High Net Worth Family

TAX REPORT

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New California Law May Require Individual Trustees of Trusts to Be Licensed

The California Professional Fiduciaries Act becomes effective on January 1, 2009. It was scheduled to have become effective on July 1, 2008, however in October, the effective date was extended by the enactment of Senate Bill 1047. The Act requires a person meeting the definition of a "professional fiduciary" to obtain a license to act in such capacity. A professional fiduciary is a person who acts as a conservator or guardian for two or more persons at a time or who acts as a trustee, an agent under a durable power of attorney for healthcare, or an agent under a durable power of attorney for finances for more than three people or more than three families (an ambiguous term), or any combination thereof at the same time. While the new law is generally not applicable until January 1, 2009, under Probate Code Section 2340, any trustee appointed by a court after July 1, 2008, will have to be licensed.

There is an important exception that excludes from the licensing requirement any individual serving in such a fiduciary capacity for members of his own family. There is also an exception to the licensing requirement for attorneys licensed to practice in California and for certified public accountants licensed to practice in California. The licensing requirement could be applicable to business managers, personal managers and financial advisors who serve as trustee for their clients, unless they are either California attorneys or certified public accountants.

If you are required to be licensed, there are a variety of requirements that you will have to satisfy, including completing thirty hours of prelicensing education courses prescribed by the bureau that will be set up to administer this law, and passing a licensing examination also

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administered by that bureau. There are certain minimum educational or work experience requirements imposed as well.

There is some uncertainty how these provisions may apply to investment advisors. A person is exempt from licensing if he acts in a fiduciary capacity only as a broker-dealer, broker-agent, or an investment advisor representative registered under the California Securities Law of 1968, the Investment Advisors Act of 1940 or the Securities Exchange Act of 1934. If such an advisor serves in any fiduciary capacity beyond the handling of his clients' investments, such as by serving as the trustee of a family trust, he will have to be licensed unless he is a California attorney or certified public accountant.

Ninth Circuit Addresses Family Limited Partnerships

The wave of litigation over the efficacy of family limited partnerships has not abated. For the first time, the United States Court of Appeals for the Ninth Circuit has considered one of these cases. This is especially significant for many of our clients because tax cases appealed by California taxpayers are heard by the Ninth Circuit. *Estate of Bigelow v. Commissioner* was another example of what we refer to as a "bad facts" case. After the decedent had suffered a debilitating stroke, her son acted through a durable power of attorney to create a family limited partnership in December, 1994, and transferred the bulk of the decedent's assets to the partnership. The principal asset transferred was a parcel of income producing real property. The property was encumbered by a mortgage and the decedent retained the liability to pay the mortgage when the property was transferred to the partnership. Nevertheless, the partnership actually made the monthly payments required on the mortgage.

In the two years preceding the decedent's death in 1997, the partnership also made approximately forty transfers to the decedent to enable her to pay her living expenses. The partnership characterized these transfers as interest free loans in its accounting records. When the decedent's estate tax return was filed, a discount of 37% for lack of marketability was claimed in valuing the interest in the limited partnership.

This case was typical of the "bad facts" cases in that the decedent, in the last few years of her life, transferred the bulk of her assets to a family limited partnership. The transfer left her unable to pay her living expenses without resort to the assets of the partnership. Thus, when the Tax Court heard the case, it had no trouble concluding that there was an implied agreement between the decedent and the partnership that allowed the decedent to retain for her life the economic benefit of the property she transferred to the partnership. The Tax Court held that all of the assets that the decedent transferred to the partnership were includable in her estate for estate tax purposes under IRC § 2036(a)(1)[1]. On appeal by the taxpayer, the Ninth Circuit agreed with the Tax Court, especially focusing on the fact that although the decedent had retained the obligation on the mortgage encumbering the property that she transferred to the partnership, the partnership nevertheless made the mortgage payments because the decedent did not have the resources to do so.

Even though the courts found that the decedent had retained the right to the income from the property during her lifetime, the transfer would not have been brought back into her estate for estate tax purposes if it could have been demonstrated that the transfer constituted a bona fide sale for adequate and full consideration. Other courts have essentially equated this test to a business purpose test. That is, in order for the transaction to be considered a bona fide sale for adequate consideration, it must be demonstrated that there were non-tax related business purposes involved in the making of the transfer. The Ninth Circuit found that such was not the case here, given that the transfer virtually impoverished the decedent.

1. References to "IRC" are to the Internal Revenue Code of 1986, as amended.

The many family limited partnership cases that have reached the courts over the last several years have provided a wealth of information on how these entities should be structured in order the maximize the chances that they will accomplish their primary objective of creating substantial valuation discounts for estate and gift tax purposes. We have recently begun contacting clients for whom we have created these entities over the last several years. We encourage anyone who has created a family limited partnership (or limited liability company) more than a year ago to contact us about updating the form of the agreement to insure that it contains provisions that are helpful and does not contain any provisions that are harmful. It is also important that these entities be operated in a business-like manner. We can provide guidance as to the various factors looked to by the courts in making these evaluations. Probably the single most important consideration in forming a family limited partnership or limited liability company is not to transfer so much of your wealth to the partnership that you are unable to pay your living expenses without resort to the partnership assets. Many of the family limited partnership valuation discount cases that taxpayers have lost had this particularly bad fact.

IRS Explains When Security Will Be Required to Defer the Payment of Estate Tax

In our last issue (Vol. II, No. 1, June, 2007), we reported on *Estate of Roski v. Commissioner*, where the Tax Court held that the IRS could not automatically require a bond or special lien in order to defer the payment of estate taxes under IRC § 6166. Section 6166 is extremely important for many high net worth families in that it allows the deferred payment of estate taxes where an interest in a closely held business accounts for more than 35% of a decedent's adjusted gross estate. Prior to *Estate of Roski*, the IRS interpreted IRC Section 6166 in a manner such that it required estates to either post a bond or agree to a special lien on the estate's assets in order to qualify for such deferral. *Estate of Roski* held that the IRS must make a good faith determination in each case as to whether such bond or lien should be required to secure payment of the deferred estate tax.

In response to the *Roski* case, the IRS recently issued Notice 2007-90 outlining the factors it would consider in determining if a bond or special lien is to be required. These factors include: (i) the duration and stability of the business; (ii) the ability of the estate to pay the installments of tax and interest on a timely basis; and (iii) the compliance history of the business regarding federal tax payments and required filings. The IRS will base its determination on information contained in the federal estate tax return and other information obtained during the audit of the return. In addition, it may ask the estate to provide further information. If the IRS determines that a bond or special lien is required, the estate may seek reconsideration of that determination by the IRS Office of Appeals. The IRS also indicated that it will eventually issue regulations on this subject.

This is an important positive development for families whose wealth is significantly comprised of an interest in a closely held business. Obtaining a bond to ensure the payment of the deferred estate tax is often prohibitively expensive, if available at all. The alternative procedure of allowing a special lien to attach to the assets can often hinder the ability of the business owners to obtain necessary financing for their business. Thus, the change of view on the part of the IRS with respect to this matter is very welcome indeed.

IRS Expands Extension of Deadline for Internal Revenue Code Section 409A Compliance

On October 22, 2007, the Internal Revenue Service issued Notice 2007-86 (the "October 2007 Notice"), which extends the effective date of the final regulations issued under Internal Revenue Code section 409A by one year, to January 1, 2009. The reporting requirements under Section 409A requiring employers to report contributions and earnings under nonqualified deferred compensation arrangements

have been delayed until 2009 as well. As we have described previously, Section 409A applies to virtually any nonqualified deferred compensation plan, agreement or arrangement that provides for the payment of compensation in a year after it is earned, potentially including not only nonqualified deferred compensation and retirement plans but also employment and consulting agreements, bonus plans, stock option plans, reimbursement arrangements, split dollar arrangements and royalty arrangements (collectively, "nonqualified plans"). If a nonqualified plan does not conform to Section 409A, participants in the plan are required to immediately include in income any amounts vested under the plan and to pay additional interest, penalties and a 20% excise tax.

The October 2007 Notice effectively revokes and supersedes most of the substantive provisions contained in IRS Notice 2007-78, issued just the previous month, which had extended by one year the deadline for bringing a nonqualified plan into full *written* compliance with Section 409A, but left unchanged the original January 1, 2008, deadline for specifying in writing any provisions relating to the time and form of payment of benefits under the plan, and for operating the plan in full compliance with Section 409A. The October 2007 Notice, by contrast, does not require operational compliance with the final Section 409A regulations during 2008 and essentially extends the transition rules allowing for the revision of documents and payment terms in almost all respects to January 1, 2009.

Although the relief provided by the October 2007 Notice is quite comprehensive, it is not absolute. For example, an election regarding the time and form of payment under a nonqualified plan that is linked to a similar election under certain qualified plans will be governed by the applicable provisions of the final Section 409A regulations as if their effective date had not been extended. While changes in distribution elections may now be made in 2008 without application of the final Section 409A regulations, in order to apply to distributions in 2008, such changes need to be in place by January 1, 2008. Thus, it is still the case that the opportunity to change the timing of 2008 payouts will expire on December 31, 2007.

The fact that the IRS felt the need to issue a second notice providing more comprehensive relief from the original effective date contained in the final Section 409A regulations further underscores just how much time and effort will be required of many taxpayers to ensure that their nonqualified plans fully comply with Section 409A. In many cases, this effort will involve careful consideration of the changes required, as well as obtaining various consents to implement the changes. Moreover, the IRS has indicated it will not support any additional delays for compliance with Section 409A. Accordingly, taxpayers should begin the process of bringing their nonqualified plans into compliance with Section 409A as soon as possible.

IRS Issues Proposed Regulations on Application of 2% of AGI Floor to Estates and Trusts

Under IRC Section 67, miscellaneous itemized deductions are allowed only to the extent that they exceed 2% of a taxpayer's adjusted gross income. In general, an estate or trust is subject to these rules in the same manner as an individual taxpayer. However, IRC § 67(e)(1) contains an exception for costs paid or incurred in connection with the administration of an estate or trust that would not have been incurred if the property was not held in an estate or trust. Such amounts are not subject to the 2% floor of IRC § 67.

In 1992, the Tax Court held in *O'Neill v. Commissioner* that investment counseling fees paid by an estate or trust were subject to the 2% floor because individuals can incur these same costs in the same manner as an estate or trust. The following year, the Sixth Circuit reversed the Tax Court's decision, holding that the fiduciary duties of an executor or trustee distinguished him or her from other individuals. In subsequent litigation, a number of other circuits adopted the Tax Court's approach. We previously

reported (Vol. I, No. 3, December, 2006) on the *Rudkin* case, where the Second Circuit held that fees for investment management are subject to the 2% floor. The *Rudkin* case is now pending before the United States Supreme Court and should be resolved during this term.

In July, the IRS issued proposed regulations to address the matter. The regulations provide that in order for a cost to be eligible for the exception of IRC § 67(e)(1), it must be unique to an estate or trust, which means it must be the type of cost that an individual could not have incurred if the same property was held outside of an estate or trust. The most common of these costs is trustee's fees. One strategy that was being used to avoid the 2% floor problem was the bundling of investment advisory fees and trustee's fees into a single fee and claiming it was a trustee's fee eligible for the IRC § 67(e)(l) exception. The proposed regulations require that where a single trustees' fee is paid that includes services for investment advice, a reasonable allocation of the bundled fee must be made and the portion of the fee attributable to investment advice subject to the 2% of AGI Floor.

The proposed regulations also provide specific examples of services that either do or do not qualify for the exemption. Qualifying services include costs of fiduciary accountings, judicial or quasi-judicial filings required as part of the administration of the estate or trust, preparation of fiduciary income tax and estate tax returns, the division or distribution of income or corpus to or among the beneficiaries, fees incurred for trust or will contests or constructions, fiduciary bond premiums and communications with beneficiaries regarding estate or trust matters. Services that do not qualify for the exception include fees for the custody or management of property, advice on investing, preparation of gift tax returns, defense of claims by creditors of the decedent or trust grantor and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property. The proposed regulations are not effective until they are finalized by the IRS, although the treatment of investment management fees will likely be resolved by the Supreme Court before that occurs.

What Is the Statute of Limitations for the Overstatement of the Income Tax Basis of an Asset?

In general, the IRS has a period of three years from the later of the due date of a federal income tax return or the date on which it is actually filed to assess additional taxes with respect to that return. However, this period is extended to six years if the amount of gross income omitted from the return exceeds 25% of the amount of gross income actually reported on the return. IRC § 6501(e)(1)(A). Many of the aggressively marketed tax shelter transactions of the 1990's resulted in the creation of artificially high basis in assets that could then be sold to create losses in order to offset other income or gains. A question arises whether overstating the basis of an asset is equivalent to omitting gross income from the return. In *Bakersfield Energy Partners, L.P. v. Commissioner*, decided in June, the Tax Court held that only the three-year statute of limitations applies to situations where the taxpayer has deducted an artificial loss as a result of having overstated his tax basis in an asset.

The taxpayers relied on, and the Tax Court followed, an old Supreme Court case called *Colony v. Commissioner* where the Supreme Court had said that the reason for the six year statute of limitations was to provide protection to the IRS in circumstances where the return itself does not offer any indication that an item is missing. Where basis is overstated in connection with the sale of an asset, the basis amount, as well as the sales price both appear on the return itself. The Supreme Court in *Colony* and the Tax Court in *Bakersfield Energy Partners* both concluded that this was adequate notice to the IRS and that only the three-year statute of limitations should be applicable.

This is a very significant taxpayer victory, although somewhat dampened by the fact that shortly after this case, a United States District Court in *Brandon Ridge Partners v. U.S.* went the other way and held that a basis overstatement can trigger the application of the six-year statute. Nevertheless, the Tax Court case is probably more significant since most taxpayers choose this forum for the litigation of contested tax matters. In addition to *Bakersfield Energy Partners*, the Court of Federal Claims in *Grapevine Imports Limited v. U.S.* also held that only the three-year statute of limitations applies to overstatements of basis.

Payment from Stockbroker for Mishandling Account Qualifies for Long Term Capital Gain Treatment

In PLR 200724012, the IRS addressed the federal income tax treatment of a settlement received by a taxpayer from his stockbroker for the alleged mishandling of his account. The alleged mishandling resulted in the taxpayer suffering losses which were treated as capital losses. Since the settlement payment was integrally related to the prior loss, the IRS ruled that it was entitled to be treated as a long term capital gain and subject to the reduced 15% rate of tax on such gains.

This ruling represents the application by the IRS of a long standing doctrine first set forth by the Supreme Court in the case of *Arrowsmith v. Commissioner*. In *Arrowsmith*, the circumstances were reversed in that the taxpayer had realized a capital gain upon a liquidation of a corporation and in a subsequent year was required to pay a liability attributable to the corporation. The Supreme Court held that the two transactions were integrally related and should be treated as parts of a single transaction. Thus, since the taxpayer had realized a capital gain on the liquidation, the later payment must be treated as capital loss. In the recent private letter ruling the loss came first, followed by a recoupment from the broker, which was allowed capital gain treatment.

Governor Signs Bill Changing the Manner in Which the California LLC Fee is Applied

We previously reported (Vol. I, No. 1, April, 2006) that a California Superior Court, in *Northwest Energetic Services v. California Franchise Tax Board*, had declared unconstitutional the fee imposed by Revenue and Taxation Code § 17942 on the gross income of limited liability companies. The basis for finding such fee unconstitutional was that it is applied to the world-wide income of all limited liability companies formed in California or formed elsewhere and qualified to do business in California. The failure to apportion the fee and apply it only to income from California sources could result in limited liability companies being subjected to duplicative taxation in multiple states on the same income. The Superior Court held that this violated both the Commerce Clause and the Due Process Clause of the United States Constitution. *Northwest Energetic Services* is still pending in the California Court of Appeals.

In September, Governor Schwarzenegger signed Assembly Bill No. 198 which revises § 17942 to limit the application of the fee to income from sources derived from or attributable to California. In the case of sales, they are assigned to California or another state using the same methodology used to determine the sales factor in the apportionment of the franchise tax on corporations. In addition, the Franchise Tax Board is authorized to aggregate multiple limited liability companies that are commonly controlled if it determines that the multiple companies were formed for the primary purpose of reducing the fees payable. Another positive aspect of the bill is that it clarifies that where a particular income item flows through multiple tiers of limited liability companies, it is subjected to the fee only a single time.

Finally, the bill addressed the many pending protective refund claims that have been filed. New Revenue and Taxation Code § 19394 provides that if the prior fee is ultimately determined to be unconstitutional, any refund to a taxpayer will be limited to that part of the fee paid that had been determined to be

unconstitutional. In most cases, that would be the application of the fee to income generated outside of California. This means that limited liability companies whose only income is from California sources will not receive any refund.

IRS Clarifies Application of Passive Loss Rules to Trusts

Under IRC § 469, losses incurred by individuals (including estates and trusts) in connection with passive activities are deductible only to the extent that the taxpayer also has income from passive activities. In general terms, a passive activity is an interest in a business with respect to which the taxpayer does not materially participate. There are a variety of tests for material participation, but the general benchmark is that the taxpayer must spend at least 500 hours per year in connection with the activity. How is this to be applied in the case of a trust?

The IRS recently provided some guidance with respect to this question in TAM 200733023. A testamentary trust acquired an interest in a limited liability company that was engaged in a business. The trustees of the trust provided certain administrative and operational services to the business. However, they also contracted with "Special Trustees" to perform other services for the business. The Special Trustees did not have any authority to legally bind the trust to any transaction or activity. The Special Trustees were heavily involved in reviewing operating budgets, analyzing a tax dispute among the partners and preparing and analyzing other financial documents. They also spent time negotiating the sale of the trust's interest in the entity to a new member. The trust reported a loss from this limited liability company on its return and concluded that it materially participated, based upon the hours spent by the trustees and the Special Trustees. In the Technical Advice Memorandum, the IRS took the position that only the time spent by the trustees counted toward the trust's material participation. The IRS analogized the Special Trustees to employees or agents of a business which, under IRC § 469(h)(1), do not count toward the material participation of the taxpayer himself.

The IRS position in this case is contrary to that taken by a United States District Court in Texas in the case of *Mattie K. Carter Trust v. United States*, where the court held that employees of the trust should be taken into account in determining whether the trust participated in connection with an activity. The IRS is essentially equating the trustee of a trust with an individual taxpayer. An individual may not count the time spent by his employees in determining whether he materially participated in a business. The IRS viewed the Special Trustees in the same light as employees in concluding that only the time spent by the actual trustees could be counted.

Kiddie Tax Extended to Age 24

In May of this year, Congress passed and the President signed The Small Business And Work Opportunity Act. One of the changes made by the Act was to extend from age 18 to age 24 the period during which a child's unearned income is taxed at the same marginal rate at which his parents' income is taxed. There is an exception for the first $1,700 of unearned income and any earned income, such as from summer jobs, which is taxed at the child's own rate. The extension to age 24 is limited to those circumstances where the child is a full-time student. If a child over the age of 18 is not a full-time student, then his unearned income is taxed at his own marginal rate.

This change further diminishes the benefit of income splitting transactions among family members. The dispersion of income producing assets among family members can be attractive because the maximum federal income tax rate of 35% is not reached for an individual taxpayer until his taxable income reaches $350,000. Thus, absent the kiddie tax provisions, considerable tax savings can be achieved by a family through the transfer of income producing assets to children, who would most often pay a lower rate of tax on the income produced by those assets than would have been paid by the parents.

Prior to 2006, the special kiddie tax rules applied only through age 13. In 2006, they were extended from 13 to 17 and then this year, they were extended by The Small Business And Work Opportunity Act up to age 24. The transfer of income producing assets can still be beneficial where the children are over 24 or over 18 and out of school.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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