High Net Worth Family

TAX REPORT

LOEB & LOEB adds Knowledge.

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Taxes are Going Up – But by How Much?

Income taxes. It seems inevitable that taxes will soon be higher on a number of fronts. If Congress does not take any action on income taxes this year, beginning in 2011, the tax reductions enacted in 2001 and 2003 will expire and the rates will revert to their previous levels. In the case of long term capital gain income, the rate will go from its current 15% to 20%. The maximum rate on ordinary income will increase from 35% to 39.6%. This will include dividend income for which the tax rate will increase dramatically from 15% today to 39.6%. The President's 2011 budget proposal would hold the line on dividend taxation at 20%, but that will only happen if Congress acts. Recently, Congress has been having difficulty acting.

The original Senate healthcare bill, H.R. 3590, "Patient Protection and Affordable Care Act," was passed by the House of Representatives on March 21 and was signed by the President on March 23. Beginning in 2013, this legislation will increase the Medicare tax imposed on an individual's wages or earned income from 1.45% to 2.35% on wages or earned income in excess of $250,000 for married taxpayers or $200,000 for single taxpayers. For purposes of this additional tax, wages and earned income of married taxpayers are combined to determine when the $250,000 threshold is exceeded.

The healthcare legislation does provide some limited tax benefits including a tax credit for small employers (25 employees or less) who make contributions for the purchase of health insurance for their employees. For most of our readers, it appears that increases under the legislation will be far more significant than any of the incidental tax benefits that may be available.

The additional reconciliation bill, H.R. 4872, "Health Care and Education Affordability Reconciliation Act of 2010," was also passed by the House on March 21. The Senate passed the bill on March 25, and the President signed it on March 30. This bill imposes a new 3.8% Medicare tax on investment income (including interest, dividends,

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royalties, rents, annuities and capital gains) for married taxpayers with modified adjusted gross income in excess of $250,000 and single taxpayers with modified adjusted gross income in excess of $200,000. This new tax also begins in 2013. As a theoretical worst case, dividends could end up being taxed at a federal rate as high as 43.4% (39.6% + 3.8%) and long term capital gains at 23.8% (20.0% + 3.8%) before you consider state income taxes. The committee reports for this legislation confirm that this tax will not apply to income that is not subject to regular income tax such as interest on state and municipal bonds or the portion of gain from the sale of your residence that is not subject to tax.

Estate Taxes. On the estate and gift tax front, inaction continues to describe the state of affairs. The much anticipated "patch" to preserve 2009 law through 2010 has not been enacted. If Congress takes no action, on January 1, 2011, the estate and gift tax rate will go back up to 55% with the exemption limited to $1,000,000. We continue to hear that there is a desire to enact legislation preserving the 45% maximum rate and $3,500,000 exemption, but so far nothing has happened. As more time passes, it will be more difficult to enact legislation that is retroactive to January 1, 2010. There have recently been reports from Washington that Congress may consider allowing estates of persons who die in 2010 to elect to apply either 2009 law or 2010 law. While 2010 law means no estate tax, there is also only a limited increase permitted to the income tax basis of the decedent's assets. Also, do not forget that there is still a gift tax in 2010 on gifts over the lifetime exemption amount of $1,000,000. For 2010 only, the maximum gift tax rate is reduced to 35%.

For many estates, the 2009 regime which imposed estate tax at a maximum rate of 45% with a $3,500,000 exemption, would be preferable because the law also permitted the income tax basis of all of the decedent's assets to be increased to fair market value. Estates would benefit from the 2009 regime where the estate is not larger than the $3,500,000 exemption amount or where the decedent left a surviving spouse and took advantage of the marital deduction for all of his assets that were in excess of his $3,500,000 exemption. These "first death" estates would not have owed any estate tax anyway due to the exemption and marital deduction but could have received considerable benefit from the income tax basis increase. We will continue to keep you apprised on any developments.

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Grantor Retained Annuity Trusts. Congress has considered for some time now the possibility of legislation that would impose a ten year minimum term for Grantor Retained Annuity Trusts ("GRAT"). That legislation has now been introduced as a provision in H.R. 4849, "The Small Business and Infrastructure Jobs Tax Act of 2010," and would also make two other changes to the rules for GRATs. A "zeroed out" GRAT, i.e., one where there is no element of gift upon the creation and funding of the GRAT, would no longer be permitted. However, the current version of the legislation does not impose any minimum gift amount so perhaps a gift of $1 will suffice. Finally, the amount of the annual payment to the creator of the GRAT could not decline during the first ten-years of the GRAT term. The changes would be effective from the date of enactment. If you have been contemplating a shorter term GRAT (two years has been popular), time is of the essence in completing it.

The ten-year term is problematic for two principal reasons. First, the GRAT will not produce any estate tax savings unless its creator survives to the end of the term. This will make GRATs less useful for people of advanced age or marginal health. Second, over a ten-year term, it will be far more challenging to invest the assets of the GRAT to generate a return that is in excess of the mandated hurdle rate.

HIRE Act Allows Payroll Tax Holiday and Tax Credit for Certain Employers and Adds Reporting Obligation for Certain Foreign Financial Assets

The "Hiring Incentives to Restore Employment Act," H.R. 2847, signed by the President on March 18, contains some important tax-related provisions:

Payroll Taxes. Employers who hire workers who have been unemployed for at least 60 days do not have to pay the employer's Social Security payroll tax (6.2% on the first $106,800 of wages) for the balance of 2010. This tax holiday does not apply to the hiring of family members and you cannot fire a current worker and replace that worker with a previously unemployed worker. If the worker is still employed after fifty-two weeks, the employer will receive a non-refundable tax credit of up to $1,000. The new worker must have been hired after February 3, 2010, and the payroll tax holiday only applies to wages paid after March 18, 2010. The employer must choose between these benefits and the Work Opportunity Tax Credit if it would have been available.

This legislation also extends through 2010 the ability of a business to expense new equipment investments of up to $250,000. The ability to expense the purchase of new equipment begins to phase out if the business buys more than $800,000 of eligible new equipment.

Foreign Financial Assets. For taxable years beginning after the date of enactment (March 18, 2010), this act also imposes information reporting requirements on any U.S. individual who holds interests valued in the aggregate at more than $50,000 in (1) any depository or custodial account maintained by a non-U.S. financial institution, (2) any stock or security issued by a non-U.S. person, (3) any interest in a foreign entity, and (4) any financial instrument or contract with a non-U.S. counterparty not held within a custodial account maintained by a financial institution. The U.S. individual is required to provide, with the individual's income tax return, certain information with respect to such specified foreign financial assets. Failure to report such assets as required, absent reasonable cause, will be subject to a penalty of $10,000, and additional penalties (up to $50,000) could apply if the failure continues after being notified by the IRS. The reporting requirements currently apply only to individuals, but the Act gives the IRS the authority to extend the reporting to U.S. entities.

This new reporting is required in addition to the FBAR reporting that is discussed in a subsequent article. The information requested under this new provision is similar to that required on an FBAR, and certain assets may be reported on both reports; however, the information required is not identical. We anticipate that the IRS will provide guidance, and/or Treasury will provide regulations, before the due date of individual returns for the 2011 taxable year.

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Taxpayers Prevail in Two More Family Limited Partnership Cases

Tax litigation surrounding family limited partnerships is unending and we are delighted to report on two recent taxpayer victories. In *Estate of Samuel P. Black*, decided by the Tax Court in December 2009, the decedent set up a family limited partnership called Black, LP. He transferred stock of Erie Indemnity Co., which was his employer. He was a strong believer in Erie stock and purchased it at every opportunity. By the 1960's, he was the second largest shareholder. His investment philosophy was described by the court as "buy and hold," particularly with respect to his Erie stock.

Mr. Black had made gifts of Erie stock to his son and to trusts that had been created for his grandchildren. He became concerned that his son might default on a bank loan and that his son's marriage was heading toward divorce. These factors could cause his son to have to sell some of his Erie stock. He was also concerned that the stock in the trusts for his grandchildren would be distributed to them beginning when they reached age twenty-five and they might also sell some of their Erie stock. Mr. Black was advised that if he set up a family limited partnership

which included his son and his grandchildren's trusts, he could minimize the possibility that Erie stock would be sold. The partnership was formed in 1993 and Mr. Black was the managing general partner until 1998, at which time his son became the managing partner. Mr. Black made several gifts of interests in the partnership to his son, his grandchildren, the grandchildren's trusts, and a charity. When Mr. Black died in 2001, the partnership still held all of the Erie stock that had been transferred to it upon its formation.

Mr. Black's wife died only five months after he passed away. In order to pay the estate taxes that resulted from her death, Erie engaged in a secondary public offering of its stock and Black, LP sold three million shares for $98 million. The partnership then loaned $71 million to Mrs. Black's estate to pay estate taxes. The Internal Revenue Service ("IRS") asserted that the Erie stock Mr. Black had transferred to Black, LP should be included in his estate under IRC Section 2036, which would include the stock in Mr. Black's estate if he either retained the possession, enjoyment or right to income from the stock or the right to designate the persons who shall possess or enjoy the stock or income from the stock. However, the retention of these rights would not cause inclusion if the transfer by Mr. Black was a "bona fide sale for an adequate and full consideration."

It is not clear at all that Mr. Black retained any of the proscribed rights; however the court addressed the bona fide sale exception first. In prior cases, the Tax Court has held that to meet the bona fide sale exception, the decedent must have had a legitimate and significant non-tax reason for creating the family limited partnership. The court then held that using the partnership to address Mr. Black's concerns about the Erie stock being sold was such a legitimate non-tax reason.

The case eases some of the concern we had following the *Jorgensen* case we reported on last year. In *Jorgensen*, the court implied that "buy and hold" investing was not necessarily a legitimate non-tax reason that would support the creation of a family limited partnership. We were concerned that only actively managed and traded portfolios might qualify. In *Black*, the lack of active management was not fatal in light of another non-tax purpose the court accepted as being significant. Since the court found that Mr. Black's transfer of the Erie stock to Black, LP satisfied the bona fide sale exception, it did not have to address whether Mr. Black had retained any proscribed rights with respect to the stock.

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The second taxpayer victory came in *Estate of Charlene B. Shurtz*, decided by the Tax Court in February 2010. Mrs. Shurtz came from a family that owned significant interests in timberlands. By 1993, at least fourteen extended family members, including Mrs. Shurtz, had interests in the family's original timber holdings. They were advised by an attorney that having so many owners made management difficult and would make any sale a cumbersome process. This led to the formation of C.A. Barge Timberlands, L.P. in June of 1993. All family members holding timber interests joined the partnership and contributed their respective interests. The partnership had a corporate general partner of which Mrs. Shurtz was a one-third owner.

In 1996, Mrs. Shurtz and her husband formed Doulos L.P. for the ostensible purpose of protecting her family's assets from possible creditor claims. Mrs. Shurtz apparently believed the Mississippi, where the timber was located, was an especially litigious state. Mrs. Shurtz contributed her interest in C.A. Barge Timberlands, L.P. along with some separate timberland that she owned. She initially held a 1% interest as a general partner of Doulos L.P. and a 98% interest as a limited partner. Her husband held a 1% interest as a general partner. Between 1996 and 2000, Mrs. Shurtz made numerous gifts of small interests in Doulos L.P. to her children and to trusts for her grandchildren. She passed away in 2002, holding her 1% general partnership interest and an 87.6% interest as a limited partner.

Doulos L.P. operated in a manner that was not optimal. Some of its expenses were paid by Mrs. Shurtz and her husband and the distributions the partnership made were not always proportional to the interests of all of the partners, although over time make up distributions were used to achieve proportionality.

Mrs. Shurtz's estate plan was set up so that between her exemption amount and the marital deduction on what she left to her husband, no tax should have been due. So what was there for the IRS to argue about? In its apparently never-ending attack on family limited partnerships, the IRS took the position that the assets Mrs. Shurtz transferred to Doulos L.P. should be included in her estate under IRC Section 2036. However, for purposes of computing the allowable marital deduction, the lesser value of the interest in Doulos L.P. had to be used. This sounds a little like "heads I win, tails you lose."

Once again, the court found that Mrs. Shurtz's transfers fell within the bona fide sale exception to Section 2036, accepting the estate's contention that Doulos L.P. was formed to protect family assets from litigation claims and to facilitate management of those assets. The court accepted as legitimate Mrs. Shurtz's expressed concern about litigation exposure. Once again, the court was not required to consider whether Mrs. Shurtz had retained any of the proscribed rights. The marital deduction also became a non-issue because it was the value of the partnership interest that was included in her estate. Thus, there was no discrepancy between the value of the estate asset and the value of the asset that gave rise to the marital deduction.

Beware: The IRS Forms a "Wealth Squad"

The IRS has created internally a series of "industry groups" that focus on tax issues and enforcement problems specific to certain industries. The Commissioner of the Internal Revenue Service recently announced the formation of a new industry group: the "Global High Wealth Industry Group." The new group will focus on the country's wealthiest individuals and their business entities. It has been instructed to take a unified look at the entire web of business entities controlled by high-wealth individuals. The objective of such in depth analysis is to determine the risks presented to tax compliance and the integrity of the tax system.

How rich do you have to be to fall within the ambit of this new group? The Commissioner only said that they are initially looking for individuals with "tens of millions of dollars of assets or income," with more focus on assets. This will require some research as there is currently nothing on the Form 1040 which requires an individual to disclose the amount of his or her net worth. Could the "IRS 400" replace the "Forbes 400" as the list to be on? We wonder whether people will start bragging to their friends that they are being audited by the IRS Global High Wealth Industry Group. We hope not.

The Commissioner of the Internal Revenue Service recently announced the formation of a new industry group: the "Global High Wealth Industry Group." The new group will focus on the country's wealthiest individuals and their business entities.

California Supreme Court Interprets "Change of Ownership" Provisions of Proposition 13

In *Steinhart v. County of Los Angeles*, the California Supreme Court was called upon to address whether a statute enacted to implement Article XIII A of the California Constitution (commonly called "Proposition 13") is consistent with the intent of the article. Section 2 of Article XIII A provides that real property can be re-appraised for purposes of the property tax only following new construction or a "change in ownership." To implement Proposition 13, the legislature enacted a number of statutes including Revenue and Taxation Code Section 61, which provides that a change in ownership occurs when any interest in real property vests in persons other than the trustor when a revocable trust becomes irrevocable.

Esther Helfrick established a revocable living trust and transferred her home to the trust. Upon her death in 2001, the trust became irrevocable. Under the terms of the trust, one of her sister's had the right to occupy the house for her lifetime after which the house was to be sold and the proceeds distributed to Esther Helfrick's living siblings and their issue. The County Assessor for Los Angles County

re-assessed the house for property tax purposes upon Esther's death and its valuation was increased from $96,638 to $499,000. Esther's sister paid the increased property tax bill and filed a claim for refund on the basis that Esther's death did not cause a change in ownership with respect to the home. The claim was denied and the litigation began.

When the case reached the California Supreme Court, the Court actually held against Esther's sister on the basis that she did not first exhaust her administrative remedies by appealing to the Assessment Appeals Board before she filed her refund claim. However, because of the importance of the issue, the Court also addressed the change in ownership question on its merits. On that issue, the Court held that the portion of Section 61 which provides a change in ownership occurs when a revocable trust becomes irrevocable is consistent with the intent of Proposition 13.

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California Legislative Bill Would Repeal IRC Section 1031 and Other Tax-Free Exchange Provisions in California

As an apparent attempt to increase tax revenue California, A.B. 2640, introduced on February 19, 2010, would repeal IRC Section 1031 and several other tax-free exchange provisions of the Internal Revenue Code for California income tax purposes. Section 1031 is widely used by taxpayers, principally to engage in tax-free exchanges of business or investment real estate for other like-kind real property. Over time, the IRS has made Section 1031 a user friendly provision by allowing deferred exchanges where funds are held by a neutral third party while the exchanging taxpayer looks for replacement property.

Other sections of the Internal Revenue Code that would be repealed for California income tax purposes include: i) Section 1032 which permits a corporation to issue its stock for money or property without paying income tax on the proceeds; ii) Section 1033 which permits the tax-free replacement of property that has been condemned or involuntarily converted to cash as the result of a casualty; iii) Section 1035 which allows for the tax-free exchange of certain insurance policies; iv) Section 1041 which permits spouses to transfer property to each other incident to a divorce without recognizing taxable gain; and v) Section 1042 which allows sales of certain companies to an employee stock ownership plan ("ESOP") without recognizing gain for tax purposes if the proceeds of the sale are invested in certain types of qualifying investments.

In the present form of the bill, these repeals would be effective starting with the current 2010 tax year. The provision repealing Section 1042 also changes the rules for tax years between 1998 and 2010 by making the tax free rollover provision inapplicable to sales of S corporations. The repeal of these provisions by California would cause a serious lack of conformity between Federal and California tax law and act as an impediment to many types of transactions. The bill has been referred to the Committee on Revenue and Taxation and a hearing on the bill has been scheduled for May 3. We will keep you posted on further developments.

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Gifts of Interests in Family Limited Partnerships Did Not Qualify for Gift Tax Annual Exclusion

Section 2503(b) of the Internal Revenue Code allows an individual to give an unlimited number of donees a certain amount as a gift each year without incurring liability for gift taxes and without using any of the donor's lifetime exemption. This annual exclusion amount is set by the Code at $10,000 per donee, but this number is inflation adjusted and is $13,000 for this year. In order to qualify for the annual exclusion, the gift must be of a *present interest* in property. This means that gifts to a trust generally do not qualify although there is an exception created by a court case called *Crummey*. If the trust contains a

provision allowing the trust beneficiary to withdraw the amount of the gift for a period of time (usually 30 days) then it is considered to be a present interest and the exclusion is applicable.

In two recent cases, the Tax Court and a United States District Court both held that gifts of interests in family limited partnerships did not qualify as gifts of present interests. In *Walter M. Price v. Commissioner*, decided by the Tax Court in January, the court followed its holding in a 2002 case called *Hackl v. Commissioner*. That case held that interests in a limited liability company were not present interests. The court decided that the gifts in *Price* were not present interest gifts because the partnership agreement prohibited partners from transferring their interests without the consent of all of the other partners. Another reason given by the court for its conclusion was that the partnership agreement did not require profits to be distributed to the partners and in some years no distributions were made.

In *John W. Fisher v. United States*, the District Court for the Southern District of Indiana also held that interests in a family limited liability company were not present interests. The court relied on provisions of the operating agreement giving the manager discretion over distributions and another provision which allowed members to sell their right to receive distributions; however it granted the company a right of first refusal to purchase any interest a member desired to sell and to pay for the transferred interest by issuing a non-negotiable promissory note payable over up to fifteen years.

Interests in family entities such as limited partnerships and limited liability companies are not always the best choice for annual exclusion gifts, if other alternatives are available. Apart from this present interest problem, interests in these entities are hard to value and even if you are willing to pay for an appraisal each year there is no guarantee that the IRS will accept the valuation reached by the appraiser, especially where minority interest and other discounts are taken into account. If you do use these kinds of interests for annual exclusion gifts, consider including a provision in the partnership or operating agreement that is similar to the *Crummey* language used in trusts. Such a provision could allow the donee to require the entity to redeem the interest received by gift within 30 thirty days of the date of the gift. This may solve the problem presented by cases like *Price* and *Fisher*.

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Recent Case Highlights the Problems with Employee Business Expenses

If tax deductions were ranked on a scale from best to worst, business related expenses incurred by employees would rank near the bottom. This lowly status was recently confirmed by the Tax Court in the case of *James and Barbara Purdy v. Commissioner*, decided in March. The taxpayer was a financial adviser at Merrill Lynch. His employment was terminated and he filed a wrongful termination claim with the National Association of Securities Dealers. He was awarded $393,165, from which he paid his attorney $120,000. He deducted the payment to his attorney on Schedule C of his Federal income tax return.

IRC Section 162 allows a deduction (taken by individuals on Schedule C) for expenses incurred in connection with a trade or business. For this purpose, working for someone else as an employee is not considered a trade or business. The Tax Court held that the taxpayer was an employee of Merrill Lynch so he could deduct his legal fees only on Schedule A, as a miscellaneous itemized deduction. These types of deductions are subject to several limitations: i) IRC Section 67 provides that miscellaneous itemized deductions are only allowed to the extent they exceed 2% of the taxpayer's adjusted gross income; ii) pursuant to IRC Section 56, these deductions are not allowed at all for purposes of computing the alternative minimum tax; and iii) under IRC Section 68, these deductions are subject to a reduction of up to 80%, depending on the taxpayer's level of income.

In this case the employee incurred legal fees but the same limitations would be applicable to any un-reimbursed expenses incurred by an employee in connection with his job. This could include things like business meals and entertainment, business

or professional organization dues, and business related travel. Employees are at a considerable tax disadvantage compared to those who generate self employment income (“independent contractors”) but are not employed by an employer. They can claim all of their business-related deductions on Schedule C and such amounts are deductible in full.

Employees are at a considerable tax disadvantage compared to those who generate self employment income (“independent contractors”) but are not employed by an employer. They can claim all of their business-related deductions on Schedule C and such amounts are deductible in full.

IRS Grants Relief for Taxpayers Who Failed to Complete Like-Kind Exchange Due to Bankruptcy of Qualified Intermediary

Most Section 1031 like-kind exchanges of real property rely on “qualified intermediaries” to hold the proceeds from the sale of the taxpayer’s original property while the taxpayer locates suitable replacement property. The taxpayer is required to identify his replacement property within 45 days of the sale of his original property and then must close the purchase of the replacement property within 180 days of the sale of his original property. When the IRS issued regulations permitting these “deferred” exchanges, it gave birth to a new cottage industry of “exchange accommodators” or “qualified intermediaries,” as they are known under the tax regulations.

Many, if not most, exchange accommodators are highly reputable companies. A number of them are subsidiaries of banks or title insurance companies. However, as in any industry, there are always a few bad apples. Some disreputable individuals owning exchange intermediary companies have absconded with the exchange funds the company was holding and then put the company into bankruptcy. These actions gave rise to the tax question of what happens to the taxpayer who was trying to complete a Section 1031 exchange but was unable to do so because his accommodator ran off with the money? Is his original sale now taxed in full because he failed to close the purchase of his replacement property within 180 days?

The IRS has continued its generous interpretation of IRC Section 1031 by issuing a revenue procedure which grants relief for taxpayers in this predicament. Rev. Proc. 2010-14 provides that if a taxpayer qualifies for relief under the procedure, he will only recognize proportionate amounts of gain when, and if, he recovers anything from the accommodator or its bankruptcy estate. A taxpayer may only rely on this safe harbor if his accommodator went into a bankruptcy proceeding under the United States Code or a federal or state receivership proceeding. If your accommodator simply took off with your money and never ended up in court, you apparently cannot rely on the revenue procedure.

In prior articles we have cautioned our readers to perform appropriate due diligence on exchange accommodation companies they are considering using. We continue to be surprised by the number of otherwise sophisticated people who are willing to have substantial sums held for up to 180 days by companies with respect to which they know virtually nothing. Please do your homework and do not allow yourself to be put in a position where you need to rely on Revenue Procedure 2010-12.

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Can a Completed Transaction be Reversed?

It is not uncommon to do something and then in hindsight decide you made a mistake and wish you could un-do or rescind what you had done. Sometimes you may be able to, but what are the tax consequences of reversing a completed transaction? As an example, suppose that in January you sold a house you owned and had previously rented to your daughter who had just finished college. You expected that she would get a job and live in the

house. She paid you with a combination of cash and a promissory note secured by the house. A few months later your daughter is offered her dream job but the job is in Europe so now she has no use for the house. If she transfers the house back to you and you tear up the note and give her back her cash down payment, can you just ignore the sale as though it never happened? Or, is the return of the house to you considered a payment on the note causing you to recognize all of your tax gain? Does the tax law permit a transaction to be rescinded without tax consequences?

In 1980, the IRS issued a favorable ruling, Rev. Rul. 80-58, on rescissions that occur within the same tax year as the original transaction. In the ruling, the taxpayer sold land to another party in February with the proviso that if the buyer could not get the land re-zoned within nine months, the buyer could give the land back to the seller and the seller would return the buyer's payment. When the buyer returned the property and the seller refunded the purchase price in October of the same year, the IRS ruled that the seller did not have to recognize gain from the sale. However, under an alternative set of facts, if the rescission does not occur until the following year, the seller does have to recognize his gain in the year of sale. Thus, un-doing the transaction within the same tax year was critical.

The IRS continues to periodically cite this revenue ruling in other rulings. Most recently, in *PLR 201008033*, a company had sold the stock of a subsidiary to another one of its affiliates. After the sale was completed, the parties were advised that the sale would create adverse tax consequences. They asked the IRS for a private ruling saying they could rescind the sale and restore the parties to their original positions and avoid the adverse tax consequences. The IRS ruled as requested, citing as authority Rev. Rul. 80-58. While this private ruling cannot be relied on as authority by other taxpayers, it is helpful to know that the IRS was willing to recognize a same-year rescission even where the taxpayer admitted that the only reason for rescinding the original transaction was to avoid undesired tax consequences. To use a golf analogy, sometimes you get a mulligan.

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New York Updates Nonresident Audit Guidelines

New York recently updated its nonresident audit guidelines after more than 10 years. Although dated March 31, 2009, the new guidelines were only just published. They provide more detailed and updated guidance, with more quotes from cases and rulings. The guidelines do not have the force of law; however, they are good indication of how New York will conduct an audit and the positions New York will take.

Residency can have a major effect on an individual's tax liability. New York residents are subject to New York income tax on their worldwide income. Nonresidents, on the other hand, are only subject to New York tax on their income that is allocable to New York. Generally, an individual is a New York resident if either he is domiciled in New York, or he maintains a permanent place of abode in New York and is present in New York on at least 183 days during the calendar year.

With states looking for new sources of revenue, nonresidents are a favored target.

Update on Foreign Bank Account Reports – Filing Suspensions, Extensions, Clarifications, and Proposed Regulations

The IRS recently issued guidance that provides relief for certain taxpayers required to file the Report of Foreign Bank and Financial Accounts (IRS Form TD F 90-22.1), commonly known as the "FBAR." In general, any U.S. person (including individuals and entities) with a financial interest in, or signature authority over, foreign bank and financial accounts that have aggregate balances over $10,000 at any time during a calendar year must file an FBAR with the Treasury Department by June 30 of the following year.

The recent IRS guidance is provided in Notice 2010-23 and IRS Announcement 2010-16. The guidance provides relief by (1) suspending the filing requirement for non-U.S. persons, (2) clarifying the definition of "commingled funds," and (3) extending the due date for U.S. persons with signature authority over, but no financial interest in, a foreign financial account for 2009 and prior years.

Suspension of Reporting By Non-U.S. Persons. The FBAR instructions had been revised in October 2008 to extend the definition of "U.S. person" to include non-U.S. persons "in and doing business in the United States." This change provoked significant comments from the tax community and the IRS temporarily suspended the June 30, 2009, FBAR reporting requirement for those who are not U.S. citizens, U.S. residents, or domestic entities. (Announcement 2009-51 (6/05/2009)). Announcement 2010-16 (2/26/2010) reports that the IRS has continued this suspension for the 2009 FBAR due on June 30, 2010. Taxpayers may rely on the definition of "United States person" found in the July 2000 version of the FBAR instructions to determine if they have an FBAR filing obligation for 2009 and earlier calendar years. This definition basically includes a citizen or resident of the United States, a domestic partnership, a domestic corporation and a domestic estate or trust.

Further Extension of Deadline for Persons with Only Signature Authority. The IRS previously extended to June 30, 2010, the FBAR filing due date for 2008 and earlier calendar years for persons with signature authority over, but no financial interest in, a foreign financial account. (Notice 2009-62 (8/7/09)). In Notice 2010-23 (2/26/2010), the IRS reports that it has further extended to June 30, 2011, the FBAR filing due date for such persons for 2009 and prior calendar years.

Clarification of Rules for Reporting Commingled Funds. The IRS also had previously extended to June 30, 2010, the FBAR filing due date for 2008 and earlier calendar years for persons with a financial interest in, or signatory authority over, a foreign financial account in which the assets are held in a commingled fund, such as an offshore hedge fund or mutual fund. (Notice 2009-62). In Notice 2010-23, the IRS has indicated that it will not interpret the term "commingled fund" as applying to funds other than mutual funds with respect to FBARs for 2009 and prior calendar years. The IRS specifically indicates that an interest in a foreign hedge fund or private equity fund is not included in the definition of commingled fund for 2009 and prior calendar years, so that such accounts will not have to be reported on an FBAR for such years. However, a U.S. person with an interest in a foreign mutual fund in 2009 and prior calendar years will have to report such interest on an FBAR for such years, which must be filed by June 30, 2010.

Advice on Answering the Tax Return FBAR Question. The IRS has advised in Notice 2010-23 that a taxpayer who has no other reportable foreign financial accounts for the year in question and qualifies for any of the filing relief provided in that Notice should check the "no" box in response to FBAR-related questions found on federal tax forms for 2009 and earlier years that ask about the existence of a financial interest in, or signature authority over, a foreign financial account (e.g., Line 7a to 2009 IRS Form 1040's Schedule B).

FinCEN Proposals. In addition to the IRS guidance, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) introduced proposed regulations intended to clarify who is required to file the FBAR and which accounts are reportable. While the IRS has been delegated the authority to issue administrative guidance related to, and the authority to enforce, the FBAR provisions, the IRS does not have the authority to write FBAR regulations. That authority is held by FinCEN, the bureau of the U.S. Department of the Treasury originally delegated the FBAR oversight authority. While the proposed regulations purport to clarify who is required to file FBARs and which accounts are reportable, in many respects, these proposed regulations reflect major changes in these areas.

While the proposed regulations address some of the suggestions that commentators have made over the past few years, they do not address all of them. Notably, the proposals would exclude from filing participants and beneficiaries in certain retirement plans and IRAs with respect to accounts held by those entities. On the other hand, the proposals do not address commentators' suggestions to provide

an exemption for exempt organizations, including pension funds, educational organizations and charitable organizations, and their employees.

In conjunction with the proposed regulations, FinCEN also provided a draft of revised FBAR instructions that would be required if the proposed regulations are adopted as a final rule. The proposed regulations do not state whether they would be effective prospectively or retroactively, which leaves open the possibility that the regulations may be applicable to FBARs required to be filed by June 30, 2010.

If you have questions about the new FBAR guidance discussed above, or you think you may have an FBAR filing obligation for 2009 or prior tax years, we suggest that you contact your accountant to review your potential filing obligation.

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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