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IRS Seeks to Limit Valuation Discounts for Family-Controlled Entities: Proposed Section 2704 Regulations

Proposed regulations issued on August 2, if finalized in their present form, will significantly limit the ability to claim valuation discounts upon the transfer of interests in family-controlled entities. If you missed our Special Alert on these proposed regulations, you can access it here.

Health Care Documents Are Important for College Students

Those of you who have or are about to have a college-age child should speak with your attorney about the need for your child to sign a health care proxy or power of attorney and a HIPAA authorization.

Once a child is no longer a minor you will generally not have the legal right to obtain medical information concerning your adult child. The difficulty in obtaining medical information concerning your child can be eased by having your child sign two forms – (i) a health care proxy (or medical power of attorney) appointing you as agent to act on behalf of your child with respect to medical decisions in the event your child cannot act for himself or herself and (ii) a HIPAA authorization, which authorizes the medical provider to release your child's medical information to you.

In California, the health care power of attorney is now commonly referred to as an Advance Health Care Directive. The Directive permits the signer to designate the person (or persons) authorized to make such decisions and to specify what those decisions should be.

We can assist you in the preparation of these forms.

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IRS Reaffirms Position That Partners Are Not Employees

It has long been the case that partners of partnerships (including a limited liability company ("LLC") that is treated as a partnership for income tax purposes) who perform services for the partnership and receive compensation for such services are not treated as employees for withholding and employment tax purposes. They are instead treated as self-employed and are subject to self-employment tax and required to make quarterly estimated income tax payments.

There has been an emerging trend of partnerships wanting to treat partners as employees, issue Forms W-2 to them, and withhold employment and income taxes. In many cases, the partner actually prefers this treatment rather than dealing with estimated payments. We see this fairly often where partnership businesses grant profits interests to key employees. While the employee is technically a tax partner (assuming the profits interest is respected), he or she may wish to still be treated as an employee for purposes of withholding and receiving a W-2 rather than a K-1.

A structure was developed where a partnership would form a single-member LLC of which the partnership was the sole member. The partners who rendered services to the partnership would become employed by the single-member LLC. Many practitioners thought that this provided justification for treating the partners as employees of the single-member LLC because Treas. Reg. Section 301.7701-2(c)(2)(iv)(B) provides that a tax-disregarded entity such as a single-member LLC is treated as a corporation for purposes of employment taxes, and the partner was employed by this entity, which is treated as a corporation, rather than by the partnership.

In temporary regulations recently issued, the IRS has said that this interpretation is not correct in the case of employees of a single-member LLC who are partners of the partnership that owns the single-member LLC. The temporary regulations reiterated that a single member LLC that does not elect to be treated as a corporation is disregarded for income tax purposes, which includes the self-employment tax. These individuals are still considered to be receiving self-employment income from the partnership.

The IRS has a notion that people are doing this to take advantage of certain types of employee benefits plans and other benefits available only to employees, but this may not be the case. In our experience, people do this simply because the partners prefer withholding and receiving a W-2 to the regime of estimated payments and self-employment tax. The IRS is also being somewhat shortsighted in that it would collect taxes much faster and more reliably through the wage withholding system than it does through estimated payments.

The IRS did request comments on whether there are circumstances in which it is appropriate to treat partners as employees, so stay tuned.

IRS Modifies Guidance on When Construction Begins on Energy Facilities

A taxpayer is allowed a federal income tax credit for electricity produced from certain renewable resources, provided construction of the qualified facility begins by a certain date. Under prior guidance, there are two methods a taxpayer may use to establish that construction of the qualified facility has begun – by beginning physical work of a significant nature (the "Physical Work Test") or by paying or incurring at least 5% of the total cost of the facility (the "5% Safe Harbor"). Both methods require the taxpayer to make continuous progress toward completion once construction has begun (the "Continuity Requirement").

In response to recent legislation extending the tax credit, the Treasury updated and modified the rules relating to when construction begins and is considered to continue. Under the new guidance:

1. If a facility is placed in service within four calendar years after the calendar year in which construction of the facility began, the Continuity Requirement will be deemed met (the “Continuity Safe Harbor”). This is a two-year extension of the prior safe harbor.

2. A taxpayer may not rely on different tests in different years with respect to a facility. For example, if a taxpayer performs significant physical work on a facility in 2016 and then pays or incurs 5% or more of the total cost in 2017, construction will be considered to begin in 2016, not 2017, and the Continuity Requirement will be applied beginning in 2016.

3. The nonexclusive list of construction disruptions that will not be considered as indicating that the taxpayer failed to meet the Continuity Requirement has been expanded.

4. The guidance provides illustrations of the Physical Work Test. For example, in connection with wind facilities, physical work of a significant nature may include excavation for the foundation, setting anchor bolts into the ground or pouring the concrete pads of the foundation. A nonexclusive list of preliminary activities that are not considered to meet the Physical Work Test is also included.

5. Generally, a facility includes all components of property that are functionally interdependent in the generation of electricity. Solely for the purposes of determining when construction has begun, multiple facilities that are operated as part of a single project (along with any property that serves some or all such facilities) will be treated as a single facility. The determination of whether multiple facilities are operated as part of a single facility is made in the calendar year in which the last of the multiple facilities is placed in service. Multiple facilities that are treated as a single facility for purposes of determining whether construction has begun will be disaggregated and treated as multiple separate facilities for purposes of the Continuity Safe Harbor if any of the facilities is not placed in service within the four-calendar-year safe harbor period. Those facilities placed in service after such date cannot rely on the Continuity Safe Harbor to meet the Continuity Requirement.

Update on Section 83(b) Elections

Taxpayers are no longer required to include a copy of their election under Internal Revenue Code Section 83(b) with their tax return for the year in which the restricted property is received. Generally, restricted property received in connection with the performance of services is subject to income tax in the year in which the restriction lapses. However, the taxpayer may elect, under Section 83(b), to treat the restricted property as being taxable in the year it is received.

The election is frequently desirable where the value of the property at the time of receipt is very small. By making the election and taking the small value into income, any future appreciation in value of the property may be taxed at the more favorable long-term capital rates, assuming that the taxpayer satisfies the requirements imposed in order for the property to become vested.

The taxpayer must file the election within 30 days after receiving the property and must furnish a copy of the election to his or her employer or other recipient of his or her services. Previously, the taxpayer was also required to include a copy of the election with his or her tax return. The change is effective for restricted property that is received on or after January 1, 2016, although the taxpayer may apply the rule beginning January 1, 2015.

New York Aggressively Seeks to Collect Sales Tax on Art Purchases

According to an article that recently appeared in *The New York Times* (July 19, 2016), the Attorney General of New York has been on an aggressive campaign to enforce the New York sales tax law in connection with art sales. The article reported that the Gagosian Gallery agreed to a substantial payment of back taxes because it has an affiliate in California that had shipped

close to $40,000,000 in art to New York customers without collecting the New York tax. The Attorney General found that the affiliate had substantial nexus with New York because it was commonly controlled and it maintained a bank account in New York.

The New York gallery also agreed to pay New York sales tax on sales to customers outside New York in cases where the gallery had turned the art over to carriers hired by the customer. The Attorney General deemed this to be a delivery to the customer within New York, so the New York sales tax became applicable. The article also mentioned the collection of previously unpaid sales taxes from prominent art collectors.

Compensation Update

We recently published two special alerts in the compensation area. One addressed new proposed regulations under IRC Section 409A, dealing with nonqualified deferred compensation arrangements, and the other reviewed new proposed regulations dealing with nonqualified deferred compensation arrangements maintained by governmental and tax-exempt entities. You can access these alerts here and here.

IRS Rules That Prospective Tenancy in Common Will Not Create a Partnership for Tax Purposes

In *PLR 20162208*, the IRS ruled that a tenancy in common ownership arrangement that might be created in the future under a contract would not be treated as a partnership for federal income tax purposes. The taxpayer owned a commercial rental property and entered into a lease of the property with another party. At the same time, the parties entered into an option agreement that granted the taxpayer a put option to sell all or a portion of the property to the lessee. The agreement also granted the lessee a call option to purchase from the taxpayer any portion of the property over which the taxpayer had not exercised his option to sell to the lessee. The purchase price upon the exercise of either of the options would be an amount based on the fair market value of the property at the time the agreement was entered, increased annually by a stated percentage which the parties determined represented a reasonable appreciation factor for the property.

In the event that either party's option was only partially exercised, they would thereafter co-own the property as tenants in common. Their relationship as co-owners would be governed by a co-ownership agreement. The agreement provided that any sale or lease of the property, or borrowing money against the property, required the approval of both of the co-owners. A third-party manager could be hired to manage the property with the agreement of both co-owners. The agreement with the manager would be for a period of one year, but it would automatically be renewed for successive one-year periods unless either the manager or a co-owner were to give 20 days' prior written notice.

Under the income tax law, a co-ownership of property can become treated as a partnership for income tax purposes if the co-owners carry on a trade, business, financial operation or venture and divide the profits therefrom. Avoiding the treatment of a co-ownership arrangement as a partnership for income tax purposes can be important because the federal income tax law does not permit a Section 1031 exchange of a partnership interest; rather the like-kind exchange would have to done by the partnership. If the arrangement between the parties is simply the co-ownership of property, then either of the parties can do a Section 1031 exchange of its tenancy in common interest.

To assist taxpayers in structuring these kinds of arrangements, the IRS issued Revenue Procedure 2002–22, which sets forth guidelines based upon which the Internal Revenue Service will issue a private letter ruling to taxpayers that their co-ownership arrangement does not constitute a partnership for federal income tax purposes. The IRS determined that the co-ownership arrangement contemplated by the parties met the requirements of Revenue Procedure 2002–22, and

would not be treated as a partnership for federal income tax purposes.

The Revenue Procedure requires, among other things, that all co-owners must consent to sales, leases or borrowing against the property, and the co-ownership agreement so provided. All co-owners' consent is required to hire a manager for the property. Any agreement with the manager cannot be for a term in excess of one year. In this case, the IRS determined that the automatic rollover of the agreement for additional successive one-year terms was acceptable.

No co-owner can have a put option to require any other co-owner to purchase his interest. While the taxpayer did have a put option, the option was in force prior to the time the co-ownership existed. The taxpayer initially owned the entire property. He had an option to sell part or all of the property to the lessee. It would be that sale of a part of his interest to the lessee that would cause the co-ownership to come into existence. Since the put option was operative prior to the creation of the co-ownership, the IRS did not view the put option as violating the requirement of the Revenue Procedure.

The Revenue Procedure does allow a co-owner to grant a call option for another party to purchase his interest. The lessee had a call option over any part of the property still owned by the taxpayer after his put option was partially exercised or not exercised. The option price under the call option must represent the fair market value of the property at the time the option is exercised. In this case, the parties agreed that the option price would be the fair market value of the property at the time the co-ownership agreement was entered, adjusted annually by a fixed percentage. The IRS determined that this would be an acceptable estimation of the fair market value of the property at the time of the exercise of the call option.

It Is Important to Keep Legal Entities in Good Standing

A recent Tax Court case illustrates the importance of keeping corporations and other legal entities in good standing under the laws of their state of formation. In *Allied Transportation Inc. v. Commissioner*, the charter of a Maryland corporation was revoked and voided because the corporation failed to file a property tax return for the taxable year 2003. The corporation continued to do business and to file federal income tax returns.

In 2014, the IRS mailed a notice of deficiency to the corporation with respect to its 2010 taxable year, asserting an income tax deficiency of $79,812 plus penalties. The corporation filed a petition with the United States Tax Court, and the IRS filed a motion to dismiss the petition for lack of jurisdiction, arguing that the petition was not filed by a party with capacity to sue as required by the Tax Court rules. The rules provide that the ability of a corporation to engage in litigation in the Tax Court is determined by reference to the law under which it is organized. Under Maryland law, when a corporate charter is forfeited, the powers conferred by law on the corporation become inoperative, null and void as of the date of the forfeiture. The Tax Court upheld the dismissal of the corporation's petition.

This case illustrates one of the many reasons it is important to keep all legal entities in good standing with their respective states. In addition to tax filings, many states require legal entities to make other periodic filings of an informational nature. For example, in California, corporations are required to file annual Statements of Information. There is a similar requirement for limited liability companies, although the statement is filed only every other year. Legal entities can be suspended for failing to keep these filings current. While such an entity can normally be re-instated, it is the better practice to keep the entity in good standing at all times.

Election Year Updates for Section 501(c)(4) Social Welfare Organizations*

The Protecting Americans from Tax Hikes Act of 2015, or the PATH Act, made several changes to tax law applicable to section 501(c)(4) organizations operating this election year. In addition, two relatively recent IRS denials of applications for section 501(c)(4) status illustrate some points a section 501(c)(4) organization should consider if it is intending to intervene in this year's political campaigns or apply for recognition of section 501(c)(4) status.

New Notification Requirement

The IRS recently announced that section 501(c)(4) organizations must begin complying with a new notification requirement contained in section 405 of the PATH Act. (See Rev. Proc. 2016-41 .) Unless an exception applies, every section 501(c)(4) organization must file a new IRS Form 8976 , Notice of Intent to Operate Under Section 501(c)(4) (and pay the accompanying $50 fee), online by the later of September 6, 2016, or 60 days from the date of its formation.

The form is required only for section 501(c)(4) organizations that have not done at least one of the following, on or before July 8, 2016:

- Applied for recognition of exemption under section 501(c)(4) on IRS Form 1024.
- Filed at least one Form 990 or, if eligible, Form 990-EZ or Form 990-N.

The Form 8976 merely notifies the IRS that an organization is operating as a section 501(c)(4) organization. It is not an application seeking recognition of section 501(c)(4) status, and the acknowledgment by the IRS that it has received the Form 8976 (which filers should receive within 60 days) is not equivalent to a determination of section 501(c)(4) status by the IRS. Organizations are not required to obtain a determination of section 501(c)(4) status by the IRS, but if they want this determination, they must apply for it on Form 1024.

Section 501(c)(4) Organizations May Now Seek Declaratory Judgments

Under section 406 of the PATH Act, any applicant that receives a denial of section 501(c)(4) by the IRS may now seek a declaratory judgment to reverse the denial from the U.S. Tax Court, the U.S. Court of Federal Claims or the U.S. District Court for the District of Columbia. The ability to seek a declaratory judgment is granted under section 7428 of the Internal Revenue Code, which has long applied to section 501(c)(3) organizations and now applies to all organizations described in section 501(c). The section 7428 procedures apply not only to denials but also to any revocation of section 501(c)(4) status or any failure by the IRS to make a determination as to section 501(c)(4) status within 270 days of an organization's application on a Form 1024.

In order to preserve the right to challenge a denial or revocation of section 501(c)(4) status under section 7428, an organization must file a protest statement with the IRS within 30 days of receiving the proposed denial or revocation letter. If the organization subsequently receives a final denial or revocation letter, a petition with the selected court must be filed before the 91st day after the date of the letter. The extension of the section 7428 declaratory judgment procedures to section 501(c)(4) organizations is effective for petitions filed after December 18, 2015.

No Gift Tax for Donors to Section 501(c)(4) Organizations

Under section 408 of the PATH Act, the federal gift tax does not apply to contributions to a section 501(c)(4) organization, effective for contributions made after December 18, 2015. This change ends long-standing uncertainty on the issue. In July 2011, IRS Deputy Commissioner Steve Miller announced in a memorandum that all enforcement activity involving the application of the gift tax to such contributions would be suspended while the need for further guidance in the area was assessed.

Recent IRS Denial Letters Offer Cautionary Guidance for Section 501(c)(4) Organizations

Two recent IRS denials of applications for section 501(c)(4) status illustrate some important substantive and procedural points organizations should consider if filing such applications. In *PLR 201615014*, the applicant had apparently been in operation for all or part of three years prior to its application. In the first year, 100 percent of its expenditures were devoted to the production and distribution of mailers and radio ads that encouraged the defeat or election of candidates for public office and were found by the IRS to constitute intervention in a political campaign, based on all of the facts and circumstances. In the second and third years, however, the applicant represented that it had spent 100 percent of its time (but not expenditures, because the hours were all volunteered) on educational campaigns for job promotion and job training for residents of its city, which the IRS acknowledged promoted social welfare. The applicant also stated that it intended to produce print and radio ads in the future as its "primary" expense. The IRS concluded that the applicant was not exempt under section 501(c)(4).

A section 501(c)(4) organization must engage primarily in activities that promote social welfare and cannot be engaged primarily in political campaign intervention — which is commonly understood to mean that it must devote more than half of its expenditures and/or time to the former and less than half to the latter. Because the applicant devoted 100 percent of its expenditures to political campaign intervention in the first year, it is not especially surprising that the IRS concluded that the applicant failed to qualify as a section 501(c)(4) organization that year (although perhaps the IRS should also have considered what the organization was devoting time to during that period). What is more surprising is that the IRS did not find that the applicant qualified as a section 501(c)(4) organization during the second and third years, even though the IRS acknowledged that all of the applicant's activities promoted social welfare during those years. Perhaps the IRS would have granted section 501(c)(4) status beginning the first day of the second year if the applicant had actually spent money on its social welfare activities in the second and third years. It is also possible that the IRS would have granted section 501(c)(4) status starting on the first day of the second year were it not for the applicant's statement about future expenditures on ads, given that the only ads the IRS had seen with the application constituted political campaign intervention. Nonetheless, the denial suggests that applicants for section 501(c)(4) status should not necessarily assume that they can "make up" for one year of excessive political campaign intervention with subsequent years of activities that promote social welfare.

In *PLR 201552032*, the IRS denied section 501(c)(4) status to an organization that had as its only activity at the time of the application a candidate forum that the IRS acknowledged might have promoted social welfare. However, the applicant's descriptions of its other planned activities were vague. According to the ruling, the IRS sent a letter requesting additional information about the applicant's past, present and future activities and made several attempts to contact the applicant by telephone, but the applicant failed to respond. As a result, the IRS denied section 501(c)(4) status on the basis that the applicant failed to establish its exemption. This ruling demonstrates that applicants should both try to provide sufficient detail in their initial application (on Form 1024) and promptly respond to any requests for additional information they receive, because failure to do so can result in a denial, even absent any evidence of activities inconsistent with section 501(c)(4) status.

*If you have questions, please contact Marc Owens (202.618.5014, mowens@loeb.com), Diara Holmes (202.618.5012, dholmes@loeb.com) or Preston Quesenberry (202.524.8470, pquesenberry@loeb.com).

Election Year Reminders: Cautionary Guidance for Employers That Sponsor PAC/Charity Matching Programs*

As we head into the final stretch of the presidential election cycle, employers — both for-profit and nonprofit — may wish to offer employee programs to encourage civic participation, including facilitating political contributions through payroll deduction plans.

Some corporate employers that sponsor affiliated political action committees offer to match an employee's contributions to the company PAC with contributions to charities selected by the employee. While charity/PAC matching gift programs of this nature have been approved by the Federal Election Commission for election law purposes as recently as 2016, the IRS recently ruled that corporate taxpayers may not claim business expense deductions for expenses associated with these programs.

Tax deductions are generally not relevant to tax-exempt corporations. However, section 501(c)(3) employers do have to contend with the prohibition on political activity. Fortunately, the IRS has ruled that a charitable employer may establish a payroll deduction plan through which employees may contribute to PACs as long as employees may contribute to the PACs of their choice and the charity does not solicit or encourage contributions to any affiliated PACs.

No Business or Charitable Deductions for Company PAC/Charity Match Programs

Charity/PAC matching programs have long been allowed by the FEC (see, e.g., FEC MUR 6873, FEC Advisory Opinion 1989-7). However, when considering the costs of implementing such programs, companies should note that their program expenses are not tax-deductible as either business expenses or charitable contributions.

In a recent private letter ruling (*PLR 201616002*), the IRS concluded that a corporation could not take a business expense deduction for expenses associated with a charity/PAC matching program. Under the program at issue, the company matched each employee's contributions to a company PAC with a contribution (in the employee's name) to charities of his or her choice. Reasoning that the employee's contributions to the PAC and the corporation's matching contributions to a charity were "inextricably linked," the IRS found that the matching contributions were "in connection with" a political campaign on behalf of a candidate for public office and therefore were not deductible business expenses pursuant to Internal Revenue Code section 162(e)(1)(B).

In prior guidance, the IRS has also opined that contributions made to charities under company PAC matching programs are not deductible as charitable contributions under section 170. (See GCM 39877 (8/21/92); Judith E. Kindell and John F. Reilly, "Election Year Issues ," 1993 IRS EO Continuing Professional Education Text, at 441.)

Business Expense Deductions Allowed for Broader Employer-Sponsored Civic Programs

The IRS has ruled that employers may deduct as ordinary and necessary business expenses the costs of administering programs intended to promote civic engagement and involvement in the political process. In a 1962 revenue ruling (Rev. Rul. 62-156, 1962-2 C.B. 470), the IRS considered corporate employers' programs that included advertisements encouraging people to vote, paid time off to vote and a payroll deduction plan under which employees could contribute to "whatever political candidate, cause, or party the employee chose to designate." In that ruling, the IRS reasoned that the business expense deductions were justified because, among other things, the expenses improved employee morale and enhanced the reputation of the employer.

Applying this 1962 revenue ruling, it stands to reason that if an employer set up a charity/PAC matching program that gave the employee the freedom to

contribute to the PAC of his or her choice and was part of a broader civic engagement effort of the sort described in the revenue ruling, the expenses associated with the program would be deductible.

Payroll Deduction Plans for Charitable Employers

The IRS has ruled that a charitable organization may establish and fund a PAC payroll deduction plan for its employees without jeopardizing its tax-exempt status under section 501(c)(3) as long as: (i) employees are free to choose the PAC and (ii) the charitable employer is politically impartial in its actions. (See PLR 201127013 .) In a 2011 private letter ruling, the IRS explained that under these conditions, contributions made through a charitable organization's voluntary payroll deduction plan may include the option of contributing to PACs established by a section 501(c)(4) organization that is controlled by the 501(c)(3) charity, provided the charitable organization does not "solicit or encourage contributions to the affiliated PACs." By contrast, the IRS has ruled that a section 501(c)(3) organization's payroll deduction plan would result in political campaign intervention (and hence would jeopardize tax-exempt status) when the only PAC to which contributions were made was one selected and endorsed by the employer. (See TAM 200446033).

*If you have questions about the issues discussed in this alert, please contact Preston Quesenberry (202.524.8470, pquesenberry@loeb.com), Diara Holmes (202.618.5012, dholmes@loeb.com) or Marc Owens (202.618.5014, mowens@loeb.com).

California Franchise Tax Board Explains Application of LLC Fee to Sales of Real Property

In addition to the $800 minimum franchise tax, California imposes a graduated annual fee on limited liability companies. The fee is based on the company's "total income from all sources derived from or attributable to this state." The maximum fee of $11,790 is reached when the total income of the company reaches $5,000,000 or more. Total income from all sources is defined to mean gross income plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer. The reason for adding back the cost of goods sold is that the LLC fee is intended to apply to the "gross receipts" of the company rather than to its gross income. When used in the context of tax law, "gross income" generally includes only the gain resulting from the sale of property.

The application of the LLC fee to the sale of real property had been somewhat uncertain. The California Franchise Tax Board ("FTB") attempted to clarify the application of the fee to real property sales in *Legal Ruling 2016-01*. The FTB determined that in the case of real property held primarily for sale to customers in the ordinary course of the company's trade or business, the cost of goods sold should include the cost of the real property sold. Therefore, with respect to what is commonly referred to as "dealer" real property, the LLC fee is based on the total selling price of the property.

A different result occurs, however, if the real property sold was held for investment. In that case, the cost basis of the property is not part of the cost of goods sold incurred in a trade or business of the company. When investment real property is sold, the LLC fee is imposed only on the gain recognized by the company from the sale.

Taxpayer Prevails in Case Involving Intergenerational Split-dollar Life Insurance

The taxpayer won an important summary judgment motion in the Tax Court in a case involving the use of intergenerational split-dollar life insurance. In 2006, Clara M. Morrissette, through her conservator, created three irrevocable dynastic trusts. One such trust was created for each of her three adult sons. The trust for each son purchased a universal life policy on the lives of his two brothers. The insurance was to be used in connection with a shareholders agreement entered into for the family business, Interstate Group. In order to keep the shares of Interstate Group within the family,

the shareholders agreement provided that upon the death of one of the brothers, the trusts for the other two brothers would buy the deceased brother's shares, using the proceeds from the universal life policy to pay the purchase price.

To pay for the life insurance policies, a split-dollar agreement was entered into between Mrs. Morrissette's living trust (the "CMM Trust") and each of the three dynasty trusts. Under this agreement, the CMM Trust transferred just under $10,000,000 to each of the three dynasty trusts, which was used to pay a lump-sum premium on the universal life policies. Pursuant to the split-dollar agreement, upon the death of one of the brothers, the CMM Trust would receive the *larger of* (i) the cash surrender value of the policies at the time of the death of the insured or (ii) the aggregate amount of the premiums paid on those policies. The balance of the death benefit of the policies would belong to the dynasty trusts of the two surviving brothers.

Mrs. Morrissette died in 2009. Upon audit of her estate tax return, the IRS determined that Mrs. Morrissette had made a gift to the dynasty trusts in the amount of $29,900,000 in 2006. The issue before the Tax Court in the taxpayer's motion for summary judgment was whether the premiums constituted a loan, which in turn depended on whether the split-dollar insurance arrangement was to be treated under the "loan regime" or the "economic benefit" regime under applicable regulations.

The tax consequences of split-dollar life insurance are determined under one of these regimes, depending on the rights of the respective parties to the proceeds of the insurance policy under the terms of the split-dollar agreement. Where one party owns the policy and the other party provides part or all of the premium payments, the loan regime normally applies. Under the loan regime, the party paying the premium is treated as having loaned money to the policy owner and annual interest is imputed on the loan and treated either as a gift in an intrafamily situation or as compensation in an employer-employee situation.

In contrast, where the same party owns the policy and pays the premiums but another party receives a portion of the death benefit, the economic benefit regime normally applies. Under the economic benefit regime, the party owning the policy and paying the premiums is treated as having provided to the other party the value of insurance protection each year. Such value is now determined using an IRS published table called Table 2001, and the amount so determined is either a gift or compensation each year.

The IRS took the position that because the dynasty trusts owned the policies and the CMM Trust provided part of the funds for premium payments, the loan regime applied. Under the split-dollar regulations, the party that is recognized by the insurance company as the owner of the insurance policy is normally treated as the owner for income tax purposes. Under that approach, for tax purposes, the dynasty trusts would be considered the owners of the policies. However, these split-dollar arrangements were carefully structured under a specific exception contained in the split-dollar regulations which the court found to be applicable called "non-equity split-dollar." The regulations provide that if the nominal owner receives no economic benefits under the policies except for current life insurance protection, then the other party who is paying the premiums will be treated as owning the policy for tax purposes and the economic benefit regime will be applicable. Stated differently, did the insured have any right to benefit from the cash surrender value of the policy or receive any other economic benefit from the policy?

The court found that the dynasty trusts were not entitled to any economic benefit beyond current life insurance protection. The CMM Trust retained the right to collect the larger of the cash surrender value or the total premiums paid, so the dynasty trusts never received more than insurance protection. This was the case whether the policy was terminated while the insured was still living or the policy was collected following the death of the insured. The IRS argued that dynasty trusts could receive additional benefits because the terms of the CMM Trust provided that upon the death

of Mrs. Morrissette, the amount receivable by the CMM Trust from the policies would be given to the dynasty trusts. The court said this was irrelevant because it was a provision of the CMM Trust and not a provision contained in the split-dollar agreement.

This is an important case for non-equity split-dollar arrangements frequently used in the estate planning context. The court ruled in favor of the taxpayer and confirmed that the economic benefit regime is applicable to this type of arrangement, so there was no taxable gift in 2006 as asserted by the IRS. Still to be determined is the value of the receivable to which the CMM Trust was entitled under the split-dollar agreement. That will be determined through further negotiation with the IRS or further litigation if an agreement is not reached. While the CMM Trust advanced nearly $30,000,000 to pay the insurance premiums, the actuarial value of the receivable payable only upon the death of her sons under the split-dollar agreements was reported on Mrs. Morrissette's estate tax return at less than $7,500,000. If the final number is anywhere near this amount, Mrs. Morrissette will have accomplished a substantial intergenerational transfer of wealth that was not subjected to either gift or estate taxes.

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MICHELLE W. ALBRECHT	MALBRECHT@LOEB.COM	212.407.4181
JOHN ARAO	JARAO@LOEB.COM	310.282.2231
MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
RYAN M. AUSTIN	RAUSTIN@LOEB.COM	310.282.2268
SASHA M. BASS	SBASS@LOEB.COM	310.282.2053
LAURA B. BERGER	LBERGER@LOEB.COM	310.282.2274
LEAH M. BISHOP	LBISHOP@LOEB.COM	310.282.2353
DEBORAH J. BROSS	DBROSS@LOEB.COM	310.282.2245
TARIN G. BROSS	TBROSS@LOEB.COM	310.282.2267
THERESA R. CLARDY	TCLARDY@LOEB.COM	310.282.2058
REGINA I. COVITT	RCOVITT@LOEB.COM	310.282.2344
TERENCE F. CUFF	TCUFF@LOEB.COM	310.282.2181
LINDA N. DEITCH	LDEITCH@LOEB.COM	310.282.2296
PAUL N. FRIMMER	PFRIMMER@LOEB.COM	310.282.2383
ANDREW S. GARB	AGARB@LOEB.COM	310.282.2302
ELIOT P. GREEN	EGREEN@LOEB.COM	212.407.4908
RACHEL J. HARRIS	RHARRIS@LOEB.COM	310.282.2175
TANYA A. HARVEY	THARVEY@LOEB.COM	202.618.5024
DIARA M. HOLMES	DHOLMES@LOEB.COM	202.618.5012
AMY L. KOCH	AKOCH@LOEB.COM	310.282.2170
KAREN L. KUSHKIN	KKUSHKIN@LOEB.COM	212.407.4984
THOMAS N. LAWSON	TLAWSON@LOEB.COM	310.282.2289
ALEXANDRA A. LETZEL	ALETZEL@LOEB.COM	310.282.2178
JEROME L. LEVINE	JLEVINE@LOEB.COM	212.407.4950
JASON R. LILIEN	JLILIEN@LOEB.COM	212.407.4911
JEFFREY M. LOEB	JLOEB@LOEB.COM	310.282.2266
MARY ANN MANCINI	MMANCINI@LOEB.COM	202.618.5006
TALIA G. METSON	TMETSON@LOEB.COM	212.407.4285
ANNETTE MEYERSON	AMEYERSON@LOEB.COM	310.282.2156
DANIELLE E. MILLER	DEMILLER@LOEB.COM	310.282.2083
VICTORIA P. MORPHY	VMORPHY@LOEB.COM	212.407.4172
DAVID C. NELSON	DNELSON@LOEB.COM	310.282.2346
STEVEN M. OLENICK	SOLENICK@LOEB.COM	212.407.4854
LANNY A. OPPENHEIM	LOPPENHEIM@LOEB.COM	212.407.4115
MARCUS S. OWENS	MOWENS@LOEB.COM	202.618.5014
RONALD C. PEARSON	RPEARSON@LOEB.COM	310.282.2230
ALYSE N. PELAVIN	APELAVIN@LOEB.COM	310.282.2298
PRESTON QUESENBERRY	PQUESENBERRY@LOEB.COM	202.524.8470
JONATHAN J. RIKOON	JRIKOON@LOEB.COM	212.407.4844
TZIPPORAH R. ROSENBLATT	TROSENBLATT@LOEB.COM	212.407.4096
BRANDON A.S. ROSS	BROSS@LOEB.COM	202.618.5026
STANFORD K. RUBIN	SRUBIN@LOEB.COM	310.282.2090
LAURIE S. RUCKEL	LRUCKEL@LOEB.COM	212.407.4836
CRISTINE M. SAPERS	CSAPERS@LOEB.COM	212.407.4262
JOHN F. SETTINERI	JSETTINERI@LOEB.COM	212.407.4851
MEGAN A. STOMBOCK	MSTOMBOCK@LOEB.COM	212.407.4226
JENNIFER TAM	JTAM@LOEB.COM	202.618.5023
ALAN J. TARR	ATARR@LOEB.COM	212.407.4900
STUART P. TOBISMAN	STOBISMAN@LOEB.COM	310.282.2323
JESSICA C. VAIL	JVAIL@LOEB.COM	310.282.2132
GABRIELLE A. VIDAL	GVIDAL@LOEB.COM	310.282.2362
BRUCE J. WEXLER	BWEXLER@LOEB.COM	212.407.4081
DANIEL M. YARMISH	DYARMISH@LOEB.COM	212.407.4116