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High Net Worth Family TAX REPORT

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No Estate or Income Tax Legislation – Yet

As of the beginning of August, Congress has not passed any of the tax legislation that has been expected. The widely anticipated 2010 estate tax fix never happened and as of now there is no estate or generation skipping tax for 2010 and only limited basis step up to assets of decedents dying in 2010. There is still a gift tax with a $1,000,000 lifetime exemption but for 2010 the maximum rate is 35%. Beginning January 1, 2011, the maximum estate, generation skipping and gift tax rates will revert to 55% and the lifetime exemption for all of these taxes will go back to $1,000,000.

Various proposals have been floated for a permanent fix, but none has gained traction in Congress on both sides of the aisle. The range of maximum rates under consideration is running between 35% and 45%, although a couple of outlier proposals have higher rates. The proposed ranges for the lifetime exemption run between $3,500,000 and $5,000,000.

It was also expected that legislation would be passed requiring a 10 year minimum term for grantor retained annuity trusts ("GRATS"). These provisions have passed the House more than once, most recently in H.R. 4899, a supplemental spending bill. However, the Senate passed that bill last month without the GRAT provision and the House relented. The House has reintroduced the GRAT legislation in H.R. 5982, the Small Business Tax Relief Act of 2010, which is pending.

On the income tax side, it looked like the partnership provision taxing carried interests as ordinary income was almost sure to pass. It passed the House again as part of H.R. 4213, the American Jobs and Closing Tax Loopholes Act of 2010. The provision was significantly diluted to provide for a mix of ordinary income and capital gain and the legislation then came within three votes of passing the Senate. The Democrats in Congress will not let this die; we will see it again.

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In the broader tax picture, as of now the Bush tax cuts will expire at the end of this year. On January 1, 2011, the maximum rate on dividend income will go up from 15% to 39.5%, the rate on other ordinary income will go up from 35% to 39.6% and the rate on long term capital gains will go up from 15% to 20%. These provisions have been in the news a lot lately. Virtually all Republicans and a few Democrats in Congress believe that any tax increase now would jeopardize the economic recovery. The administration and most Democrats in Congress believe that current tax rates should be preserved for families earning up to $250,000, but that taxes should be increased on those earning more. President Obama previously favored limiting the top tax rate on dividends to 20% even for high income taxpayers, but now may have changed his position to favor a higher rate for high income taxpayers. Without legislation being enacted, maximum tax rate on dividends will increase to 39.6% on January 1, 2011. In 2013, when the new Medicare tax kicks in, this top rate will increase another 3.8% to 43.4%. This debate is likely to intensify as we get closer to the November elections.

Stay tuned. We will report on any important legislation as soon as it is enacted.

The administration and most Democrats in Congress believe that current tax rates should be preserved for families earning up to $250,000, but that taxes should be increased on those earning more.

Restrictions on Deduction of Trustee's Fees Deferred Through 2009

The IRS has deferred for one more year, through 2009, new rules that will require fees charged by trustees to be broken into their various components in order to determine the extent to which they can be deducted for federal income tax purposes. The issue is whether the trustee's fees paid by a trust are subject, in whole or in part, to the 2% of adjusted gross income floor imposed on miscellaneous itemized deductions by IRC Section 67.[1] IRC Section 67(e)(1) provides that expenses incurred by a trust that would not have been incurred but for the fact that the property was owned by a trust are not subject to the 2% floor. A controversy developed over fees paid by a trust for investment advice and management. The Supreme Court actually resolved the controversy in 2008 in *Knight v. Commissioner*, where the Court held that costs incurred for investment advice and management are costs that might be incurred by individuals as well as trusts, so the 2% floor does apply when these costs are incurred by a trust.

In Notice 2010-32, the IRS has stated that the new rules do not apply to tax years beginning before 2010. This means that on 2009 tax returns, a trust can deduct the full amount of the trustee's fees it paid without regard to the 2% floor of IRC Section 67.

In 2007, the IRS issued proposed regulations dealing with "bundled" trustee's fees, where the fee charged includes investment management along with other services performed by the trustee. The regulations prescribe methods for allocating the bundled fee among services to which the 2% floor applies and those to which it does not. The IRS previously had provided that the regulations would not apply to tax years beginning before 2009. In Notice 2010-32, the IRS has stated that the new rules do not apply to tax years beginning before 2010. This means that on 2009 tax returns, a trust can deduct the full amount of the trustee's fees it paid without regard to the 2% floor of IRC Section 67.

Gifts and Sales Combined to Determine Applicable Discount

Last September (See, Vol. 4., No. 2) we reported on the first part of the Tax Court's opinion in *Pierre v. Commissioner*. The taxpayer had transferred cash and marketable securities to a single member limited liability company ("LLC") and made gifts of some interests and sold other interests to trusts for her child and grandchild. The single member LLC was a disregarded entity for income tax purposes and the first question confronted by the court was whether that same treatment should apply for gift tax

[1] References to "IRC" or "Code" mean the Internal Revenue Code of 1986, as amended.

purposes. If it did, the taxpayer would be considered to have given and sold cash and marketable securities to the trusts and no discount would be available for transfer of fractional interests.

In August, 2009, a sharply divided Tax Court held that for gift tax purposes, the taxpayer should be treated as having given away and sold interests in the LLC rather than its underlying assets. While this opened up the possibility of the taxpayer obtaining valuation discounts, the court reserved for a second opinion the question whether the sales could be combined with the gifts to determine the percentage transferred for purposes of determining the appropriate discount

The court recently issued its opinion on this issue. The taxpayer gave a 9.5% interest in the LLC to each trust and sold a 40.5% interest to each trust. She obtained an appraisal that valued each of these separate interests as a minority interest. In its second opinion, the court concluded that the gift and sale should be combined since they happened on the same day and were part of a plan to transfer ownership of all of the LLC interests to the trusts. The court also found that the only reason the taxpayer gave away part of the interest and sold the rest was to avoid incurring any gift tax liability. There was no non-tax reason for such bifurcation. Thus, the taxpayer was considered to have transferred a 50% interest in the LLC to each trust.

In its second opinion, the court concluded that the gift and sale should be combined since they happened on the same day and were part of a plan to transfer ownership of all of the LLC interests to the trusts.

A 50% interest should have commanded a smaller valuation discount because a 50% holder can block any action that requires a majority in interest of the members. The taxpayer suffered only a small downward adjustment to the discount she had claimed because the IRS did not present an expert witness to testify as to the appropriate discount for a 50% interest. Apparently the IRS was so confident they would prevail on their argument that the LLC should be disregarded for gift tax as well as income tax purposes that they did not feel they needed an expert witness.

This case does not tell us how long the taxpayer would have needed to wait between transfers for them to be considered separate transfers. It only tells us that doing multiple transfers on the same day is not a good idea.

Medicare Tax on Investment Income Applies to Trusts and Estates

In April, we reported on the new 3.8% Medicare tax that will be imposed on investment income beginning in 2013. For individuals, the tax applies to the lesser of the taxpayer's net investment income or the amount of his modified adjusted gross income in excess of $250,000 for taxpayers filing a joint return or $200,000 for single taxpayers.

This tax also applies to investment income accumulated by estates and non-grantor trusts. The 3.8% tax applies to the lesser of the estate or trust's undistributed investment income or its adjusted gross income in excess of the dollar amount at which the highest tax bracket begins. For 2010, that amount is $11,200.

Pronouncements on Same Sex Marriage and Qualified Domestic Partners

There have been several tax pronouncements dealing with same sex marriage and domestic partners. First, the State of New York Department of Taxation and Finance issued an advisory opinion concluding that same sex marriage partners will not be treated as married for purposes of the New York State personal income tax. Section 607(b) of the Tax Law provides that an individual's marital status is the same as that individual's status established for federal income tax purposes. Section 651(b) provides that his filing status shall be the same for New York purposes as for Federal purposes.

The opinion goes on to point out that under the Federal Defense of Marriage Act, the IRS does not recognize same sex marriages for Federal income tax purposes. The Defense of Marriage Act defines marriage as the legal union between one man and one woman. The IRS position has been upheld by the Tax Court in *Mueller v. Commissioner, TC*

Memo 2001-274 (2001). As an aside, last month in *Gill v. Office of Personnel Management*, the United States District Court for Massachusetts held that the Defense of Marriage Act is unconstitutional. The case will no doubt be appealed.

Based on this change in California law, the IRS has issued CCA 201021050 which concludes that starting January 1, 2007, registered domestic partners in California must each report one-half of any earned income received by either partner for Federal income tax purposes.

The IRS also issued a series of Chief Counsel Memoranda outlining certain Federal tax consequences of California's Domestic Partner Rights and Responsibilities Act ("Act"). A significant change was made to the California Act effective 2007. The Act had previously contained a provision that said earned income of registered domestic partners may not be treated as community property for state income tax purposes. Based on this provision, the IRS had determined (CCA 200608038) that the partner who earned income had to report all of that income on his income tax return, rather than splitting the income with his partner, as would happen if the income was community property. Effective January 1, 2007, the California legislature repealed the language which stated that earned income was not community property. Based on this change in California law, the IRS has issued CCA 201021050 which concludes that starting January 1, 2007, registered domestic partners in California must each report one-half of any earned income received by either partner for Federal income tax purposes. On August 9, 2010, the California legislature passed a resolution (AJR 29) asking the IRS to apply the same rule to California same sex married couples.

In CCA 201021048, the IRS addressed Federal gift tax consequences of earned income of registered domestic partners in California. The IRS concluded that since a domestic partner has a vested interest in one-half of the earnings of his partner that is granted by California law, there is no transfer deemed to be made between the partners for purposes of the Federal gift tax law.

In this same release, the IRS also stated that each partner is entitled to one-half of the credit for any tax withholding from the wages of either partner.

Finally, the IRS addressed certain issues related to offers in compromise. The offer in compromise is a procedure for which a taxpayer can apply when he cannot pay all of his taxes. Based on the financial resources available to him, the IRS may agree to accept less than the full amount owing in settlement of the taxpayer's federal income tax obligations. One of the financial resources the IRS takes into account is the extent to which the taxpayer seeking the reduction may be able to get funds from his spouse or other family members.

In CCA 201021049, the IRS considered whether the financial resources of the taxpayer's registered domestic partner in California should be considered in evaluating an offer in compromise. Under California's domestic partner law, property acquired by the partners after the registration of their partnership is community property. Community property is liable to satisfy the debts of either partner. Therefore, the IRS concluded that in considering an offer in compromise, it is appropriate to consider the resources of the taxpayer's registered partner.

Capital Contribution Does Not Increase Tax Basis of Loans to S Corporation

In a recent case involving the tax basis of a loan made by shareholders to an S corporation, the taxpayers made a very clever argument but could not get the court to go along. In *Nathel v. Commissioner*, the taxpayers owned shares in an S corporation to which they had also made loans. The corporation sustained losses which were passed through to the taxpayers as the shareholders. Under the applicable tax rules, the losses reduce the basis of the shareholder's stock. When that basis reaches zero, further losses reduce the tax basis of any loans the shareholder has made to the corporation. When the basis of the loans reaches zero, the shareholder cannot deduct any further losses from the S corporation until he builds his basis back up. Further, if the basis of a loan has been reduced and the loan is repaid, the shareholder recognizes

taxable income. If the S corporation earns income after suffering losses, the income first restores the tax basis of the shareholder's loans to its original amount and thereafter increases the tax basis of the shareholder's stock.

In *Nathel*, the losses had reduced the shareholders' stock basis to zero and their debt basis to nearly zero. The shareholders subsequently made capital contributions to the corporation and then the loans were repaid. Normally a capital contribution would increase the tax basis of the shareholders' stock and would not affect the tax basis of their loans. The taxpayers here tried to get around that problem by arguing that the capital contributions represented income to the corporation that was not subject to tax. If the capital contribution was income, even if not taxable income, then the debt basis would be restored first. The result would be that the debt basis would equal its face amount at the time the loans were repaid and no taxable income would result to the shareholders.

While the argument was very clever, the court quickly rejected it. First the Tax Court, and more recently in June, 2010, the Court of Appeals for the Second Circuit, pointed out that Section 118 of the Internal Revenue Code says that capital contributions are not income. Therefore, the contributions made by the shareholders only increased the basis of their stock. Their loans still had a reduced basis when they were repaid and the taxpayers did recognize income on such repayment.

One might ask, could they have converted their loans to stock and been able to get money out of the corporation without paying tax? That would most likely have caused the S corporation to recognize cancellation of indebtedness income that would have passed through to the shareholders. IRC Section 108(e)(6) provides that when a shareholder contributes debt of a corporation to its capital, the debtor corporation is deemed to have satisfied the debt for an amount equal to the shareholder's tax basis in the debt. Since the shareholders' basis was less than the face amount of the debt, the corporation would have recognized income under Section 108. If the shareholders had known the magnitude of the expected losses, they probably would have been better off contributing the debt to capital before the losses began to reduce the loans' tax basis.

IRS Points Out the Importance of Designating a Beneficiary for Your IRA

A recent IRS private letter ruling reminds us of the importance of designating a beneficiary for your Individual Retirement Accounts ("IRA"). A much longer period of continued tax deferral will be available if you have designated a beneficiary for your account before you die. If you die before distributions commence from your account and the account has a designated beneficiary, the balance in the account can be distributed over the life expectancy of the designated beneficiary. If the account does not have a designated beneficiary, it must be fully distributed within five years after your death. If distributions have commenced prior to your death and you have no designated beneficiary, distributions must continue to be made over your remaining actuarial life expectancy. If the account has a designated beneficiary, distributions can be made over the longer of your remaining life expectancy or the life expectancy of the designated beneficiary. You can have more than one beneficiary named, but the age of the oldest one will be used to determine the distribution period. Designating a beneficiary, especially a much younger one, permits the account to enjoy the benefits of tax free accumulation for a much longer period.

Normally a designated beneficiary must be an individual. However you can designate a trust if it has the right provisions. In particular, the trust beneficiaries who are to receive the payments from the IRA must be identifiable from the trust instrument. They do not have to be identified by name if they are identified in a manner that you can determine who they are. For example, you could say "my children" or "my spouse." This is where the taxpayer made a mistake in *PLR 201021038*. The taxpayer named a Bypass Trust under his revocable trust as the beneficiary of the IRA. The problem was that the Bypass Trust did not clearly define a beneficiary because the named beneficiaries could receive distributions from the Bypass Trust only if the beneficiaries' other resources were not adequate for their support and maintenance. The taxpayer's daughters were the beneficiaries of the Bypass Trust,

but it was not clear that they would ever get anything from the trust.

Normally a designated beneficiary must be an individual. However you can designate a trust if it has the right provisions. In particular, the trust beneficiaries who are to receive the payments from the IRA must be identifiable from the trust instrument.

Following the taxpayer's death, the trustees of the Bypass Trust obtained declaratory relief from a court (retroactive to the taxpayer's death) that the daughters were to receive all amounts distributed from the IRA. The IRS held that this retroactive attempt to fix the problem was not effective. It was like musical chairs and the music stopped at the taxpayer's death. The terms of the trust at that moment were controlling and there was no proper designation of a designated beneficiary.

The lesson here is pretty clear. First, make sure all of your IRAs have designated beneficiaries. Second, if you designate a trust, you must be sure that the trust clearly identifies which individual(s) will receive the amounts distributed from the IRA.

One Year Covenant Not to Compete Must be Amortized Over Fifteen Years

A recent Tax Court case points out a problem with the statutory provisions that govern the amortization of intangible assets. IRC Section 197 was enacted in 1993 to clarify the treatment of intangible assets. Prior to that time, goodwill purchased in connection with the acquisition of a business could not be amortized or deducted for tax purposes. However, taxpayers had made significant inroads in chipping away at this rule by characterizing goodwill as something else, like customer lists or the core deposit base of a commercial bank. If someone agreed to a covenant not to compete in connection with the sale of his interest in a business, the buyer amortized the amount paid for the covenant over its term – a logical result.

When it enacted Section 197 in 1993, Congress swept many types of intangible assets into its arena. Any kind of intangible asset covered by Section 197 is amortized on a straight line basis over 15 years. Section 197 covers covenants not to compete that are entered into in connection with an acquisition of an interest in a trade or business or substantial portion thereof.

This background laid the groundwork for a most unfortunate tax result in *Recovery Group v. Commissioner (April, 2010)*. A founding employee of a company called Recovery Group who owned 23% of the stock decided he wanted to leave the company. A buyout was structured that included a payment of $400,000 in consideration of his agreement not to compete with the company for a period of one year. The company deducted the payment over the 12 month period in which it was made, which encompassed two different tax years. The IRS took the position that the agreement not to compete was covered by Section 197 and had to be amortized over 15 years even though it was only for a term of one year.

In the Tax Court, the taxpayer's argument for the non-application of Section 197 was that the 23% interest in the business which it bought back in the transaction was not a "substantial" interest in a business so Section 197 was inapplicable. The court did not believe that the taxpayer read the statute correctly. Section 197 applies if the covenant not to compete was given "in connection with the acquisition of an interest in a trade or business, or a substantial portion thereof." The court said the "substantial portion" modifies "trade or business" not "interest." In the court's view, the term "substantial portion" is limited to transactions structured as asset acquisitions. If you buy the assets of a business, you must acquire a substantial portion of the assets. On the other hand, if the business is operated by an entity, the acquisition of any level of interest in the entity owning the trade or business is sufficient.

The result was that even though the restriction only applied for one year, the taxpayer had to amortize the $400,000 it paid over 15 years. This was clearly a terrible tax result. This taxpayer would have had a better chance of deducting his payment over 12 months if he had been able to structure the arrangement as a one year consulting arrangement which prohibited the employee from competing during the term of his consulting contract. The

regulations provide that an employment arrangement is not subject to treatment as a covenant not to compete under Section 197 if the amount paid is reasonable for the services rendered.

> The result was that even though the restriction only applied for one year, the taxpayer had to amortize the $400,000 it paid over 15 years.

Tax Court Rejects Two Securities Monetization Strategies

People who hold large blocks of a single security often wish to diversify their holdings but do not want to incur the tax liability that would result from selling their block of stock. To address this problem, a variety of strategies have been developed in the hope of allowing the holder of the large block to get cash equal to a substantial part of the value of his large holding without making a sale of the stock for income tax purposes. One of these strategies that has been popular is the "variable prepaid forward contract." The holder of the stock enters into a contract with a counter party, typically an investment bank, to sell stock on a future date, often 10 years away. The holder receives a fixed amount of cash at the inception of the contract, which he does not have to return. On the sale date 10 years in the future, the number of shares he delivers to close the sale is based on the price of the stock at that time. The contract would typically prescribe minimum and maximum numbers of shares to be delivered. It is this variability feature that has been thought to prevent the transaction from being a sale at the front end.

The IRS approved the basic version of this transaction in *Rev. Rul. 2003-7*. In the ruling, the taxpayer pledged to the counter party the maximum number of shares he may have been required to deliver, in order to secure its obligation to deliver shares in the future. The taxpayer reserved the right to deliver other shares or to settle its obligation to the counter party in cash. In concluding that the transaction was not a present sale, the IRS also addressed Section 1259 which statutorily treats some monetization transactions, including forward contracts, as sales. In this case, the IRS determined that Section 1259 did not apply because it applies to forward contracts only where the contract calls for the delivery of a substantially fixed amount of property. In the facts of this ruling, the taxpayer could be required to deliver between 80 and 100 shares so the IRS concluded the amount was not substantially fixed.

Following this ruling, taxpayers got a little bit too greedy. To do these transactions, the investment bank counter party must execute a short sale of the same security to hedge its position. While it may be able to borrow the shares from the market, there are costs associated with doing that which would be passed through to the customer who wanted to enter into the variable prepaid forward contract. To reduce their costs, taxpayers began to lend the counter party their own shares, which they had also pledged to the counter party to secure their obligations under the forward contract. The share lending agreement permitted the counter party to sell the borrowed shares. The IRS warned taxpayers in 2006 that it believed the added securities lending feature would cause the transaction to be treated as a current sale. We previously reported on TAM 200604033. (See, Vol. 1., No. 2).

In July, 2010, the Tax Court confirmed that adding the securities lending feature to the variable prepaid forward contract converts the transaction into a current sale. The case, *Anschutz v. Commissioner*, involved a forward sale contract between an S corporation owned by Philip Anschutz and investment bank Donaldson, Lufkin & Jenrette ("DLJ"). The taxpayer received 75% of the current value of the maximum number of shares it could be required to deliver. It also received a 5% fee for lending the securities to DLJ. The taxpayer had no downside exposure and, based on the minimum number of shares it might deliver under the contract, could benefit from increases in the price of the stock up to 50% of its value at the inception of the contract. The court found that the forward sale contract, coupled with the lending of the securities to DLJ, transferred virtually total control over the securities to DLJ and thus constituted a present sale. While the taxpayer lost here, the tenor of the court's opinion is that this transaction, without the securities lending feature, likely would have been held not to constitute a present sale. Future taxpayers who are willing to incur the additional cost of their counter party having

to borrow the shares from the market may well succeed where this taxpayer failed.

The second case involved a purported loan against an appreciated securities position. In *Calloway v. Commissioner*, also decided in July, the taxpayer was an IBM executive with holdings of IBM stock. He entered into a three year loan where he borrowed 90% of the current value of his stock, pledging the stock as collateral. The taxpayer's problem started when the loan agreement permitted the lender to sell the pledged shares of the IBM stock, which it did immediately. The loan bore interest at 10.5% per annum and any dividends paid on the stock were credited against interest due. Except for the dividends applied, all interest was paid at maturity. The loan was neither callable by the lender prior to maturity nor prepayable by the borrower. At maturity, the taxpayer could pay the balance due and receive back an equivalent number of IBM shares, extend the loan for an additional term, or satisfy the loan by giving up any rights in the IBM shares.

The Tax Court also found this transaction to be a current sale of the IBM shares. The court considered a number of factors which indicated that the taxpayer no longer owned the stock, including the ability of the lender to sell the shares, the taxpayer's failure to report the dividends paid on the stock and the fact that, upon receiving 90% of the value of the stock, the taxpayer had no further risk of loss with respect to the stock. While the taxpayer retained the upside from price increases in excess of the interest he had to pay on the loan, the court characterized this upside as being economically equivalent to having an option to purchase IBM shares at the end of the loan term. The retention of this upside did not prevent the transaction from being treated as a current sale.

Loans against securities positions have been used for decades to monetize appreciated securities positions and for the most part the transactions have always been respected as loans. However, in the typical transaction, the lender does not have the right to sell the shares that are pledged to secure the loan. A further problem for the taxpayer was that the company who sponsored the loan program, Derivium Capital USA, was permanently enjoined from promoting abusive tax shelters by the United States District Court for the Northern District of California in March, 2010.

Both of these cases offer examples of basically sound transactions being pushed a bit too far, principally in the interest of securing a better economic result for the taxpayer. A variable forward sale without any accompanying loan of securities to the counter party, or a loan against a securities without granting the lender the right to sell the stock, should still represent legitimate ways to partially monetize appreciated securities holdings.

Both of these cases offer examples of basically sound transactions being pushed a bit too far, principally in the interest of securing a better economic result for the taxpayer.

California Rolls Forward Date of Conformity with Federal Tax Law

California has finally updated its date of conformity to Federal tax law to January 1, 2009. The previous conformity was to Federal tax law as of January 1, 2005. Much of the California income tax law simply adopts comparable provisions of the Federal law as of a specified date, called the "conformity date." SB 401 was signed by Governor Schwarzenegger on April 12, 2010. As always, there are a number of provisions of the Federal tax with which California has chosen not to conform. The Franchise Tax Board has a useful chart showing the areas of non-conformity available at: http://www.ftb.ca.gov/law/legis/09_10bills/sb401_Final.pdf.

Family Offices to Be Exempt from Certain Advisor Registration Required by Wall Street Reform Legislation

The historic Wall Street reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act"), became law on July 21, 2010. One of the effects of this sweeping legislation is that many investment advisors for the first time will have to register under the Investment Advisers Act of 1940. Section 409 of the Act provides an exemption for advisors to family offices, which is to be defined in regulations to be promulgated by the Securities and Exchange Commission.

The reform legislation does contain one tax provision. Certain futures and options contracts traded on regulated boards or exchanges are subjected to a special tax regime by IRC Section 1256. Gain or loss on covered contracts is automatically classified as 60% long term capital gain or loss and 40% short term without regard to the taxpayer's holding period. In addition, all Section 1256 contracts must be marked to market at the end of each year and resulting gain or loss reported for tax purposes even though the contract is still open.

There was concern among many that since many common swaps and other derivative contracts may now have to be cleared through clearing houses or exchanges under the Act, they might fall into the jurisdiction of Section 1256 and have to be marked to market. Section 1601 of the Act alleviates this concern by amending Section 1256 to provide that it simply does not apply to several common types of swap transactions, regardless of how they are traded and cleared. Transactions specifically excluded from Section 1256 treatment include interest rate swaps, currency swaps, basis swaps, interest rate caps and floors, commodity swaps, equity swaps, equity index swaps, credit default swaps or similar agreements.

More in depth coverage of the Act is beyond the subject matter of this newsletter. However our firm has created a task force to address issues raised by the Act. More information on the Act and the members of the task force can be found on our website. Links to more information on the Act can be found here and the members of the task force can be found here.

Court Addresses Concept of Personal Goodwill in Connection with the Sale of a Business

The United States District Court for the Eastern District of Washington recently decided a very interesting case. In *Howard v. United States*, *(July 30, 2010)*, the taxpayer was a dentist who practiced through a professional corporation. He had a written employment agreement that contained a covenant that so long as he was a shareholder and for three years thereafter, he would not compete with the corporation. Dr Howard wished to sell his practice but the corporation presented a problem. A buyer who bought his stock would obtain tax basis in stock and not in any asset that could be depreciated or amortized to produce future tax deductions. On the other hand, if Dr. Howard caused the corporation to sell its assets, he would incur tax at two levels: i) the corporation would pay tax on its gain; and ii) when he dissolved the corporation to obtain the proceeds, he would incur a personal capital gains tax. This is the well known "double tax" problem associated with corporations.

In an attempt to solve his tax problem and still allow the buyer to purchase an asset it could amortize, Dr. Howard structured the transaction as a sale of his "personal goodwill" for most of the purchase price. He was paid $549,900 for his personal goodwill and the corporation was paid $47,100 for its assets. With this structure, the buyer of the practice could amortize the goodwill over 15 years. The argument that the goodwill belonged to Dr. Howard is that he had the relationships with the patients, not the corporation. If he moved to another practice, the patients would likely follow him.

The court found that despite Dr. Howard's relationships with his patients, the corporation legally owned the goodwill, based on Dr. Howard's employment agreement and covenant not to compete. The court therefore treated the payment for the goodwill as being a dividend from the corporation to Dr. Howard rather than a capital gain from the sale of his own goodwill. For the year in issue dividends were taxed at a higher rate. It is not clear from this case whether the IRS also treated the corporation as having received the payment for the goodwill but it should have, which also would cause the corporation to owe tax on the sale.

Personal goodwill is a legitimate consideration to relieve some of the double tax burden associated with corporate asset sales. This case does not mean the concept is dead – only that it will not work where the shareholder is subject to a covenant not to compete in favor of the corporation.

Would the result have been different had there not been any covenant not to compete? There is a good chance it would have been. There are other cases which have held that the shareholder of a corporation may own goodwill that is used by the corporate business. One such commonly referred to case is *Martin Ice Cream v. Commissioner*, where the shareholder had personal relationships with store managers that allowed the corporation to place its products for sale in the stores. In that case, the shareholder was not bound by a covenant not to compete in favor of the corporation.

Personal goodwill is a legitimate consideration to relieve some of the double tax burden associated with corporate asset sales. This case does not mean the concept is dead – only that it will not work where the shareholder is subject to a covenant not to compete in favor of the corporation.

Taxpayers Not Permitted to Exclude Gain on Sale of Rebuilt Residence That They Never Occupied

Section 121 of the Internal Revenue Code permits a married couple to exclude the first $500,000 of gain they recognize upon the sale of their home if they have occupied the home as their principal residence for at least two years out of the five years preceding the sale. In *Gates v. Commissioner*, decided by the Tax Court on July 1, 2010, the court was called upon to determine whether the taxpayers had sold the same home they had occupied for two years as their residence.

The Gates used a home previously purchased by Mr. Gates before their marriage as their principal residence for at least two years from August, 1996 to August 1998. At that point, they moved out of the house, demolished it, and constructed a new house on the lot. They never lived in the new house and sold it on April 7, 2000 for $1,100,000, resulting in gain of $591,405. The question before the court was whether they could exclude the first $500,000 of their gain under Section 121. The IRS argued that the house the Gates lived in for two years was not the same house that they sold. They never lived in the new house that they sold. This caused the IRS to take the position that they did not qualify for the gain exclusion of Section 121.

Unless there is further clarification, the conservative course would now be to occupy the home for two years after a significant remodeling, if you can.

The court sided with the IRS and ruled that the taxpayer must actually have lived in the particular dwelling that was sold. It is not good enough to sell any structure on the same parcel of real property. This decision will lead to uncertainty in the application of Section 121. It is common for people to substantially remodel their homes. At what point does a remodeling become so extensive that the home is considered a new home for purposes of Section 121, requiring two more years of occupancy before it is sold? Will it make a difference whether you move out or continue to live in the home during the remodeling? Unless there is further clarification, the conservative course would now be to occupy the home for two years after a significant remodeling, if you can. This is especially the case if your remodeling was so extensive that you moved out of the house while the work was being done.

California Extends Credit for Purchase of Qualified Residence Through 2010

California provided a tax credit for the purchase of a qualified principal residence between March 1, 2009 and March 1, 2010. The credit was the lesser of 5% of the purchase price and $10,000. Beginning with the year of purchase, the credit was claimed in equal amounts over three tax years. The credit was only available for the purchase of a home that had never been occupied and which would be the principal residence of the taxpayer for a minimum of two years.

AB No. 183, approved by Governor Schwarzenegger on March 25, 2010, extends the credit for houses purchased between May 1, 2010 and December 31, 2010, or by August 1, 2011 if pursuant to a contract that was enforceable on December 31, 2010.

The eligibility for the extended credit was expanded to provide that the house must either have never been occupied before or must be purchased by a first time home buyer, which is defined as someone who

did not own a principal residence for the three years preceding the purchase.

The amount of credit available to all taxpayers is limited to $100,000,000 for houses that have never been occupied and $100,000,000 for houses purchased by first time home buyers, although there is a mechanism that reduces the aggregate limit as each type of credit gets used. There is a procedure to apply to reserve a credit allocation upon entering an enforceable contract. Escrow companies should be familiar with the procedure. The credit may prove beneficial if you are considering the purchase of a new home that has never been occupied or you have children or grandchildren in the market for their first home.

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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