

NewsNotes

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FROM THE IRS

Revenue Ruling on S Elections for Partnerships Converting to Corporations

The IRS has issued a revenue ruling that addresses the question of whether, when a partnership becomes a corporation for federal tax purposes, it is eligible to elect to be taxed as an S corporation in its first tax year (Rev. Rul. 2009-15). The ruling clarifies that a partnership that converts to a corporation is eligible to make an S election, effective for the corporation's first tax year.

The revenue ruling looks at two situations. The first is when a partnership elects under the check-the-box regulations to be taxed as an association. The second is when a partnership converts to a corporation under a state formless conversion statute. Under Rev. Rul. 2004-59, these two situations should be treated the same for federal tax purposes.

In the first situation, under Regs. Sec. 301.7701-3 the following steps are deemed to occur: The partnership contributes all its assets and liabilities to the association in exchange for association stock, and immediately the partnership liquidates by distributing the stock to its partners. Under these steps, the revenue ruling says, the partnership (which would

be an ineligible S corporation shareholder) never owns the association stock during the association's first tax year. Therefore, the association is eligible to elect S status in its first tax year.

In the second situation, the same steps are deemed to occur, except that instead of association stock, stock of a corporation is involved. But according to the revenue ruling, the results are the same: The partnership never owns the corporation stock during the corporation's first tax year because it is deemed to have distributed it immediately to its partners. Therefore, the corporation is eligible to elect S status in its first year.

In addition, the corporation is not deemed to have had a short C corporation year preceding its first S year.

Guidance on Sales and Purchases of Life Insurance Contracts

On May 1, the IRS released two revenue rulings that provide guidance for sellers and purchasers of life insurance contracts (Rev. Ruls. 2009-13 and 2009-14).

Rev. Rul. 2009-13 addresses policyholders who sell or surrender their life insurance contract. The ruling addresses three situations in which an individual enters into a cash-value life insurance

contract under which the individual is the insured and a family member is the named beneficiary. In the first situation, the individual surrenders the contract for its cash surrender value. In the second and third situations, the individual sells the contract to an unrelated person.

In the first instance, the individual must recognize income to the extent the amount received exceeds the investment in the contract. The ruling specifies that this is characterized as ordinary income, not capital gain.

In the second situation, the individual recognizes income to the extent the amount realized in the sale exceeds the individual's basis in the contract. The ruling applies the "substitute for ordinary income" doctrine to hold that the amount realized, up to the amount of the contract's inside buildup, is ordinary income, and the amount realized that exceeds the inside buildup is capital gain. The inside buildup equals the cash surrender value minus the aggregate premiums paid on the contract.

The third situation posits that there is no cash surrender value on the contract, so there is no inside buildup and the entire amount realized will be characterized as capital gain.

Rev. Rul. 2009-14 gives guidance to investors who purchase a life insurance contract. The ruling addresses three situations in which a U.S. citizen purchases a life insurance contract and then receives death benefits or sale proceeds from the life insurance. The ruling says that in these situations the individual must recognize ordinary income when receiving death benefits and must recognize long-term capital gain when selling the contract.

IRS Clarifies Guidance on Small Business NOL Carrybacks

The IRS has issued Rev. Proc. 2009-26, which clarifies the guidance in Rev. Proc. 2009-19 on how small businesses can elect to carry back 2008 net operating losses (NOLs) for three, four, or five years, as provided for by Sec. 172(b)(1)(H) (instead of the usual two years).

The change to the NOL carryback for small businesses was enacted by the

American Recovery and Reinvestment Act of 2009, P.L. 111-5, on February 17, 2009—after the 2008 filing season was under way. Rev. Proc. 2009-19 (released in March) provided procedures for eligible taxpayers to properly make the election with their 2008 return. Taxpayers who had already filed a 2008 return had to file an application for tentative refund or an amended return. Not surprisingly, given the late date on which this guidance was released, many taxpayers failed to make the election. So the IRS has modified the election procedure to allow eligible taxpayers who missed the original deadline to file their application for tentative refund or amended return within six months of their original return due date and make the election.

Rev. Proc. 2009-26 also provides a procedure for eligible taxpayers who originally elected to forgo the extended NOL carryback but have changed their minds. Such taxpayers can revoke their original election by filing an application for tentative refund or amended return and writing across the top of the appropriate form: "Revocation of NOL Carryback Waiver Pursuant to Rev. Proc. 2009-19."

Residential Energy-Efficient Property Credit Rules Issued

The IRS has provided guidance to manufacturers and consumers on satisfying the requirements of the residential energy-efficient property credit (Notice 2009-41). The notice outlines procedures manufacturers must follow to certify that property satisfies the credit's conditions. Taxpayers receive guidance on when they may rely on a manufacturer's certification.

Sec. 25D allows taxpayers a tax credit when they purchase certain qualified solar electric property, solar water heating property, fuel cell property, small wind energy property, and/or geothermal heat pump property. The property must be used in a residence located in the United States.

In order to claim the credit, the notice says taxpayers may rely on the manufacturer's certification that the property meets the requirements of Sec. 25D. Taxpayers do not have to attach the certification to

their return but must retain it as part of their records.

The notice provides manufacturers with specific requirements that their certifications must meet. The manufacturer's certification can be included with the property packaging or be made available in printable form on the manufacturer's website. The manufacturer must declare, under penalty of perjury, that the facts presented in the certification are true and must maintain documentation establishing that the property meets the Sec. 25D requirements.

If the IRS discovers that a manufacturer's certification is wrong, it can withdraw the manufacturer's right to issue certifications and will publish an announcement of that withdrawal. Taxpayers can rely on erroneous certifications for any products purchased before the announcement was published but cannot rely on any certifications for that manufacturer's products for property purchased after the announcement was published.

The IRS says it plans to publish regulations incorporating the rules set forth in Notice 2009-41. Taxpayers may rely on the notice for tax years beginning after December 31, 2008. Currently, the residential energy-efficient property credit applies only to property placed in service before January 1, 2017.

REGULATIONS

Prop. Regs. on Graduated Retained Interests Under Sec. 2036

On April 30, the IRS issued proposed regulations providing guidance on the portion of trust property includible in the grantor's gross estate if the grantor has retained certain interests in the property (REG-119532-08). The retained interests covered include the use of the property and the right to an annuity, unitrust, graduated retained interest, or other payment from such property for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death.

The new proposed regulations address comments the IRS received in response to

2007 proposed regulations on the portion of trust corpus properly includible in a grantor's gross estate under Secs. 2036 and 2039. Rather than address those comments when the earlier proposed regulations were finalized (T.D. 9414), the IRS decided instead to issue separate proposed regulations that address the comments on graduated retained interests. (For more on the final regulations, see Ransome and Satchit, "Significant Recent Developments in Estate Planning," 39 *The Tax Adviser* 588 (September 2008).)

The new proposed regulations provide the method to be used to determine the portion of trust corpus includible in the grantor's gross estate if the grantor reserves a graduated retained interest in a trust.

The portion of the corpus of a grantor-retained interest trust or a charitable remainder trust includible in the decedent's gross estate under Sec. 2036 is that portion of the trust corpus necessary to generate a return sufficient to pay the decedent's retained annuity, unitrust, or other payment. The proposed regulations would measure the amount of corpus needed to generate sufficient income to produce the payments that would have been due even after the decedent's death, as if the decedent had survived and continued to receive the retained interest.

The proposed regulations provide a formula for calculating this amount and an example illustrating its computation. They also clarify the computation of the includible amount if the decedent retained the right to receive an annuity or other payment (rather than income) after the death of the current recipient of that interest.

The proposed rules would apply to estates of decedents dying on or after the date the rules are finalized.