
Cash	$400	$400	
equip	$100	$400	
	$500	$800	

Capital Accounts

	Tax	Book
A	$400	$400
B	$100	$400
	$500	$800

KNOWLEDGE POINT: Tax capital accounts are required to show the tax/book disparities and to help keep track of Section 704(c) allocation problems.

Partnership liabilities are not important when maintaining capital accounts (tax or book) because capital accounts reflect an owner's equity in the partnership which does not change

[6] The Regulations refer to this tax capital account as "previously taxed capital." IRC § 1.743-1(d).

when a liability is added.[7] However, liabilities will increase a partner's inside basis and outside basis.[8] This is important for at least two reasons: (1) a partner can deduct losses only to the extent of the partner's outside basis in the partnership,[9] and (2) a partner will recognize gain if the partner receives a distribution of cash in excess of his or her outside basis.[10] Thus, another set of books should be maintained to keep track of outside basis. Assume that the partnership borrows $700 and uses the proceeds and excess partnership cash to purchase a building for $1,000.

	Assets			***Liabilities & Capital***	
	basis	Book			
Cash	$100	$100		mortgage	$700
equip	$100	$400			
Bldg	$1,000	$1,000			
	$1,200	$1,500			

Capital Accounts

	Tax	Book	Outside Basis
A	$400	$400	$750
B	$100	$400	$450
	$500	$800	$1,200

Note that the tax/book capital accounts did not change as a result of the added liability. This is so because the capital accounts reflect the partners' equity in the partnership that did not change as a result of the borrowing. The partners' combined outside basis equals the inside basis. This will change when a partner transfers an interest in the partnership or if a new partner is added.

B. Income Tax Consequences to Selling Partner

A selling partner must recognize gain or loss on the sale of a partnership interest equal to the difference between the amount realized and the partner's outside basis.[11] The character of the gain or loss will be capital, but if the partnership contains unrealized receivables or inventory

[7] For example, if a partnership borrows cash, the liability will offset exactly the added cash leaving equity intact.

[8] IRC § 722.

[9] IRC § 704(d).

[10] IRC § 731(a)(1).

[11] IRC § 741.

items, then a pro rata portion of the gain or loss attributable to the unrealized receivables or inventory items will be taxed at ordinary income tax rates.[12]

> ***Illustration 2:*** A and B form a partnership with A contributing $400 and B contributing equipment with a tax basis of $100 and a value of $400. After a year of operations in which revenues exactly equaled expenses, A decides to sell her partnership interest to X for $500. A has a gain of $100 and if the partnership contains no unrealized receivables or inventory, the character of the gain is capital (not ordinary). If the partnership had appreciated inventory, a portion of the sale will be taxed as ordinary income. Consider the following balance sheet and capital accounts:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
B	$100	$400	$100	$500
	$500	$800	$500	$1,000

From A's perspective, there exists $50 of inventory appreciation and $150 of equipment appreciation (not subject to depreciation recapture). Therefore, one-fourth of A's gain ($25) from the sale of her partnership interest will be ordinary income and three-fourths ($75) will be capital gain. Had B, rather than A, sold the interest to X for $500, the result would be slightly different. B's total partnership gain is $400. $300 of the gain will be capital gain[13] to rectify the original Section 704(c) special allocation to B. As for the remaining $100 of gain, $25 will be ordinary and $75 will be capital.[14]

Now, assume the same facts as Illustration 2, above, except the partnership borrowed $900 several years ago and used the borrowed proceeds to fund the partnership's operations, all of which resulted in losses flowing through to the partners. The partners increase their outside

[12] IRC § 751(a); Treas. Reg. § 1.751-1(a)(2).

[13] Assume that there is no depreciation recapture under IRC § 1245(a)(1).

[14] Treas. Reg. § 1.751-1(a)(2).

basis (but not their capital accounts) by $450 each,[15] but because of the $900 of operating expenses, each partner's capital account and outside basis is reduced by $450. The partnership's balance sheet is now as follows:

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
B	($350)	($50)	$100	$50
	($400)	($100)	$500	$100

Because of the liability, X is only willing to pay $50 for A's partnership interest. If only the outside basis of A's interest were looked at to determine A's gain or loss on the sale, it would appear that A would have a $350 loss to report ($400 less $50). This would be wrong. A's "amount realized" not only includes the $50 she will receive from X, but will also include half of the $900 liability, or $450.[16] Why? The borrowing allowed A to take deductions of $450 solely as a result of the borrowing—a borrowing that A will not be obligated to pay back. Viewed another way, A has been discharged from liability and is the equivalent to discharge of indebtedness income.[17] Therefore, to compute A's gain or loss, her amount realized is $500, the $50 paid to her by X plus A's share of the partnership's liabilities ($450). A's outside basis is $400 so A has a taxable gain of $100 which is exactly the same result that occurred in the prior example with no mortgage liability. By virtue of Section 751, $25 of the gain will be ordinary and $75 will be capital gain.

The same result occurs to B if B had sold her interest to X for $50. B's gain will be $400 measured by the amount realized of $500 ($50 + $450 discharge of indebtedness) less B's outside basis of $100. As in the previous example, $25 will be ordinary and $375 will be capital gain.

---

[15] IRC § 722.

[16] IRC § 752(b) & (d); *Crane v. Commissioner*, 331 US 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300 (1983). This applies to gifts as well such that a donor partner will be deemed to have received a distribution of money in the amount of the partner's share of partnership liabilities. This has not been applied to deceased partners.

[17] See IRC § 61(a)(12).

C. Income Tax Consequences to Buying Partner

In the previous illustration, X purchased A's partnership interest for $500. X succeeds to A's capital accounts, both tax and book.[18] The partnership's inside basis remains the same, but X's outside basis is his purchase price. The balance sheet of the partnership now is as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
X	$400	$400	$500	$500
B	$100	$400	$100	$500
	$500	$800	$600	$1,000

There is a disparity of tax accounting caused by this result that will eventually require X to report phantom gain as a result of the built-in gain inherent in the inventory and equipment. If immediately after X purchases A's interest, the partnership decides to sell the inventory at its fair market value, X will have to report $25 of the gain. The resulting balance sheet will be as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$450	$450	$450	
equip	$100	$400	$550	
	$550	$850	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
X	$425	$425	$525	$500
B	$125	$425	$125	$500
	$550	$850	$650	$1,000

The disparity can be resolved in one of three different ways. **First**, X can negotiate a discount in the purchase price of the interest with A to accommodate the built-in gains. **Second**,

[18] Treas. Reg. § 1.704-1(b)(2)(iv)(l).

X can wait until he sells the partnership interest to someone else, or until the partnership liquidates, in which case he will have an offsetting $25 loss to report. **Third**, he can negotiate with B to make a section 754 election.[19] Under section 754, the partnership adjusts the basis in its assets whenever there is a transfer of a partnership interest.[20] However, the basis adjustment applies only to the buying partner and not the other partners and thus requires much more meticulous recordkeeping. If a section 754 election had been made, the balance sheet immediately after the sale would have been as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$125	$125	$150	
equip	$175	$475	$550	
	$600	$900	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
X	$500	$500	$500	$500
B	$100	$400	$100	$500
	$600	$900	$600	$1,000

X's capital accounts and his outside basis are the same indicating X's share of inside basis equals his outside basis. A review of the assets accounts will confirm this. If the partnership sells the inventory for $150, X would be entitled to A's original share of the inventory basis of $50 (1/2 of $100) plus $25 of basis resulting from the Section 754 election for a total basis of $75. The $75 basis exactly equals one half of the sale proceeds of the inventory resulting in no gain allocated to X. With respect to the equipment, X inherited A's book capital account basis of $200 plus the $75 Section 754 election basis increase for a total basis of $275 which equals exactly half the sale proceeds of the equipment. B would be allocated all of the $375 gain on the sale of the equipment, $300 of which was allocated to him as pre-contribution gain under Section 704(c).

[19] The partnership must file the 754 election and the buying partner may have no control over that. Once a partnership makes a 754 election, the election remains in effect with respect to all future transactions, and it can only be revoked with the consent of the IRS. Treas. Reg. §1.754-1(c). Notwithstanding whether an election under 754 has been made, if the partnership has a "substantial built-in loss," the partnership must adjust the basis of the partnership property as if a 754 election had been made. IRC § 743(a). A "substantial built-in loss" is defined as when the partnership's adjusted basis in its property exceeds the property's fair market value by more than $250,000. IRC § 743(d). Presumably, for purposes of determining "substantial built-in loss," the loss must occur after the formation of the partnership (and thus excludes any Section 704(c) loss).

[20] The amount of the adjustment is determined under IRC Section 743(b), and it is equal to the difference between the buyer's outside basis and her share of inside basis.

What if X had purchased B's interest rather than A? If no Section 754 election had been in place, X would inherit B's capital accounts and her pre-contribution gain under 704(c).[21] The balance sheet would be as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
X	$100	$400	$500	$500
	$500	$800	$900	$1,000

In this example, X inherited B's tax liability of $400 of gain consisting of B's $300 Section 704(c) pre-contribution gain plus $100 of partnership gain. This gain will eventually be reversed with an offsetting loss when X sells his partnership interest or if the partnership liquidates.[22] Thus, the absence of a Section 754 election creates nothing more than a timing problem for X. The Section 754 election, of course, resolves the tax timing problem by stepping up the inside basis of the assets upon X's purchase of the partnership interest from B. The balance sheet of the partnership would be as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$125	$125	$150	
equip	$475	$475	$550	
	$900	$900	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
X	$500	$500	$500	$500
	$900	$900	$900	$1,000

[21] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)(7) and 1.743-1(j)(2).

[22] This result occurs because the $400 gain would increase X's outside basis to $900 which is $400 more than the fair market value of X's partnership interest.

Notice that the Section 704(c) pre-contribution gain of $300 was eliminated as a result of the Section 754 election.

> **KNOWLEDGE POINT: Section 754 eliminates the timing problem associated with the taxation of partnership profits when a new partner succeeds to a former partner's interest.**

II. TAXATION OF DEVISES OF LLC INTERESTS

A partnership interest transferred at death has a stepped-up basis, to estate tax value, plus the estate's share of partnership liabilities.[23] However, a successor to a decedent's partnership interest does not get a step-up in basis to the extent that partnership assets include accounts receivable (for a cash basis partnership) and other items of income in respect of a decedent.[24]

A person succeeding to a deceased partner's interest will inherit the deceased partner's capital accounts (both tax and book) as well as the deceased partner's pre-contribution Section 704(c) built-in gain or loss, unless a Section 754 election is in place.[25]

Illustration 3. Consider the same facts as Illustration 2 except the cash-basis partnership has $100 of accounts receivable. The balance sheet is as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
A/R	$0	$0	$100	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$550
B	$100	$400	$100	$550
	$500	$800	$500	$1,100

[23] IRC § 1014; IRC § 742; Treas. Reg. § 1.742-1.

[24] IRC § 1014(c).

[25] IRC § 734(a). Notwithstanding whether an election under 754 has been made, if the partnership has a "substantial built-in loss," the partnership must adjust the basis of the partnership property as if a 754 election had been made. IRC § 743(a). A "substantial built-in loss" is defined as when the partnership's adjusted basis in its property exceeds the property's fair market value by more than $250,000. IRC § 743(d).

B dies leaving her interest to B jr. B's estate reports B's interest in the partnership at $550 on B's Federal estate tax return even though B jr. will only receive a tax basis in the partnership interest of $500. This is because $50 reflects accounts receivable which is income in respect of a decedent.[26] B jr. steps into the shoes of B, but with a new outside basis of $500. The partnership's balance sheet now is as follows:

Assets				***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
A/R	$0	$0	$100	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$550
B jr.	$100	$400	$500	$550
	$500	$800	$900	$1,100

KNOWLEDGE POINT: A decedent is entitled to a full step-up (or step-down) to fair market value for purposes of reporting the partnership interest on the decedent's Federal estate tax return, but the decedent's stepped-up basis in the partnership interest will be reduced by the deceased partner's share of income in respect of a decedent.[27]

B jr. will later report gain on the partnership's collection of accounts receivable and the sale of inventory and equipment. The gain on the inventory and equipment will eventually be reversed with an offsetting loss when B jr. sells her partnership interest or if the partnership liquidates.[28] Thus, the absence of a Section 754 election creates a timing problem for B jr. just like it did for X in Illustration 2 in the context of a sale. The Section 754 election, of course,

[26] IRC § 1014; IRC § 742; Treas. Reg. § 1.742-1. Of course, B's estate may also be allowed a valuation discount for lack of control or lack of marketability. For illustration purposes, this example assumes no such discount applies.

[27] IRC § 1014(c).

[28] This result occurs because the $400 gain would increase B jr's outside basis to $900 which is $400 more than the fair market value of B jr's partnership interest (without considering the accounts receivable).

resolves the tax timing problem by stepping up the inside basis of the assets upon B's demise. The balance sheet of the partnership would be as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
A/R	$0	$0	$100	
Invent	$125	$125	$150	
equip	$475	$475	$550	
	$900	$900	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$550
B jr.	$500	$500	$500	$550
	$900	$900	$900	$1,100

The other partners of a partnership can also benefit by the step-up caused by the death of a partner. To illustrate, use the same facts as described in Illustration 3 with B jr. succeeding to B's interest. First assume that the accounts receivable are realized and that the inventory is sold for cash. The sale generates $250 of cash and both A and B jr. recognize gain of $75 (from the sale of inventory and collection of A/R). Further assume no 754 election is in effect. The balance sheet now looks as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$550	$550	$550	
equip	$100	$400	$550	
	$650	$950	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$475	$475	$475	$550
B jr.	$175	$475	$575	$550
	$650	$950	$1,050	$1,100

Now, assume C joins the partnership by contributing $550 of cash. The balance sheet now is as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$1,100	$1,100	$1,100	
equip	$100	$400	$550	
	$1,200	$1,500	$1,650	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$475	$475	$475	$550
B jr.	$175	$475	$575	$550
C	$550	$550	$550	$550
	$1,200	$1,500	$1,600	$1,650

If the partnership terminates B jr.'s interest by distributing the equipment to B jr., B jr. will take the distributed property at B jr.'s outside basis of $575 even though the partnership's basis in the equipment is only $400.[29] The partnership is left with cash of $1,100 which is shared equally by A and C. A has received the benefit of B jr.'s step-up in basis because A will not have to report as gain any of the appreciation of the equipment. This is only temporary, though, as A will report an offsetting gain when the partnership liquidates or when A sells her interest to a third party. The balance sheet of the partnership is now as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$1,100	$1,100	$1,100	
equip	$0	$0	$0	
	$1,100	$1,100	$1,100	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$550	$550	$475	$550
C	$550	$550	$550	$550
	$1,100	$1,100	$1,025	$1,100

[29] IRC § 732(c). Note that B jr.'s basis in the equipment is $25 higher than its fair market value. When B jr. later sells the equipment, he will recognize the $25 loss. Also note that if any partner other than B jr. received the equipment as a liquidating distribution, then B jr. would be taxed on the pre-contribution 704(c) built-in gain, unless seven years had passed since the contribution of the equipment. IRC §§ 704(c)(2)(B) & 737.

Notice that A's tax and book capital accounts increased by $75 reflecting what would have been A's share of the appreciation in the equipment distributed to B jr. This is required in order to make the balance sheet balance and also because the regulations so demand.[30]

KNOWLEDGE POINT: Property distributed to a partner in a liquidating distribution of a partner's interest will have a basis equal to the partner's outside basis.[31]

III. TAXATION OF GIFTS OF LLC INTERESTS

Generally, under Code Section 1015, the donee of a gift receives a basis in the gifted property equal to the lesser of the fair market value of the property or the donor's basis.[32] The same is true for gifts of partnership interests. The donee inherits the donor's capital accounts and pre-contribution Section 704(c) gain or loss.[33] In other words, the donee steps into the shoes of the donor. Following through with the previous illustration in which A and B formed a partnership:

Assets ***Liabilities & Capital***

	basis	Book	FMV
Cash	$300	$300	$300
Invent	$100	$100	$150
equip	$100	$400	$550
	$500	$800	$1,000

Capital Accounts

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
B	$100	$400	$100	$500
	$500	$800	$500	$1,000

[30] Revaluations of the capital accounts are required by Treas. Reg. § 1.704-1(b)(2)(iv)(f) when a new or existing partner contributes money or property and when money or property is distributed to a partner in liquidation of all or part his interest.

[31] IRC § 732(b). Beware, however, of IRC §§ 704(c)(2)(B) & 737 which requires recognition of pre-contribution built-in gain if the property is distributed within seven years of contribution. Also beware that the distribution of unrealized receivables and appreciated inventory may result in a recognition event. IRC §§ 751(b) & 732(e).

[32] IRC § 1015(a); Treas. Reg. § 1.1015-1(a)(2). Thus, if the fair market value of the gifted property is less than the donor's basis, the donee's basis floats such that the donee recognizes no gain or loss if the gifted property is subsequently sold by the donee at a price between the fair market value of the property at the time of the gift and the donor's basis.

[33] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)7 and 1.743-1(j)(2).

If B decides to gift her interest to B jr., B jr. will essentially replace B and succeed to B's tax and book capital accounts. Because B's basis is less than the fair market value of B's partnership interest, B jr. will succeed to B's outside basis of $100. The balance sheet will appear as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$550	
	$500	$800	$1,000	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A	$400	$400	$400	$500
B jr.	$100	$400	$100	$500
	$500	$800	$500	$1,000

The following year, after the partnership's equipment lost $250 in value, A decides to gift her partnership interest to A jr. A's outside basis is now $25 higher than the fair market value of A's partnership interest. A jr. takes an outside basis equal to the lesser of A's basis ($400) or the fair market value of A's interest ($375). The balance sheet now appears as follows:

	Assets			***Liabilities & Capital***
	basis	Book	FMV	
Cash	$300	$300	$300	
Invent	$100	$100	$150	
equip	$100	$400	$300	
	$500	$800	$750	***Capital Accounts***

	Tax	Book	Outside Basis	FMV
A jr.	$400	$400	$375	$375
B jr.	$100	$400	$100	$375
	$500	$800	$475	$750

Because A's outside basis was $400, A jr.'s basis will essentially float between $375 and $400 such that if A jr.'s partnership interest were sold or liquidated within that range, A jr. would recognize no gain or loss.[34]

[34] IRC § 1015(a); Treas. Reg. § 1.1015-1(a)(2).

Now, assume the same facts except the partnership borrowed $900 several years ago and used the borrowed proceeds to fund the partnership's operations, all of which resulted in losses flowing through to the partners. Partners A and B increase their outside basis (but not their capital accounts) by $450 each,[35] but because of the $900 of operating expenses, each partner's capital account and outside basis is reduced by $450. The partnership's balance sheet is now as follows:

Assets				***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
B	($350)	($50)	$100	$50
	($400)	($100)	$500	$100

If B gifts her interest to B jr., several things happen. First, B is relieved of $450 of partnership liabilities and such debt relief is equivalent to a distribution of money to B.[36] B will recognize gain to the extent money distributed to her exceeds her basis which in this situation requires B to recognize $350.[37] This result makes sense because B was the beneficiary of $450 of previous deductions due to the $900 partnership borrowing, and now B is being relieved of her obligation to pay the $450 back.

Second, B jr. will take a transferred basis from B which will be $0 because B used her $100 basis to apply against the deemed distribution of $450 to her. However, B jr. will be allowed to increase his outside basis by one-half of the partnership liabilities.[38]

Third, B jr. will succeed to B's tax and book capital accounts and pre-contribution 704(c) built-in gain adjustment.[39]

---

[35] IRC § 722.

[36] IRC § 752(b); IRC § 752(d); *Crane v. Commissioner*, 331 US 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[37] IRC § 731(a)(1).

[38] IRC § 722.

[39] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)7 and 1.743-1(j)(2).

After the gift, the partnership's balance sheet will be as follows:

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
B jr.	($350)	($50)	$450	$50
	($400)	($100)	$850	$100

KNOWLEDGE POINT: In the absence of a Section 754 election, the donee of a partnership interest will step into the shoes of the donor and inure to the attributes of the donor's tax and book capital accounts as well as the donor's pre-contribution Section 704(c) built in gain or loss.

IV. TAXATION OF GIFTS OF LLC INTERESTS TO CHARITY

If B were to gift her partnership interest to a charity, the same result would occur as if the gift had been made to a person with two exceptions: First, B's basis is allocated between the part that is considered a sale and the part that is considered a gift.[40] Second, B is entitled to a charitable contribution deduction in an amount equal to the fair market value of the partnership interest ($50).[41] Charity will succeed to B's tax and book capital accounts and pre-contribution 704(c) built-in gain adjustment.[42] Charity will also be allowed to increase its outside basis by one-half of the partnership liabilities ($450).[43] B's gain would equal $350 ($450 debt relief less $100 basis). The partnership balance sheet will be as follows:

[40] IRC § 1011(b); Treas. Reg. § 1.1011-2(b); Rev. Rul. 75-194; Rev. Rul. 81-163 (stating that the adjusted basis for determining the gain from the sale is the portion of the adjusted basis of the entire property that bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property).

[41] Treas. Reg. § 1.170A-4(c).

[42] Treas. Reg. §1.704-1(b)(2)(iv)(l); Treas. Reg. §§1.704-3(a)7 and 1.743-1(j)(2).

[43] IRC § 722.

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$550		
	$500	$800	$1,000	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$50
charity	($350)	($50)	$450	$50
	($400)	($100)	$850	$100

If the fair market value of B's partnership interest were $900 (rather than $50), then B's outside basis would be allocated half to the sale and half to the charity.[44] B's gain would be $400 ($450 debt relief less $50 basis). The Charity's outside basis would consist of $50 of B's basis plus $450 (half of the $900 debt). B would have a charitable contribution deduction of $200. The balance sheet would now appear as follows:

	Assets			***Liabilities & Capital***	
	basis	Book	FMV		
Cash	$300	$300	$300	mortgage	$900
Invent	$100	$100	$150		
equip	$100	$400	$2,250		
	$500	$800	$2,700	***Capital Accounts***	

	Tax	Book	Outside Basis	FMV
A	($50)	($50)	$400	$900
charity	($350)	($50)	$500	$900
	($400)	($100)	$900	$1800

KNOWLEDGE POINT: When a partner's share of partnership liabilities exceeds the partner's outside basis, the partner will always have taxable gain on a gift of the partnership interest.

[44] IRC § 1011(b); Treas. Reg. § 1.1011-2(b); Rev. Rul. 75-194; Rev. Rul. 81-163 (stating that the adjusted basis for determining the gain from the sale is the portion of the adjusted basis of the entire property that bears the same ration to the adjusted basis as the amount realized bears to the fair market value of the entire property). Based on Rev. Rul. 81-163, the amount realized is $450 and the fair market value of the property is $900. Thus, B's basis of $100 is split in half (450/900) with $50 allocated to B to apply against her gain and the other $50 given to the charity.

V. INVESTMENT TAX CREDIT RECPATURE FROM FORMER PARTNERS

If B were the beneficiary of any tax credits that flowed through the partnership to B, B would continue to be liable for repayment of such tax credits if a later default occurred notwithstanding the fact that B gifted her partnership interest to B jr.[45]

KNOWLEDGE POINT: Substituted partners are not liable for a former partner's share of tax credit recapture.

00056935-1

[45] Treas. Reg. § 1.48-6(b), ex 2.

Bloethe

Tax School

IOWA STATE BAR ASSOCIATION

The New World of Partnership Audits: Why You Need to Worry about 2018 today

Track Two

11:40 a.m.-12:30 p.m.

Presented by
Joe Kristan
Roth & Company, P.C.
666 Walnut Street
Suite 1450
Des Moines, IA 50309
Phone: 515-244-0266

FRIDAY, DECEMBER 9, 2016

Background and learning objectives. Congress in 2015 quietly tore down and rebuilt the rules governing IRS examinations of partnership returns. New rules will control how partnerships are examined for tax years beginning in 2018. The delayed effective date will require practitioners and the IRS to cope with multiple sets of examination rules.

The new rules create problems for existing and new partnership agreements and LLC operating agreements. The new default regime requires to partnerships to pay taxes on behalf of partners on examination adjustments in ways that can give some partners unfair benefits and burdens. The powerful new role of "partnership representative" also requires consideration.

This presentation outlines key aspects of the new rules and highlights uncertainties that will require administrative guidance.

Basics of old TEFRA examination structure.

- "Tax Matters Partner" is point of contact and representative of partnership throughout proceedings.
- Other partners are given opportunity to participate
- Partnership Examination determines correct amount of "partnership items."
- Once partnership examination is completed, separate partner-level proceedings are required to compute assessment.

A separate structure covers "electing large partnerships."

Problems of old structure.

The TEFRA examination rules were enacted in 1982. The pass-through world has changed since then. Some of the big changes include:

- The repeal of the *General Utilities* doctrine and the subsequent rise of pass-through entities to avoid the resulting double taxation in corporations.
- The rise of LLCs and other novel pass-through entities.
- Master limited partnerships
- Hedge funds and private equity partnerships.

The TEFRA regime has not aged well. The multiple examination levels and the inability to assess at the partnership level has discouraged agents from pursuing partnership examinations. A 2015 GAO report showed that only .8% of partnerships with $100 million or more of assets were examined in 2012, compared to 27.1% corporations that size.

Bipartisan Budget Act (BBA)

By 2015, there was a bipartisan consensus to update the partnership examination system. The rules were enacted as a revenue raiser in the Bipartisan Budget Act of 2015. Technical corrections were made in the Protecting Americans from Tax Hikes (PATH) act later that year.

BBA Structure:

- **Sec. 6221** says that adjustments of items of income, gain, loss, deduction are credit are determined at the partnership level, and any taxes, penalties and interest related to such adjustments are also determined at the partnership level. It also provides an opt-out for "small" partnerships.

- **Sec. 6222** provides that partner reporting that differs from K-1 reporting can be assessed as a math error, absent partner filing notice of inconsistent treatment.

- **Sec 6223** provides for a **partnership representative** whose actions with respect to the examination are binding on the partnership and its partners.

- **Sec. 6225** provides computational rules for assessing additional tax to the partnership. It also directs the Treasury to write regulations reducing the tax at the partnership level to the extent partners file amended returns and pay tax on partnership adjustments.

- **Sec. 6226** allows partnerships to "push out" the liability to partners.

- **Secs. 6231 through 6235** provide procedural rules for partnership adjustments, including a uniform statute of limitation for adjustments.

- **Sec. 6241** provides definitions under the new rules, as well as rules for bankrupt or terminated partnerships.

Rules for imposition of tax at the partner level (Sec. 6221 and 6225).

Tax is imposed at the highest statutory rate for the partners to whom the adjustment is made. This ignores phase-outs. Capital gain top rates apply where applicable.

If the examination results in a re-allocation of income among partners, only the increase in income is taken into account.

Interest and penalties are computed at the partnership level based on the year for which the examination is made.

Sec. 6231 provides that the IRS will issue a notice of proposed adjustment, with a 330-day period for the taxpayer to provide information to mitigate the payment. There are two key ways this might be accomplished:

1. By identifying exempt partners or determining that favorable capital gain rates should apply.
2. By having partners file amended returns taking adjustments into account.

This second issue will be key for dealing with shifts in income among partners. It will only work if all partners affected -- positive and negative -- file amended returns.

Amended return procedures. The mechanics of amending returns to avoid partnership-level tax will not be known until the IRS issues guidance.

Push-out option. Partnerships will have the option to push the payment burden to the partners under Sec. 6226. If the partnership so elects within 45 days of receiving the notice of final partnership administrative adjustment (FPAA), the partners are required to take over the payment obligation.

The partnership will provide the partners an information return with the partners' share of adjustments. The partners will recompute their tax for the exam year and, to the extent affected, subsequent years. The resulting tax will be considered assessed for **the year in which this information return is received.**

Example. A partnership is examined for its 2018 tax year. IRS issues the FPAA in 2020 and the partnership elects under Sec. 6223 to pass the adjustment to the partners. The notice of the adjustments goes out to the partners in 2021. The partners recompute their tax for 2018, 2019 and 2020 taking the adjustments into account. The resulting tax is added to the tax owing on 2021 tax returns. No amended returns are filed. (Sec. 6226(b)(2)).

Even though the income is added to later returns, interest is computed going back to the due date of the return year under examination and is paid by the partners.

Early opt-in.

For years beginning after 11/2/2015, taxpayers can elect to opt in to the new rules rather than the existing TEFRA rules. Temporary regulations (Reg. Sec. 301.9100-22T) provide a procedure to elect the new rules instead of the TEFRA rules. The election must be made within 30 days of notification of an examination.

Why? *A partnership might select early opt-in if it has many partners and confidence that adjustments will be minor. It might also do so to exert greater control over the examination process. Partnerships may not be willing to do so because it will deprive individual partners of rights to intervene under the TEFRA rules.*

"Small" partnership opt-out.

For many partnerships, the most important action to be taken with respect to the new examination rules is whether to opt out of them. This is an annual election to be made on the tax return.

Partnerships may opt out if they meet all of the following requirements (Sec. 6221(b)):

- Each partner is an individual, a domestic C corporation, a foreign entity taxable as a C corporation, an estate of a deceased partner, or an S corporation.
- The partnership has no more than 100 K-1s to issue.
- The partnership makes the appropriate opt-out election on a timely-filed return for the year.
- The partnership notifies each member as directed by regulation.

S corporations will be required to furnish their owner names and ID numbers to the partnership for the partnership to make the election. Each S shareholder is counted for the 100-partner limit.

Tiered partnerships are not eligible for the election out. That creates an incentive for using S corporations rather than tiered partnership arrangements.

The Treasury has authority to broaden the classes of owners allowed for partnerships making an opt-out election.

Significantly differs from TEFRA small partnership rule, which was an "opt-in" program for partnerships with 10 or fewer owners who were otherwise excluded.

State issues.

As of November 6, only one state (Arizona) has enacted rules addressing these new audit procedures.

If Iowa does nothing, it would appear that it would miss out on any adjustments taxed at the partnership level, as Iowa has no provisions to impose its own tax on partnerships. I expect Iowa to adopt the federal rules, with modifications that would enable partnerships to pay tax even when the "push out" election is made for federal purposes.

Drafting considerations.

While the full impact of the new rules on partnership agreements will take time to sort out, some likely issues for agreements and transactions are already evident. They include:

- Should partners be required to amend returns if requested to avoid partnership level tax?

- If partners refuse to amend returns, should the partnership have authority to reduce their capital account to reflect the cost to the partnership of the tax payment.

- When acquiring a partnership interest, a buyer might want to require a “push out” election on any examinations to ensure that the ongoing partnership doesn’t bear the cost of exam adjustments attributable to departing partners.

- On the flip side, a partner leaving a partnership they might want protection against a “push-out” of liability after they no longer own the interest.

- Agreements should keep in mind the broad power of partnership representatives to bind the partnership and partners.

- Should “opt-out” elections be addressed for eligible partnerships?