LOEB & LOEB LLP

High Net Worth Family TAX REPORT

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There Is Still Time to Make Annual Gifts

If you have not done so already in 2006, consider making gifts of up to $12,000 to family members or anyone else to whom you wish to make a gift. There is an annual gift tax exclusion, currently $12,000, available for each person to make gifts to an unlimited number of individuals. This is a "use it or lose it" exclusion as it is available each year, but if not used in a particular year it does not carry over.

Many clients take advantage of the annual exclusion to make gifts each year to their children, grandchildren, and in some cases more distant family members. A husband and wife can each make a $12,000 gift to a particular person (and if the gift is made from community funds, it is treated as being made by them equally). If the donee is a minor, the gift can be made to a custodianship account under the Uniform Transfers to Minors Act, to be held until the minor attains the age specified under that state's applicable act (in California, that can be extended beyond the age of majority to 21 if you so specify when you create the account). Normally, neither the donor nor the donor's spouse should serve as the custodian, in order to avoid any risk that the assets will be included in his or her taxable estate.

The annual gift can also be made to certain types of trusts. Since the gift must be a present interest to qualify, the trust to which it is transferred must permit the beneficiary the right to withdraw it for some period of time, and the beneficiary must be given notice of this right. These trusts are commonly referred to as "Crummey" trusts and the letter notifying the beneficiary of his right to withdraw the gift is referred to as a "Crummey Letter" or "Crummey Notice." The annual gift can also be made to a trust that terminates at age 21.

The amount of the annual gift tax exclusion is adjusted for inflation. The Internal Revenue Service has recently announced that based on the applicable cost of living index, the exclusion amount will remain at $12,000 for 2007.

Have You Addressed Your Charitable Contributions?

Everybody should review his or her year-to-date charitable contributions to determine whether additional gifts should be made before the end of the year to achieve the maximum tax benefit for the deduction. This can depend upon a number of factors that often entail a degree of complexity and is something best reviewed with your tax advisers.

In August, we reported on the charity-related provisions of H.R. 4, the Pension Protection Act of 2006 which was signed into law by President Bush on August 17, 2006. One of those provisions enables taxpayers who have reached the age of 70 1/2 to transfer up to $100,000 a year in assets from an Individual Retirement Account (IRA) to a qualified charity.

"The ability to transfer amounts from an IRA to a charity without including the amount in income may be more valuable than the deduction a taxpayer would receive if he simply wrote a check to the charity."

The provision applies only to IRAs, not to other types of qualified retirement accounts. For this purpose, the charity must generally be a public charity and not a private foundation, donor-advised fund, charitable split-interest trust, or supporting organization. The amount transferred from the IRA to the charity does not have to be included in the donor's income, although no separate charitable contribution deduction is allowed. This benefit is available only for tax years 2006 and 2007.

The ability to transfer amounts from an IRA to a charity without including the amount in income may be more valuable than the deduction a taxpayer would receive if he simply wrote a check to the charity. This is because itemized deductions are subject to various limitations and phaseouts that are not applicable if an amount is transferred from an IRA.

The Right Way and the Wrong Way to Leave Your Individual Retirement Account to Charity

An IRA or other retirement plan account can be an ideal asset to leave to charity at one's death. Such an account is included in the decedent's estate for estate tax purposes, and the beneficiary of the account will also have to pay income tax when amounts are withdrawn. This double tax potential may make a charitable gift attractive. However, it needs to be done in the right way.

In *Private Letter Ruling 200617020*, the decedent's estate was named the beneficiary of his IRA. His will left the residue of his estate to a charity. Under Section 691 of the Internal Revenue Code (IRC), items of income due to a decedent but not properly includable in the decedent's taxable income for his final taxable year will represent taxable income when received by the decedent's estate or the person who receives the item as a result of a bequest, devise or inheritance from the decedent. More simply stated, the basis step-up at death does not apply to items of income the decedent was entitled to receive at the time of his death. In this case, because the charity was the residuary beneficiary of the decedent's estate, the IRS ruled that the charity, and not the estate, would include distributions from the IRA in income. Of course, the charity is a tax-exempt organization and does not have to pay tax on such amounts. The decedent could receive an estate tax charitable deduction for the full amount in the account without recognizing taxable income.

Contrast this with the facts of Internal Legal Memorandum 200644020. In this case, the decedent had set up a revocable trust that provided, upon his death, the sum of $100,000 to be distributed in cash or in kind to each of three charities. The trust was the beneficiary of the decedent's IRA, and the trustee instructed the IRA custodian to create an account for each of the charities. IRC Section 691(a)(2) provides that if the right to receive an amount of income in respect of a decedent is transferred by a sale or exchange, then the estate of the decedent recognizes an amount of income equal to the fair market value of the right transferred, plus any amount of consideration in excess of the fair market value received for such right. Because the trust had used the IRA to satisfy specific bequests of pecuniary sums, the IRS held that IRC Section 691(a)(2) was applicable and the estate recognized ordinary income equal to the fair market value of the IRA transferred to the charities. Even worse, the trust did not receive a charitable contribution deduction, because the terms of the trust did not direct the trustee to use trust income to pay charitable gifts.

An IRA or other type of retirement account can be transferred to a charity as part of the residue of a decedent's estate or trust or can be specifically gifted to the charity without adverse tax consequences. However, if the decedent's will or trust leaves a pecuniary sum to a charity, an IRA or other retirement account should not be used to satisfy that gift.

Charitable Contributions of Property Require Qualified Appraisals

In *Ney v. Commissioner*, decided by the Tax Court in September 2006, the taxpayers were denied a charitable contribution deduction for a bargain sale of real property to a charity because they did not comply with the appraisal requirements. Appraisals are required with respect to donations of property worth more than $5,000 and Treas. Reg. 1.170A-13(c)(3) contains very specific requirements that must be satisfied with respect to the appraisal. Regulations also set forth requirements and qualifications that must be satisfied by the person rendering the appraisal.

In this case, the court determined that the appraisal offered by the taxpayer did not satisfy the requirements of the regulations. Consequently, no charitable contribution deduction was allowed. When making a gift of property to a charity, it is extremely important that you obtain an appraisal from a qualified appraiser meeting all the requirements set forth in the regulations. These requirements are also set forth in the instructions to Form 8283, which must be attached to the taxpayer's return for the taxable year with respect to which deduction is claimed.

IRA Rollover Options Expanded

The Pension Protection Act of 2006 expanded the rollover options available to taxpayers with respect to IRAs and accounts in qualified retirement plans. Under prior law, retirement plans often provided that if a participant's account balance was left at his death to someone other than his spouse, the amount was paid to the nonspouse beneficiary in a single lump-sum. This resulted in the beneficiary having to pay income tax on the full amount of the lump sum distribution. Under the Pension Protection Act of 2006, beginning in 2007 the plan must offer the nonspouse beneficiary the right to make a trustee-to-trustee transfer of the decedent's account balance into an IRA account set up by the beneficiary. From that IRA account, the beneficiary may withdraw the inherited benefit over his own life expectancy, and if he dies before the entire account has been withdrawn, the balance may be paid to his beneficiaries, using the remaining years of his life expectancy. Thus, beginning in 2007 a nonspouse beneficiary can no longer be forced to accept an immediate lump-sum distribution and the tax liability it would entail. The ability to have the benefit transferred may also give the beneficiary more investment flexibility than if the account balance had remained in the prior plan.

A number of aspects of the new law will need to be clarified. For example, it is not clear whether benefits may be rolled over to a trust if a trust is designated as the nonspouse beneficiary. As some of these issues are clarified, we will report on them in future editions of this newsletter.

Ability of States to Tax Partners' Retirement Payments Is Clarified

In 1996, Congress enacted P.L. 104-95, called the Pension Source Act. The act prohibits states from taxing retirement income of any individual who, upon receipt of the income, was not a resident or domiciliary of that state. Prior to this law, many states taxed retirement income if an employee had worked in the state while his retirement benefit was being earned, even if he moved to another state after retiring. The original act was ambiguous as to the treatment of retirement benefits earned by self-employed individuals and partners in partnerships.

Congress recently enacted P.L. 109-264, which clarifies the Pension Source Act by providing that its limits on state taxation do apply to the retirement earnings of self-employed individuals and partners in partnerships, as well as to those

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of common-law employees. The correction is retroactive to the original effective date of the Pension Source Act, which was applicable to amounts received after December 31, 1995. This raises the possibility that retired partners who have paid income tax to states in which they are not resident may be entitled to claim a refund.

Internal Revenue Service Limits Private Annuity Sales

Without advance warning, the IRS proposed regulations on the taxation of private annuity sales that overruled a revenue ruling on which taxpayers had relied for 37 years. A private annuity arises where someone transfers property to another person and the recipient of the property agrees to make actuarially determined payments to the transferor until the transferor's death. The actuarial calculation takes into account the transferor's age but not the condition of his health, unless he is likely to die within one year.

The value of this type of private annuity is determined by using standard mortality tables prescribed by the IRS. Taxpayers often take advantage of these rules in circumstances where the transferor is in poor health. For example, if a person of the transferor's age would normally have a 25-year life expectancy, but the particular transferor is seriously ill and expected to live only about three more years, he can transfer property to a family member for a stream of annuity payments that would be valued based upon the assumption that he is going to live 25 years. If he passes away after having received only three years of payments, he will have effectively made a bargain sale to the family member without any estate or gift tax consequences.

Under Rev. Rul 69-74, the taxpayer was also allowed to spread out any capital gain that he recognized over the number of annuity payments (25 in the above example) that he would be expected to receive based on his life expectancy. If the taxpayer dies after receiving only three payments, he avoids recognizing most of his tax gain.

The new proposed regulations, effective for transactions after October 18, 2006, provide that all of the seller's gain is taxed in the year of the transaction, based upon the fair market value of the annuity contract determined under the applicable mortality tables; in our example, assuming he will receive 25 payments.

Note that nothing in these regulations really diminishes the value of this technique to extract property from one's taxable estate at a discount. It simply requires the immediate recognition by the transferor of any tax gain inherent in the property. A private annuity sale can still be a valuable planning technique with respect to property that has little or no income tax gain.

Buy/Sell Agreements Funded by Life Insurance Need to be Reviewed After the Pension Protection Act of 2006

The Pension Protection Act of 2006 enacted new IRC Section 101(j), which deals with the income tax consequences of corporate-owned life insurance, commonly referred to as COLI. The new provisions were enacted to stop certain abuses, which included, among other things, employers purchasing life insurance policies on their employees and not even telling the employees of the existence of the policies. Under the new rules, unless an exception applies, the proceeds of life insurance received by an employer or a related party on the life of an employee is tax-free only to the extent of the premiums paid by the employer. Any excess is now taxable income.

In a common type of buy/sell agreement, sometimes referred to as an "entity purchase agreement," on the death of an owner, the company has a contractual obligation to purchase his shares or other ownership interests. Sometimes the liquidity to make such purchase is arranged by the company taking out life insurance policies on its owners. Such an arrangement would fall under the new rules contained in IRC Section 101(j) for corporate-owned life insurance. There is an exception to the taxability rule available for policies, the proceeds of which are used to purchase an interest in the company from one of its owners; however, certain notice and consent requirements must be satisfied.

Other types of buy/sell arrangements that are funded with life insurance can fall under these new rules as well. Under related party provisions contained in the new rules, even "cross-purchase arrangements" may be covered. A cross-purchase arrangement occurs when the other owners agree to purchase the interest of a deceased owner and may own policies on each other's lives to fund the purchase. Again, an exception is available, provided that the notice and consent requirements are satisfied.

The new rules are applicable only to policies issued after August 17, 2006. However, material changes to policies issued on or before August 17 will result in those otherwise grandfathered policies becoming subject to the new rules.

Another Circuit Court Weighs In on the Treatment of Fees Paid by a Trust for Investment Advice

There has been an ongoing tax controversy about investment advisory fees paid by trusts. The controversy involves IRC Section 67 and whether such fees are subject to the 2 percent of adjusted gross income floor before they may be deducted. Trusts are generally treated in the same manner as individuals for the purposes of IRC Section 67. However, Code Section 67(e)(1) does contain an exception for trusts, which provides that the limitation does not apply to costs paid in connection with the administration of a trust that would not have been incurred if the property was not held in trust.

In *Rudkin Testamentary Trust v. Commissioner*, the Court of Appeals for the Second Circuit held that investment advisory fees incurred by a trust are subject to the 2 percent floor. The court reasoned that an individual can incur investment advisory fees, and therefore such fees do not qualify for the exception, which most clearly applies to trustees' fees. This issue had previously been addressed by the Fourth and the Federal Circuits, which held the same as the Second Circuit. It had also been addressed by the Sixth Circuit, which went the other way and held that such fees are not subject to the 2 percent floor. This is an issue that may ultimately be resolved by the Supreme Court, due to the conflict among the various Courts of Appeal.

A possible way around the limitation would be to pay the trustee a larger fee and then have the trustee pay the investment advisory fees itself, rather than having them separately billed to the trust. However, given the IRS position on this matter, there is no assurance that the IRS would not still seek to subject a portion of the trustee fees to the 2 percent floor.

Court of Appeals for District of Columbia Circuit Holds That Damages for Emotional Distress Cannot be Taxed

In August, the Court of Appeals for the District of Columbia Circuit held that damages received by a taxpayer for the infliction of emotional distress are not income within the meaning of the 16th Amendment to the Constitution and therefore cannot be subjected to income tax. The case was *Murphy v. U.S.,* where the taxpayer had received damages from her employer because she had been blacklisted and given unfavorable employment references as the result of having been a "whistleblower." The damages were awarded to her for emotional distress and injury to her professional reputation.

"Relying on an old Supreme Court case, the Court of Appeals held that these damages were not income, because income must represent 'gains' or 'ascensions of wealth.'"

IRC Section 104(a)(2) excludes from income only those damages that are awarded for personal physical injuries or sickness. This section had been amended in 1996 for the specific purpose of limiting the exclusion to physical injuries and not permitting income to be excluded when damages were awarded for emotional distress. Relying on an old Supreme Court case, the Court of Appeals held that these damages were not income, because income must represent "gains" or "ascensions of wealth." Other courts have indicated that damages for emotional distress are taxable as income and not subject to exclusion because of IRC Section 104(a)(2).

The government has requested that the case be reheard by the entire court. Most likely, the result will be reversed; if it is not, this case will almost certainly end up before the Supreme Court due to the fundamental nature of the issue.

IRS Promises Guidance on Charitable Reforms Contained in the Pension Protection Act of 2006

The IRS has recently issued Notice 2006-109 announcing that it will publish interim guidance on the supporting organization and donor-advised fund reforms included in the Pension Protection Act of 2006. This is of great importance to grant-making private foundations. The Notice provides guidance for reliance on representations by the grantees as to their tax classification. If your private foundation is making a grant and you are not sure of the grantee's tax classification, be sure to consult your attorney or accountant for more information.

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Family Limited Partnerships Are Still in the News

Every issue of this newsletter has reported some new development with respect to family limited partnerships or limited liability companies, and this one is no exception. Litigation still abounds over the appropriate discounts to take into account with respect to minority interests in these entities for estate and gift tax purposes, and whether the full value of the partnership's assets should be included in the estate of a decedent who attempted to give away the partnership interests during his lifetime.

A recent Tax Court case, *Langer v. Commissioner*, is interesting not because of the result that the court reached, but because of what a footnote in the opinion revealed about the parties' negotiations before the case reached the court.

The only issue for the court to decide was the value of some real property that was owned by a family limited liability company. It was a question of fact, and the court was not required to make any rulings on any legal issues.

In a footnote early in the opinion, the court summarized the points on which the taxpayer and the IRS had agreed before trial, as reflected in the stipulation of facts that the parties had filed with the court. One of the facts agreed to by the parties was that a combined discount of 47.5 percent would be applied to the interest in the limited liability company owned by the decedent. In other words, the court would determine the value of the real property, multiply that by the decedent's percentage interest in the limited liability company, and then subtract 47.5 percent of that number.

For the moment, substantial discounts continue to be available. As we reported previously, the taxpayers who lose tend to be the ones with the "bad facts" cases, typically where somebody creates a partnership on his or her deathbed and then tries to use it to give away all the assets.

Estate and Gift Tax Discounts Go Both Ways

With all the attention being paid to estate tax discounts for fractional interests, it is worthwhile to take a moment and remember that it is the final estate tax value of property that determines the income tax basis for the person who acquires the property from the decedent. A lower estate tax value means a lower income tax basis and a larger gain when the property is sold. If the property is a capital asset, the estate tax discount is still very valuable, because the estate tax rate (45 percent beginning in 2007) is considerably higher than the capital gains tax rate (currently 15 percent plus state taxes).

In *Janis v. Commissioner*, the Court of Appeals for the Ninth Circuit (with jurisdiction over California) affirmed a Tax Court decision held that taxpayers must be consistent between the estate tax valuation and the income tax basis claimed. The decedent owned a valuable and extensive art collection. The estate successfully negotiated a substantial "blockage" discount with the IRS on the theory that the prices of the works of art would be depressed if they were all put on the market at the same time. For income tax purposes, the successors to the estate claimed a tax basis equal to the full value before the blockage discount was applied.

Despite some very clever arguments by their counsel, the court nevertheless held that taxpayers have a duty to be consistent between the estate tax valuation and the income tax basis they later claim.

A slightly different twist on this issue was presented in *Koblick v. Commissioner*, another case decided by the Tax Court earlier this year. The taxpayer donated a 45 percent interest in a closely held corporation to a charity. The IRS argued that the taxpayer's charitable contribution should be reduced by a minority interest discount. The court agreed, although it imposed a smaller discount than the IRS was seeking. One has to question whether the IRS strategy of seeking to impose a discount was well thought out. Our guess is that discounts save taxpayers many of estate and gift taxes compared to what they may cost in terms of reduced charitable contribution deductions.

IRS Reviews Tax Consequences of Converting Cooperative Apartments to Condominiums

In *PLR 200645001*, the IRS addressed the consequences of a corporation owning cooperative apartments, converting them to the condominium form of ownership, and distributing them to the tenant-stockholders of the corporation. The ruling addressed the consequences both to the corporation and to the tenant-stockholders. As to the corporation, IRC Section 216(e) provides that the corporation will not recognize gain upon the distribution of an apartment unit to a stockholder in exchange for his stock, provided that the stockholder occupies the apartment as his principal residence within the meaning of IRC Section 121.

As to the tenant-shareholder, the exchange of his stock for his apartment unit is treated as a sale or exchange upon which gain is recognized; however, gain of up to $250,000 ($500,000 on a joint return) can be excluded if the taxpayer meets the requirements of IRC Section 121. The requirements generally are that the taxpayer must have used the apartment as his principal residence for a period of two years or more out of the last five years and has not made another sale excluded under Section 121 in the two prior years.

Some HR 4 Tidbits

We close with a few quick bullet points on other provisions of the Pension Protection Act of 2006:

- The ability to make tax-free withdrawals from IRC Section 529 plans, originally scheduled to sunset after 2010, has been made permanent. Up to five years of contributions can be made in one year without paying gift tax (although a gift tax return must be filed).
- Significant limitations were placed on the ability to make a fractional gift of property to a charity, e.g., shared use of a painting given to an art museum. Be careful here pending further clarifications.
- The act expanded from two years to three years the amount of time a charity must file a return to report the sale of a noncash gift.
- Written receipts are now required for cash charitable contributions of any size.
- The private foundation excise taxes have been doubled.
- Many new restrictions have been placed on donor-advised funds. If you have set up such a fund, expect to receive a letter from the sponsoring organization apprising you of these new limitations.

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