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TAX REPORT

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CONTENTS

Court of Appeal Affirms Decision That LLC Fee Is Unconstitutional

The Superior Court decision which struck down the California LLC fee as applied to an LLC registered in California but conducting all its activities outside the state (*Northwest Energetic Services*) has now been affirmed by the Court of Appeal. A second case involving an LLC active both within and without the state (*Ventas Finance*) has been won by the taxpayer in Superior Court. It is unlikely that the Franchise Tax Board will pursue cases of these kinds any further; rather it will process all refund claims by LLCs according to the rules enacted by the Legislature in Assembly Bill 198 which we previously described to you (Vol. II, No. 2, November 2007). This means that LLCs with at least some out-of-state activity will have their fee liability reduced by apportioning their gross receipts to sources within and without the state by the sales factor rules set forth in Rev. & Tax. C. §§ 25135 and 25136; but LLCs operating entirely in California will receive no refund and will continue to be subject to an annual fee measured by their total gross receipts. The Franchise Tax Board reports that more than 90 percent of LLCs registered in California fall into this latter category.

There is a case still pending in court in which the fee is being challenged by an LLC doing business entirely in California (*Bakersfield Mall*). The argument that a tax measured by un-apportioned gross receipts is an unconstitutional discrimination against interstate commerce is not available to such a taxpayer, so the taxpayer is citing Article XIII, Section 26 of the California Constitution which authorizes income taxes and is contending that a gross receipts tax would also require constitutional authorization. We do not hold much hope for this argument but will keep you advised of developments.

Eleventh Circuit Allows Valuation Discount for 100% of Potential Tax on Built-in Gains

The Court of Appeals for the Eleventh Circuit has recently allowed a 100% discount for the corporate income tax that would be incurred upon a sale of the corporate assets, for purposes of establishing the estate tax value of shares representing a minority interest in the stock of a closely held corporation. In *Estate of Jelke III v. Commissioner*, the issue was the valuation of a 6.44% interest in a closely held corporation owned by the decedent. A corporate income tax of $51 million would have resulted if the corporation sold all of its assets.

The Tax Court previously allowed a discount of only $21 million, based on the notion that the assets would not be sold immediately, but rather over a period of sixteen years after a buyer acquired the stock, so a present value discount was applied by the court. The Eleventh Circuit thought that estimating present value required a lot of guess work about when assets would be sold. Instead, it determined that the valuation should assume that all of the assets would be sold on the date of the decedent's death, since that was the date for which the value of the stock needed to be established. Accordingly, it allowed a discount for the full amount of the income taxes that would be payable by the corporation upon such a sale.

This issue did not arise before 1986 because prior to that time, a corporation being liquidated could sell all of its assets without incurring corporate level income tax (often called the "General Utilities" rule). The law was changed in the Tax Reform Act of 1986 and corporations now incur a corporate level tax on gains resulting from the sale of their assets, even in liquidation. Taxpayers began arguing that these potential corporate level taxes should be taken into account in determining the value of corporate shares for estate and gift tax purposes. Until 1998, these arguments did not succeed in court. The tide began to turn in 1998 when the Tax Court, in a case called *Estate of Davis v. Commissioner*, held that potential tax liability could be taken into account as a part of the discount for lack of marketability.

In subsequent litigation, the Tax Court sometimes allowed discounts based on the present value of the tax, which in turn was based on an estimate of when the assets would be sold. In 2002, the Fifth Circuit allowed a 100% discount for potential corporate level taxes in a case called *Estate of Dunn v. Commissioner*. The block of stock being valued there was a majority interest where a buyer of the stock could force an immediate liquidation of the corporation. Many practitioners questioned whether a 100% discount would be allowed in valuing a minority interest, where a buyer of the interest would not be able to force a liquidation. In the Eleventh Circuit, the answer to that question is yes.

The potential tax on built-in gains can be a very significant issue in valuing closely held stock. We expect the litigation will continue and will keep you informed of further developments.

Partnership Tax Planning Structure Upheld by Tax Court

For the most part taxpayers have not fared well in court over the last several years, particularly where the transactions at issue had been designed to create specific tax benefits. Recently, taxpayers scored a stunning Tax Court victory in such a case. *Countryside Limited Partnership et. al v. Commissioner, (January, 2008)*, involved a partnership that owned appreciated real property which eventually would be sold. Two partners owning more than 90% of the total interests in the partnership wanted to be redeemed from the partnership before the gain from the sale of the property was realized.

If the partnership had simply distributed cash (or marketable securities) to the partners, they would have recognized taxable gain to the extent the amount distributed exceeded the income tax basis of their partnership interests. On the other hand, if the partnership distributed property other than marketable securities, the partners would not recognize gain. Instead they would take a basis in the property equal to the basis of their partnership interests and their gain would be deferred until they sold the distributed property.

In substance, Countryside borrowed money and used the money to purchase privately placed promissory notes. The notes were issued by a unit of AIG, a highly credit worthy company. Barely two months later, Countryside distributed the notes to the partners, to retire their interests in Countryside. In reality, the notes were first contributed to a two-tier subsidiary partnership structure and partnership interests were distributed to the partners. This was done in an attempt to prevent the reduction in the tax basis of the notes themselves while at the same time allowing Countryside to increase the basis of the real property it owned prior to its sale. The issue of the partnership basis step up and the ultimate tax basis of the notes is still pending in court. For a variety of technical reasons, the partnership and redeemed partners may not prevail on these issues.

The *Countryside* case came before the court on the taxpayer's motion for summary judgment. For purposes of the summary judgment proceeding, the taxpayer stipulated that the court could treat the transaction as though Countryside had distributed the notes directly to the retiring partners. The only issue for the court to decide was whether the partners should be treated as receiving cash, marketable securities, or other property.

The IRS attacked the purchase of the private placement notes and the subsequent distribution of those notes as both lacking economic substance and not having a business purpose other than tax avoidance. From the IRS' perspective, the transaction should be treated as though Countryside borrowed money and distributed it to its partners, which would have resulted in taxable gain to the partners. Alternatively, the IRS argued that the notes should be considered marketable securities since arrangements were in place to have them redeemed. Finally, the IRS said the transaction ran afoul of the controversial partnership anti-abuse regulation.

Economic substance and business purpose are issues where taxpayers have fared extremely poorly in litigation in recent years. Even though the taxpayer conceded that the private placement notes were acquired because a distribution of cash would have been taxable, the court nevertheless held that the purchase had the economic effect of converting their interest in real estate into an interest in notes, which were an economically distinct type of investment. The court also found the exchange of an investment in real estate for an investment in the notes to be an adequate business purpose for the transaction. The court then determined that the notes were not marketable securities. Finally, the court declined to apply the controversial partnership "anti-abuse" regulation to upset the transaction.

Whether this case will withstand an appeal and how the partnership basis issue is determined remain to be seen. For now, this is significant taxpayer victory. We will keep you apprised of further developments.

IRS Rules That Sale Of Logo Merchandise by Breast Cancer Charity Does Not Result In Unrelated Business Taxable Income

Charities normally do not have to pay income tax on donations they receive and the income they generate from their investments. However, it would be unfair to allow charities to compete with businesses that do have to pay tax on their income. Thus, there are rules that impose income tax on charities when they regularly engage in business activity unrelated to their charitable purpose. This is referred to as "unrelated business taxable income" or commonly "UBTI."

In PLR 200722028, the exempt purpose of a charity was to educate the public about breast cancer and the fact that early detection saves lives. One of the things the charity did was to sell merchandise with a logo that is the universal symbol for breast cancer (likely the pink ribbon). The merchandise included pins, apparel, home and office goods, jewelry and special gifts. The IRS ruled that the merchandise sales do not give rise to UBTI because the sales of merchandise with the breast cancer logo help to create awareness about the disease. Thus, the sales, even if considered a business, are related to the organization's exempt purpose so no UBTI results.

Wash Sale Rules Take Into Account IRA Transactions

If a taxpayer sells stock at a loss, his loss is disallowed for tax purposes by IRC Section 1091 if he purchases substantially identical securities within the period beginning thirty days before the sale and ending thirty days after the sale. The policy being implemented is that a loss deduction should only be allowed where the taxpayer actually alters his economic position. If he sells stock and buys it back the next day, his economic position is not altered in any meaningful way. The disallowed loss is used to increase the tax basis of the replacement stock in order to prevent the taxpayer from being taxed later on a non-economic gain.

In *Rev. Rul. 2008-5*, a taxpayer tried to get too clever and paid a high price. The taxpayer sold stock at a loss and the next day had his IRA purchase the same number of shares in the same company. The IRS ruled that the purchase by the IRA is attributed to the taxpayer so his loss was disallowed under IRC Section 1091. What really hurt was that the IRS then said the basis of the IRA is not increased by the disallowed loss, so the taxpayer will eventually pay tax on a gain he never economically realized. This taxpayer paid the price for pushing the envelope too far.

50% Bonus Depreciation for Depreciable Property Purchased in 2008

If you have been thinking it's time for a new airplane, 2008 is a good year to acquire one. The Economic Stimulus Act of 2008, signed by President Bush on February 13, 2008, is best known for providing tax rebates for which high income taxpayers do not qualify. Less publicized is the depreciation benefit that may be very helpful to high income taxpayers. For most kinds of new personal property (real estate does not qualify) placed in service by a taxpayer after December 31, 2007, and before January 1, 2009, the taxpayer may deduct 50% of the cost of the property in the 2008 tax year. The taxpayer may also claim the regular depreciation deduction on the other half of the cost of the property. An added benefit is that the bonus depreciation is applicable for alternative minimum tax purposes as well.

It is important to remember the property must be new. That is, the original use of the property must commence with the taxpayer. In the case of things like automobiles, boats and airplanes, all of the other deduction limitations, i.e., personal use, etc., still apply.

Due to serious budget problems, it is not likely that California will conform its tax law to allow the 50% bonus depreciation for new property acquired in 2008. Many other states that normally conform their tax laws to federal law may also decline to adopt this provision.

Rules Limiting Estate and Gift Tax Charitable Contribution Deduction for Gifts of Fractional Interests in Property Repealed

Before 2006, a common technique to donate property such as art to a charity was for a taxpayer to donate an undivided fractional interest in the art and take an income tax deduction for the donation. Upon his death, he would leave the balance of the art to the charity and his estate would receive a charitable contribution deduction for estate tax purposes. The fractional gift allowed the taxpayer to get a tax benefit during his lifetime, but still enjoy periodic use of the artwork or other property.

For such gifts made after August 17, 2006, the 2006 Pension Protection Act imposed some very unpopular rules. Under these rules, the deduction for the second gift was limited to the lesser of the fair market value of the property either at the time of the first gift or the time of the second gift. The taxpayer did not benefit from appreciation to the property after the first gift was made, but was penalized if the property declined in value. A pretty good example of "heads I win, tails you lose!" Even worse, if the property had appreciated between the time of the first gift and the taxpayer's death, the higher date of death value was included in his estate for estate tax purposes, but his deduction was limited to the lower value at the time of the first gift. This phenomenon was often referred to as "whipsaw." For the most part, these rules resulted in the cessation of these fractional interest gifts, to the great chagrin of charities and taxpayers.

In December, 2007, as part of the Technical Corrections Act of 2007, Congress retroactively repealed these rules as applied to the charitable contribution deduction for estate and gift purposes. Sadly, the rule was not repealed for income tax deductions available with respect to a subsequent gift. Thus, if a taxpayer donates a 25% interest in a painting worth $1,000,000 he will get a $250,000 income tax deduction. If, in a later year when the painting has appreciated to $2,000,000, the taxpayer donates the remaining 75%, his income tax deduction for the second gift will be limited to $750,000 rather than $1,500,000. If instead his estate gave the remaining 75% interest at his death, it would be permitted the full $1,500,000 deduction for estate tax purposes.

Also left intact are provisions that require the gift tax charitable deduction claimed on the first gift to be recaptured if: i) the donor does not give the charity the balance of the property by the earlier of ten years from the first gift or his death; or ii) the charity has not had substantial physical possession of the property during the time it owned a fractional interest and used the property in a manner related to its exempt purpose. Uncertainty remains regarding the application of these rules to community property interests.

Care Required When Disclaiming Property

A recent Tax Court case points up a mistake that can be made when disclaiming property. When property passing to a person as a gift or upon the death of the of owner is disclaimed using a "qualified disclaimer," the property is treated as though it never passed to the party making the disclaimer. This allows someone to disclaim property left to them without being deemed to have made a taxable gift when the property then goes to someone else.

In *Estate of Christiansen*, the decedent's will left her entire estate to her only child. The decedent anticipated that her daughter would disclaim a portion of the estate. Her will provided that any disclaimed property would go in part to a charitable foundation and in part to a charitable lead trust. The trust was to pay the foundation an amount equal to 7% of corpus each year for 20 years. Any amount remaining in the trust after 20 years would go to the daughter. As expected, the daughter disclaimed her interest in the estate above $6,350,000. The estate tax return filed by the estate reported a gross estate of about $6,500,000. Since the disclaimed property passed to the foundation and a charitable lead trust, the estate claimed an estate tax deduction for the amount transferred to the foundation and the trust.

Upon audit, the IRS raised the value of the gross estate to just over $9,500,000. The estate believed it would get a deduction for the amount of any increase because, since the daughter had retained a fixed amount and disclaimed any excess, any such increase went to the foundation and the charitable lead trust. Unfortunately, as to the portion going to the trust, the daughter's disclaimer was not a qualified disclaimer since she held a remainder interest in the trust. She would have had to disclaim the remainder interest as well in order to make the disclaimer a qualified disclaimer. Because the disclaimer was not qualified, the property passing from the trust was considered to come from the daughter and not from the estate so the estate did not get any increased deduction for the additional value that went to the trust. The court did allow an increase in the deduction for the portion of the increase in value that went to the foundation because the daughter had no interest in the foundation.

Disclaimers can be a powerful planning tool. Frequently they can be used to do estate planning for a person after they have died. However, as this case illustrates, they are subject to technical and complex rules that must be carefully followed.

Estate Tax Reform Update

For the moment, estate tax reform has taken a back seat to election year politics and problems in the economy. It seems unlikely that anything will happen before the election this fall. There will be tremendous pressure to do something in 2009, since 2010 is the year with no estate tax and limited carryover basis. In 2011, the law reverts back to its pre-2001 state, with a $1,000,000 exemption and marginal rates up to 55%. No politician from either party will want to face his or her constituents if that is allowed to happen.

People who watch this area closely still believe we will eventually end up with a an exemption in the range of $3.5 to $5.0 million and rates that start around 15%-20% and work up to a maximum of around 35%. There has been some discussion of using legislation to stop the discounts being claimed on intra-family transfers of minority interests in things like family limited partnerships. This may stem some of the revenue loss from lower rates and higher exemptions although phase-in periods may also be required to satisfy budgetary constraints.

For now, the exemption is $2,000,000 in 2008 and $3,500,000 in 2009. The maximum rate is 45% in both years. For 2008, the gift tax present interest annual exclusion remains at $12,000 per donee. The exclusion amount may be subject to an inflation adjustment for 2009. We will keep you apprised on any developments.

IRS Issues Helpful Like Kind Exchange Rulings

IRC Section 1031 is one of the most useful sections of the Internal Revenue Code for taxpayers. It allows taxpayers to exchange property used in a business or held for investment for other like kind property without the recognition of gain, provided the replacement property is also used in a business or held for investment. However, since 1984 it has not been possible to exchange partnership interests for other partnership interests under IRC Section 1031. In *PLR 200807005*, the IRS provided a very taxpayer-favorable interpretation of this restriction. The taxpayer sold property to a qualified intermediary to permit it to acquire the replacement property from someone other than the buyer of their property. The property that the taxpayer desired to acquire as replacement property was owned by a partnership. Rather than acquire the property from the partnership, the taxpayer entered into an agreement (through the qualified intermediary) to acquire 100% of the interests in the partnership that owned the real property. Most likely this was done to avoid some kind of state transfer tax on real property or restrictions in loan documents.

The IRS ruled that the acquisition of 100% of the partnership interests would permit the taxpayer to complete its like kind exchange. The IRS relied on Rev. Rul. 99-6 where it had previously held that where all of the interests in a partnership are sold to a single buyer, the buyer is treated for tax purposes as though the partnership had dissolved and the buyer had purchased the assets from the partners.

This ruling may be particularly useful if it allows taxpayers to avoid incurring state transfer taxes, which can be significant. While a private letter ruling can only be relied on by the taxpayer who obtained it, the IRS presumably would be willing to issue similar rulings for other taxpayers. Even without a ruling, taxpayers can take comfort in the fact that the IRS reached its conclusion here based on a published ruling, upon which taxpayers can rely.

PLR 200805012 addressed the question of what qualifies as "like kind" property. In the real property area, the IRS has interpreted like kind quite liberally in favor of taxpayers and this recent ruling is no exception. The taxpayer sold a parcel of real property it owned through a qualified intermediary, in order to be able to do a Section 1031 exchange. In order to complete the exchange, the taxpayer acquired (through the intermediary) "Development Rights" with respect to another parcel of real property it already owned. The Development Rights allowed the taxpayer to construct a building on the property with greater rentable floor space than would have been permitted without the Development Rights. The IRS ruled that the Development Rights constituted real property and thus the taxpayer's acquisition of those rights enabled it to complete a Section 1031 exchange.

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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