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High Net Worth Family TAX REPORT

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CONTENTS

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Roth IRA Conversion Becomes Available to High Income Taxpayers in 2010 1

Taxpayers Prevail on Use of Fixed Dollar Formula Valuation Clauses 2

Five Year Carry Back of Net Operating Losses Extended and Expanded 4

First Time Home Buyer Credit Extended and Expanded 4

California Property Tax Entity Change of Ownership Reporting Is Now Mandatory 4

Taxpayers Prevail in Two Tax Shelter Cases 5

Like-kind Exchange Runs Afoul of the Related Party Rules . . . 6

Estate and Gift Tax Update . . . 6

Roth IRA Conversion Becomes Available to High Income Taxpayers in 2010

In 1997, Congress enacted the Roth IRA provisions. If you have a Roth IRA, your contributions to that IRA are not tax deductible, but (like a regular IRA) amounts earned in the Roth IRA are not subject to income tax. However, unlike a regular IRA, amounts that are withdrawn from the account are not subject to income tax, and there is no requirement to begin taking distributions no later than the year you attain age 70 ½.

A regular IRA may be converted to a Roth IRA by paying income tax on the amount of pre-tax contributions and untaxed earnings in the regular IRA. For this treatment to apply, funds must remain in the Roth IRA for at least five years following the conversion.

Until now, Roth IRAs have been beyond the reach of high income individuals as they have been limited to individuals earning less than an inflation adjusted amount. For 2009, the ability to maintain a Roth IRA is phased out for a couple filing a joint return at income levels between $166,000 and $176,000. In addition, individuals having a modified adjusted gross income of greater than $100,000 have not been permitted to convert a regular IRA to a Roth IRA.

Beginning in 2010, the $100,000 limit on conversions is eliminated, and individuals at any income level can convert a regular IRA to a Roth IRA. If the conversion is made in 2010, the payment of the income taxes that result from the conversion may be deferred and paid in two installments, for 2011 and 2012. However, the taxes on the converted amount will be based on the prevailing rates in those years, and there is a very good chance that those rates will be higher than they are currently.

State and local income tax rules regarding Roth IRAs must also be taken into account when evaluating the conversion of a regular IRA to a Roth IRA. The Roth IRA provisions under the California, New York and New York City income tax laws are exactly the same as federal law, so the same conversion rules are also applicable.

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Roth IRAs can also have significant estate planning implications, since neither the original nor successor owners pay income tax on distributions. Moreover, although successor owners cannot delay distributions indefinitely in the same manner as the original owner, they can take distributions over their projected lifetimes and thereby further extend the benefits of tax free build up of the account's investments. If your estate can pay the estate taxes attributable to a Roth IRA with other estate assets, the successor owner (perhaps your children) can obtain many of the income tax deferral benefits available to you.

The analysis of whether it makes sense to convert is complex. The person converting the account must pay tax now, but in return the amounts in the Roth IRA accumulate tax-free past age 70 ½, and can ultimately be withdrawn from the Roth IRA free of income taxes. Many of the financial advisory firms have created financial models to assist in making this decision. While circumstances may differ, in general, conversion may make sense if: i) you have funds available to pay the resulting income taxes without using your IRA funds; ii) you do not anticipate that you will need to use the IRA funds for living expenses until well past age 70 ½, and iii) you do not anticipate moving from a high income tax state (like California or New York) to a low income tax state (like Nevada or Florida). These factors determine the extent to which you will be able to benefit from the additional tax-free accumulations of the account earnings after the payment of income taxes resulting from the conversion. The greatest benefit of converting may result if you are able to live indefinitely by using other funds and are therefore able to leave your Roth IRA to your heirs. To make the conversion and pay taxes now, you also have to trust that the federal and state governments will not change the rules in the future and subject Roth accounts to taxation.

In order to evaluate whether converting a regular IRA into a Roth IRA may be a smart move, we suggest that you consult with your financial advisor. They can help you evaluate your specific circumstances and make an informed decision.

Taxpayers Prevail on Use of Fixed Dollar Formula Valuation Clauses

Taxpayers have prevailed in two cases where the amount given to a charity was to be determined by reference to asset values as finally determined for estate or gift tax purposes. In *Estate of Christiansen*, Helen Christiansen left her estate to her only child, her daughter Christine Christiansen. However, her will provided that if Christine disclaimed any portion of the estate, 25% of the amount disclaimed would pass to a charitable foundation. Christine disclaimed her interest in her mother's estate as to all amounts over $6.35 million, using values as finally determined for federal estate tax purposes. The value of the estate was adjusted upward on audit and the estate sought an increased charitable contribution deduction because 25% of the amount of the increase passed to the foundation. The IRS challenged the estate's entitlement to the charitable contribution deduction and the Tax Court held in favor of the taxpayer. The IRS then appealed the case to the United States Court of Appeals for the Eighth Circuit.

In November, the court of appeals upheld the Tax Court's decision in favor of the taxpayer. The IRS had raised two arguments. First, it argued that the amount disclaimed was contingent upon a subsequent event. Therefore the disclaimer was not a qualified disclaimer and there should be no charitable contribution deduction. The court found that the amount disclaimed was not contingent. The disclaimed amount and the amount of the resulting gift to the foundation were fixed at Mrs. Christiansen's death. Because a qualified disclaimer relates back to the date of death, once the daughter disclaimed the amount of her mother's estate in excess of $6.35 million, the amount of property that would pass to the foundation was fixed. It was simply a matter of determining the value of the estate as of the date of death and then the amount of property that would pass to the foundation would be known. The amount of the gift was not based on any factors that could change the value of the gift after the decedent's death.

The second argument raised by the IRS was that allowing an increased charitable deduction where the IRS increased the value of the estate would provide a disincentive for the IRS to audit estates. While the court agreed that this may be the case, that did not change the result. The court pointed out that the role of the IRS was not simply to maximize tax receipts; its proper role is to enforce the tax law.

A second case involving the use of a fixed value formula clause is *Estate of Anne Y. Petter*, decided by

the Tax Court on December 7, 2009. The taxpayer had inherited shares of United Parcel Service stock from her uncle. She contributed shares of the United Parcel stock to a family limited liability company. She then made three types of transfers of the units of the company. She made a gift of some units to trusts she set up for her children, she sold some units to the trusts for her children and she gave some units to charities. The units given and sold to the trusts were not described as a fixed number of units, but instead with reference to a specific dollar value. In the case of the gift, the number of units given was whatever number of units was worth an amount equal to her unused gift tax exemption. In the case of the units sold to the trusts, the number of units sold was that number equal in value to a stipulated dollar sum, which in turn was the same amount that the trust paid her for those units. The charities received all of the rest of the units. Initial transfers were made based on an estimate of the value and the transfers were then adjusted based upon a third party appraisal of the value of the units.

The taxpayer's objective here was to insure that she would not owe any gift tax. If the IRS increased the value of the units above the appraised amount, then more units would be allocated to the charities for which she would receive a charitable contribution deduction and she should have no resulting gift tax liability. An increase in value simply meant that her children's trusts would receive a lesser number of units and the charities would receive more.

The IRS challenged this approach and said that fixed value formula transfer clauses violate public policy. The IRS thought this case to be similar to a prior case, *Commissioner v. Procter*. In *Procter*, the taxpayer had transferred property to trusts for his children but had provided that if the value transferred was determined to be in excess of his gift tax exemption, then the excess amount of property reverted to him. There, the court held that this was an attempt to undo a gift by the use of a condition subsequent, which was contrary to public policy. It would not only frustrate tax collection, it would also require courts to pass on meaningless cases. If the court decided a gift had occurred, then the condition subsequent would undo the gift and there would have been no point in the court hearing the case to determine whether there was a gift.

However, the Tax Court felt that the *Petter* case was different. The taxpayer was not trying to get any property back if the value turned out to be higher than expected. Under all circumstances, the taxpayer had parted with all of the property. The only thing that the valuation affected was who would get the property as between the taxpayer's children and the charities. A higher value meant that the charities would get more and her children would get less. The court's determination was not meaningless as it allocated the property between the children and the charities. Finding that gifts to charities should be encouraged, the court determined this case was different from *Procter* and that Ann had not made any taxable gift. The court described *Procter* as involving a "savings clause" which violates public policy and the *Petter* case as involving a "formula value clause" which does not violate public policy.

One of the great challenges in planning intra-family transfers is determining the value of the assets to be transferred. While taxpayers generally obtain independent appraisals, the IRS is not bound by the appraisal and frequently does challenge them, particularly the amount determined by the appraiser for minority interest and other discounts. Thus, it is nearly impossible to insure that you are not making some taxable gift. Even where an asset is sold to children or trusts for their benefit, if the value ultimately determined is higher than the purchase price, a gift results.

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These recent cases may provide a means of protecting against the risk of making an unintended gift. By providing that a charity will receive any portion of the transfer above a fixed value, it appears that a taxpayer can insure that he has not made an unintended gift. It remains to be seen whether the IRS appeals the *Petter* case and the result of any such appeal.

Five Year Carry Back of Net Operating Losses Extended and Expanded

The American Recovery and Reinvestment Tax Act of 2009 adopted a special rule allowing some taxpayers to carry back net operating losses incurred in 2008 for up to five years instead of the normal two years. In order to qualify for the extended carry back period, the taxpayer had to be an eligible small business, which was generally a business with not more than $15,000,000 in annual gross receipts.

On November 6, 2009, President Obama signed H.R. 3548, the Worker, Homeownership and Business Assistance Act of 2009 ("Act"). One of the provisions of the Act makes the extended carry back available for 2008 or 2009 losses and eliminates the $15,000,000 gross receipts limitation. In general, a business can use the extended carry back in only one of the years, i.e., either 2008 or 2009, but not both. However, if a taxpayer made an extended carry back of a 2008 loss under the prior law in effect for small businesses, then it may also make an extended carry back of a 2009 loss. If a taxpayer elects to carry a loss back to its fifth prior year under this new provision, only 50% of its taxable income in the fifth prior year can be offset by the loss carried back.

If an alternative minimum tax net operating is carried back, it normally can only be applied to offset 90% of alternative minimum taxable income in the carry back year. However, for 2008 or 2009 losses eligible for the extended carry back, this 90% limitation is suspended.

First Time Home Buyer Credit Extended and Expanded

While most of our readers have probably owned several homes, some may have children or grandchildren who are in the market for their first home. These readers will be happy to learn that the Act also extended the first time home buyer credit for another four to six months to include homes purchased before May 1, 2010, or before July 1, 2010, if the taxpayer had entered into a written binding contract to purchase the home before May 1, 2010. Eligibility for the credit was expanded to include individuals who had previously purchased a home but had lived in the same principal residence for any five consecutive year period during the eight year period ending on the date a new home is purchased. The credit for these purchasers is limited to $6,500 as compared to $8,000 for a true first time buyer.

The Act also raises the income ceiling to qualify for the credit. For the year of purchase, the credit is now phased out on a joint return at adjusted gross income levels from $225,000 to $245,000 as compared to a range of $150,000 to $170,000 previously. Also, for the first time a price limit is imposed in order for a house to qualify for the credit. For homes purchased after November 6, 2009, no credit is allowed if the purchase price exceeds $800,000. This is an absolute ceiling; there is no phase-out. A house purchased for $800,000 qualifies for the full credit whereas a house purchased for $800,001 will not qualify for any credit. For this purpose, the purchase price is the same as the purchaser's adjusted tax basis, so expenditures that are capitalized into the tax basis, such as closing costs, must be taken into account. This may serve to drive down prices of houses that would otherwise have sold for a price somewhat about $800,000. Buyers may start holding their price line at not more than $800,000 in order to qualify for the credit.

California Property Tax Entity Change of Ownership Reporting Is Now Mandatory

Under the rules of California's Proposition 13, real property is re-assessed at fair market value for property tax purposes when there is a change of ownership or substantial improvements are made to the property. Where real property is owned by a legal entity (i.e., corporation, partnership, limited liability company), the property is re-assessed whenever someone acquires control of the entity (more than 50% ownership). Real property owned by an entity is also re-assessed if the entity received the property in an exempt transfer from its prior co-owners and thereafter more than 50% of the ownership interests in the entity change hands.

These entity changes of ownership were supposed to be reported to the State Board of Equalization but a penalty was imposed only if the change was not reported within 45 days after a written request was made by the Board of Equalization. This changes beginning on January 1, 2010. Under the provisions of S.B. 816, signed by the Governor on October 11, 2009, entity changes of ownership must be reported to the State Board of Equalization within 45 days of their occurrence or a penalty is imposed. The penalty is 10% of the annual property tax based on the new assessed value, so it is a significant penalty. The change of ownership is reported using Form BOE 100-B.

Under the provisions of S.B. 816, signed by the Governor on October 11, 2009, entity changes of ownership must be reported to the State Board of Equalization within 45 days of their occurrence or a penalty is imposed.

Taxpayers Prevail in Two Tax Shelter Cases

Taxpayers' fortunes in litigating tax shelter cases improved a bit over the last couple of months. For years now, the tax community has been following a case popularly known as *"Castle Harbor"* involving a subsidiary of the General Electric Capital Corporation ("GECC"). GECC owned aircraft that it leased to users which were fully depreciated for tax purposes. In order to effectively depreciate the aircraft a second time, it contributed them to a partnership the other partners of which were foreign banks, which contributed cash. The partnership agreement allocated a very high percentage of the partnership's operating income to the banks. However, for financial accounting purposes, the aircraft were depreciated based on their fair market value so very little accounting net income resulted. Because there was no tax depreciation left, the banks were also allocated very substantial amounts of taxable income. Since the banks were not US taxpayers, they did not have to pay US income taxes on this income. From GECC's point of view, allocating taxable income to the banks rather than to GECC was as good as having depreciation deductions to offset its own taxable income.

The IRS challenged these partnership allocations and initially GECC prevailed at trial in the United States District Court. However, in 2006 the United States Court of Appeals for the Second Circuit reversed the decision after finding that the foreign banks should not be treated as partners because the economic arrangement between them and GECC was more akin to that of a lender. The Court of Appeals remanded the case to the District Court for further consideration of certain issues.

Upon remand, in October 2009 the district court once again held in favor of GECC. This time the court found that a section of the Internal Revenue Code captioned "Family Partnerships" was applicable. The court acknowledged that this was not a family partnership but only the caption to the section referred to family partnerships. The actual code section (Section 704(e)) provides that if a person owns a capital interest in a partnership where capital is a material income producing factor, then that person *must* be recognized as a partner. The court held that the foreign banks fell within this provision and must be recognized as partners.

The government will no doubt appeal once again to the Second Circuit. Of course, if the Second Circuit feels that the banks' cash contribution was economically more like a loan, it could easily say they do not hold a capital interest and reverse the case again.

The second case was decided by the Court of Federal Claims, also in October 2009. It involved a complicated leasing transaction entered into by the Consolidated Edison Company of New York, Inc. We will not go into the details of the complex transaction but they were designed to produce tax deferral for the party engaging in the transaction. What is significant is that the main way the IRS attacks these transactions is to say they have no "economic substance;" that is they do nothing but produce tax benefits for taxpayers engaging in the transaction. A transaction generally is found to lack economic substance where the taxpayer is protected against economic losses but at the same time has little or no opportunity to realize an economic profit from the transaction. Economic substance has become such a hot button issue that Congress has repeatedly entertained the notion of adopting a statutory economic substance requirement and imposing new penalties on transactions that do not comply. In fact, such a provision is con-

tained in the version of the healthcare legislation that has been passed by the House of Representatives.

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In the *Consolidated Edison* case, the court found that the transactions engaged in by the taxpayer did have economic substance. Although the transactions were clearly structured to minimize any economic risk to the taxpayer, the court found the taxpayer still had several different ways in which the transaction could generate an economic profit. While this case will likely also be appealed, it is nevertheless a meaningful victory in light of the possible codification of an economic substance requirement.

Like-kind Exchange Runs Afoul of the Related Party Rules

If a taxpayer engages in a like-kind exchange with a related party, the taxpayer qualifies for gain deferral under IRC Section 1031 only if the related party holds the property that it acquired from the taxpayer for at least two years. In *Teruya Brothers, Ltd. v. Commissioner*, the taxpayer unsuccessfully attempted to use a qualified intermediary to make an end run around this rule. Most exchanges are completed through qualified intermediaries because the use of an intermediary allows a taxpayer to sell his current property and have the intermediary hold the funds for a short period of time while he locates a replacement property to purchase.

In this case, the taxpayer transferred property to an intermediary which sold it to an unrelated third party. At the taxpayer's direction, the intermediary used the resulting funds to purchase a replacement property from a party related to the taxpayer ("Times"). If the taxpayer had instead transferred its property to Times in exchange for Times' property, Times' sale of the taxpayer's property within two years would have disqualified the transaction from Section 1031 tax free treatment. The Tax Court held, and the Court of Appeals for the Ninth Circuit agreed, that the taxpayer cannot change this result by running its transactions through a qualified intermediary. Times did not hold the taxpayer's exchanged property for two years (or at all for that matter) so the transaction ran afoul of the related party rule.

Most exchanges are completed through qualified intermediaries because the use of an intermediary allows a taxpayer to sell his current property and have the intermediary hold the funds for a short period of time while he locates a replacement property to purchase.

Estate and Gift Tax Update

The estate tax is still scheduled to go away for one year during 2010. Nobody ever expected that to happen but to date no legislation has been enacted to prevent it from happening. On December 3, 2009, the House of Representatives passed H.R. 4154, The Permanent Estate Tax Relief For Families, Farmers and Small Businesses Act of 2009. Essentially, this bill simply makes permanent the 2009 estate and gift tax rules. For estate tax and generation skipping tax purposes, the lifetime exemption amount will remain at $3,500,000 and the top rate will be 45% as currently in effect. We were disappointed that the gift tax lifetime exemption also remains at its currently level of $1,000,000. While many had hoped this exemption would be re-unified with the estate tax exemption at $3,500,000, such a provision is not contained in the House bill. There had also been some earlier talk of making the lifetime estate and generation skipping tax exemption portable between spouses so that any exemption not used by the first spouse to die would carry over to the other spouse. That provision is also not a part of H.R. 4154.

It is not clear that the Senate's schedule will permit it to consider estate tax legislation before the end of the year. Even if legislation is not enacted until some time in 2010, we expect it will be made retroactive to January 1, although there has been a fair amount of debate as to whether such a law can be made effective retroactively. There is still some hope that the

Senate may produce a bill that is more favorable to high net worth families.

As has been widely reported, Congress failed to pass legislation to avoid elimination of federal estate taxes and generation-skipping transfer taxes as of January 1, 2010. Unless such legislation is enacted and made retroactive to January 1, many existing estate plans may be adversely affected. Estate plans, including estate plans prepared by this firm, often provide that certain gifts are measured by reference to the available estate tax or generation-skipping transfer tax exemption at the person's death. Because there will be no such taxes as of January 1, there will be no such exemptions, and gifts measured by such exemptions could be eliminated. Gifts measured by estate tax or generation-skipping transfer tax exemptions are commonly allocated to so-called Bypass or Credit Shelter Trusts. Although the result may not be serious where such a trust has the same beneficiaries as the balance of the estate plan, it could result in beneficiaries being unintentionally excluded if that type of gift has been made to different beneficiaries. For example, if the exemption amount is left to or in trust for the children, and the balance is left to or in trust for the surviving spouse, the children could end up receiving nothing. Until uncertainties regarding the law are resolved, some people may prefer to "patch" their estate plan by having documents prepared that make reference to the exemption amounts in effect as of December 31, 2009.

On a related note, the IRS has announced that the gift tax annual exclusion amount will remain at its current level of $13,000 per donee through 2010 ($26,000 per donee for married couples who split gifts or make gifts from community property). Take this as a reminder to make your annual exclusion gifts for 2009, if you have not already done so. Remember that these gifts must be of a "present interest" so gifts in trust only qualify if the beneficiary has the "Crummey" power to withdraw the gift amount. Please let us know if you need notification letters prepared for any trust beneficiaries.

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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