High Net Worth Family

TAX REPORT

DECEMBER 2013

LOEB & LOEB adds Knowledge.

CONTENTS

Vol. 8 No. 4

IRS Explains Federal Tax Consequences of Windsor Case Regarding Same-Sex Marriages . . 1

Inflation Adjustments for 2014 . . 2

Be Sure You Are Prepared for Higher Taxes in 2013 2

Be Sure to Obtain Proper Substantiation for Charitable Gifts 3

New Jersey Sales Tax Treatment of Cloud Computing 3

U.S. Supreme Court Denies Certiorari in New York Amazon Cases 3

Taxpayer Fails to Prove Sufficient Participation under Passive Activity Loss Rules 4

Termination of Joint Tenancy between Brothers Was California Property Tax Change in Ownership 4

Taxpayer Does Not Convince Court That She Was a Stock Trader . . . 5

Supreme Court Resolves a Split in the Circuit Courts over the Application of a Valuation Penalty Where Deductions Are Disallowed for Lacking Economic Substance. . . . 6

IRS Explains Federal Tax Consequences of *Windsor* Case Regarding Same-Sex Marriages

In our last report (Vol. 8, No. 3, September 2013), we told you about the recent *Windsor* case, in which the Supreme Court held unconstitutional Section 3 of the Defense of Marriage Act, which precluded the Federal government from recognizing a marriage between a same-sex couple that was recognized by the state where the couple resided. This ruling of the Court will have far-reaching ramifications for a variety of federal taxes, including income, estate, and gift taxes. There are over 200 places in the Internal Revenue Code where a person's marital status is relevant to a particular tax treatment.

In order to clarify these tax ramifications, on August 29, 2013, the IRS issued *Rev. Rul. 2013-17*, which by its terms is effective as of September 16, 2013. Taxpayers who were validly married under state law in prior years may also rely on the ruling to amend returns for those prior years that are still open under the applicable statute of limitations, but they are not required to do so.

The ruling clarifies two issues that were uncertain from the Court's opinion in *Windsor*. First, a same-sex couple will be treated as married for Federal tax purposes if their marriage was valid in the state or foreign jurisdiction where it took place, even if the couple is currently domiciled or residing in a state that does not recognize same-sex marriage. This is an important clarification, as same-sex marriage is recognized in only about one-third of the states.

This is the position of the Internal Revenue Service for all tax purposes; however, other federal agencies are not bound to follow this approach and indeed may choose the domicile approach to determine the validity of a same-sex marriage. Thus far, the Social Security Administration and the Department of Labor have indicated they will follow the domicile approach.

The second clarification is that the recognition of marriage for a same-sex couple does not extend to registered domestic partnerships or other civil unions. A same-sex couple who desires to be treated as married for

This publication may constitute "Attorney Advertising" under the New York Rules of Professional Conduct and under the law of other jurisdictions.

Federal tax purposes will have to actually become married under the law of a state that permits same-sex marriage.

Income tax consequences. Beginning with the 2013 tax year, a same-sex married couple will be required to file their Federal income tax return(s) either as married filing jointly or married filing separately. Filing as an unmarried individual will no longer be allowed, although filing as unmarried may still be mandatory in the state where the couple resides if that state does not recognize same-sex marriage. Married filing separately will usually result in higher taxes than filing as an unmarried individual. Married filing jointly may result in lower taxes if only one of the spouses has significant income, but will usually result in higher taxes if both spouses have significant income compared to filing as an unmarried individual.

If the couple did not file their 2012 Federal income tax returns before September 16, 2013, then they will also have to file their 2012 returns as either married filing jointly or married filing separately. Spouses who were legally married under state law in prior years may amend prior year filings if they determine doing so will reduce their income tax in the prior year and the statute of limitations is still open for the prior year. At this time, income tax returns for 2010, 2011, and 2012 can still be amended. In order to determine whether amending a return from a prior year to file it as a joint return will be beneficial, it will be necessary to have your accountant re-compute your tax for that year under the filing jointly classification.

The IRS ruling points out that if one of the spouses had a pre-tax salary reduction for health coverage under a cafeteria plan, but paid into the plan on an after-tax basis for his or her same-sex spouse, he or she may amend the return and treat the contribution for the spouse on a pre-tax basis as well.

Same-sex couples who separated or divorced in tax years before 2013 were not able to avail themselves of the benefits of IRC Section 1041, which allows spouses to transfer appreciated property to each other without recognizing the tax gain inherent in the property. If a couple made such a transfer and one of the spouses paid tax on the gain, it may be advantageous to amend that return if the statute of limitations is still open.

Estate and Gift Taxes. In the estate and gift tax arena, being treated as married may offer substantial benefits to a same-sex couple. It makes available the unlimited marital deduction for both estate and gift taxes, provides for portability of the estate tax exemption, and also allows the couple to treat gifts they make jointly as being made one-half by each spouse. Most couples should amend their estate planning documents to incorporate traditional marital deduction planning, at least if they intend to leave significant amounts to each other. Various beneficiary designations should also be reviewed to see if they are still appropriate in light of the couple now being treated as married. The IRS said that further guidance will be forthcoming regarding employee benefit plans and arrangements.

Estate and gift tax returns involving a same-sex spouse that were filed for prior tax years should be reviewed to see if amending to claim a marital deduction will be advantageous, provided the statute of limitations has not expired on the tax year. In almost all cases, it will be beneficial to claim a marital deduction where available.

We will continue to update you as further guidance is issued.

Inflation Adjustments for 2014

The IRS has announced the 2014 adjustments for those items under the Internal Revenue Code ("Code") that are annually adjusted for inflation. Among the most significant of these are:

- The maximum 39.6% income tax bracket for a married couple filing jointly will become applicable at a taxable income level of $457,600 (increased from $450,000 in 2013) and on the return of an unmarried individual at $407,650 (increased from $400,000 in 2013). For married individuals who file separate returns, the maximum bracket becomes applicable at $228,800 (increased from $225,000 in 2013).
- The lifetime exemption from estate, gift, and generation-skipping transfer taxes will be $5,340,000 (increased from $5,250,000 in 2013).
- The annual exclusion for gifts of a present interest will remain at $14,000, as in 2013.

Be Sure You Are Prepared for Higher Taxes in 2013

Many people will experience significantly higher income taxes in 2013 than in recent years. A number of factors will contribute to increased income tax liabilities including: i) the increase in the maximum marginal rate

from 35% to 39.6%; ii) the increase in the income tax rate imposed on long-term capital gains and qualified dividends from 15% to 20%; iii) the imposition of the new tax on net investment income of 3.8%; iv) the .9% increase in the Medicare tax imposed on wages and net income from self-employment from 2.9% to 3.8%; and v) the return to the law of the scaling back of allowable itemized deductions after adjusted gross income exceeds certain threshold amounts.

This year is a particularly important year for you to work with your tax advisors to develop a projection of your taxable income so that you can be sure you have made sufficient estimated tax payments to avoid underpayment penalties.

Be Sure to Obtain Proper Substantiation for Charitable Gifts

We have previously reported on several cases where deductions for charitable gifts were disallowed because the taxpayer did not have the required substantiation for the gift. In 2013 alone, there were at least a half dozen cases where the taxpayer lost a charitable contribution deduction only for lack of substantiation.

The required substantiation depends on the amount of the gift and whether it is cash or other property. All contributions of $250 or more require the donor to obtain a contemporaneous written acknowledgement of the gift from the donee. The written acknowledgement must state the amount of any cash gift and a description of any property that was given. The donee must also state whether the donor received any goods or services and a good faith estimate of the value of such goods or services. For gifts of property that are more than $5,000, the donor must obtain a qualified appraisal. Additional requirements apply if the value of the property exceeds $500,000 or if the contributed property is art.

Please be sure that you obtain all required substantiation before you file your income tax return and that you attach all the required forms to your income tax return. You should contact us or your return preparer if you have any questions about the substantiation required for a particular gift.

New Jersey Sales Tax Treatment of Cloud Computing

The New Jersey Division of Taxation ("NJDT") has released guidance addressing the sales tax treatment of cloud computing, which generally refers to services that allow a customer to remotely access and use a service provider's software. In cloud computing transactions, the service provider does not actually transfer software to the customer and the customer has no right to download, copy, or modify the software.

NJDT has determined that cloud computing services generally are non-taxable services for sales tax purposes. NJDT reasoned that cloud computing services do not constitute taxable tangible personal property because customers do not receive title or take possession of the software and such services do not alone constitute enumerated services that are otherwise subject to New Jersey sales tax. However, cloud computing services may be subject to New Jersey sales tax if they are provided together with the transfer of tangible personal property or other taxable services (e.g., information services).

The New York State Department of Taxation and Finance ("NYDTF") has taken the opposite position, treating cloud computing services as the sale of tangible personal property subject to New York sales tax. In NYDTF's view, customers receive taxable licenses to use prewritten software because customers obtain constructive possession of the software. NYDTF's position has been viewed by many as very aggressive and in conflict with prior binding legal precedent.

U.S. Supreme Court Denies Certiorari in New York Amazon Cases

The U.S. Supreme Court ruled in *Quill v. North Dakota* that the U.S. Constitution mandates that an out-of-state taxpayer must have a physical presence in a state before such state may require the taxpayer to collect a sales or use tax. The New York Court of Appeals previously ruled that New York's "Amazon" law, attributing physical presence to an out-of-state taxpayer by virtue of such taxpayer's contractual relationships with in-state persons, is constitutional. The U.S. Supreme Court recently denied Amazon and Overstock's petition for writ of certiorari seeking review of the New York Court of Appeals decision.

Several states currently have or are considering adopting “Amazon” laws. The New York Court of Appeals decision, even though it is not binding on other states, and the U.S. Supreme Court’s denial of certiorari will likely give other states comfort that similar laws can withstand scrutiny. The U.S. Supreme Court suggested in *Quill* that Congress “may be better qualified to resolve” the extent to which the physical presence standard should extend or whether a different standard should apply. Several pieces of federal legislation have been proposed over the years to address this issue, without any resolution. Unless Congress acts to resolve this issue, litigation challenging Amazon laws will likely continue in other states.

Taxpayer Fails to Prove Sufficient Participation under Passive Activity Loss Rules

If an individual owns an interest in a business in which he does not materially participate, he is subject to the Code’s passive activity loss limitations. In general, tax losses from a passive activity can only be deducted against income from a passive activity until the year in which the entire interest in the passive activity is sold. There are a number of ways in which an individual can materially participate in a business, the principal one of which is working in connection with the business for at least 500 hours during the tax year.

The ownership of income-producing real property is always a passive activity for an individual unless he is actively engaged in a real property trade or business as provided under Section 469(c)(7)(B) of the Code (such a person is often referred to as “real estate professional”). One of the requirements to qualify as a real estate professional is that the individual must spend at least 750 hours working in his real property businesses.

Clients often ask us what they must do to prove that they worked either the 500 or 750 required hours for purposes of the passive activity loss rules. The Tax Court shed some light on these requirements in the recently decided case of *Daco v. Commissioner (September 9, 2013)*. The taxpayer claimed to be a real estate professional and, as a result, the losses produced by his rental properties were not subject to the passive activity loss rules. In order to prove his 750 hours of participation, he prepared written summaries of his time and activities and also testified about his time and activities at the trial. In rejecting his claims, the court found the written summaries untrustworthy because they were created in preparation for the trial, rather than kept contemporaneously by the taxpayer. The court also found his testimony at the trial to be uncorroborated and self-serving.

The regulations provide some leeway to taxpayers as to how they keep track of their time, but it seems clear that in most cases a taxpayer is going to need some kind of contemporaneous written records. We believe that keeping either daily time sheets or making daily calendar time entries and notations are the best means of creating a record that can be used later to prove your level of participation.

Termination of Joint Tenancy between Brothers Was California Property Tax Change in Ownership

In *Richard N. Benson, as Assessor, v. Marin County Assessment Appeals Board*, the Court of Appeal (1st Dist., Div.1) for the State of California held that the conversion of joint tenancy ownership between two brothers into tenancy in common ownership constituted a change in ownership that allowed a reassessment of the property for purposes of the California real property tax. Peter Mikkelsen became the sole owner of real property in 1997 upon the death of his mother. His mother had previously transferred the property into joint tenancy ownership with Peter. Apparently believing that his brother James should have also acquired an interest in the property, Peter transferred title to the property from himself to himself and James as joint tenants, and it was held in that manner for about 10 years.

In 2007 James severed the joint tenancy by executing and recording a deed to himself as a tenant in common. The county assessor determined that this was a change in ownership and reassessed the property. James appealed to the Assessment Appeals Board, which reversed the Assessor. The Assessor then petitioned the Superior Court for a writ of review, which was denied. This led to the subsequent appeal to the Court of Appeal.

The court admitted that the statutes enacted to implement Proposition 13 are somewhat contradictory and conflicting. James argued that the termination of the joint tenancy was not a change in ownership under

Section 60 of the California Revenue and Taxation Code ("R & T Code") because a change in ownership requires the transfer of a present interest in the property and the conversion of a joint tenancy to a tenancy in common does not involve any transfer of a present interest. He also relied on Section 62(a)(2) of the R & T Code which provides that a change in ownership does not include any transfer between co-owners that results in a change in the method of holding title to the real property transferred without changing the proportional interests of the co-owners. On its face, this section supports James' argument that the conversion from a joint tenancy to a tenancy in common is not a change in ownership.

The Court of Appeal determined, however, that the more specific provisions of Section 65 of the R & T Code were applicable, which deal specifically with the creation and termination of joint tenancies. Section 65(b) provides that the creation of a joint tenancy is not a change in ownership as long as the transferor of the property is one of the joint tenants. This means that when Peter transferred the property from his sole ownership to joint tenancy ownership between himself and his brother, there was no change in ownership. While Peter certainly had transferred a present interest in the property to James, the court reviewed the legislative history of the change in ownership provisions and determined that the legislature made a conscious determination to limit the number of reassessments by providing that the creation of a joint tenancy was not a change in ownership where the prior owner continued his ownership as one of the joint tenants.

Instead of treating the creation of a joint tenancy as a change in ownership, the legislature decided instead to treat the termination of a joint tenancy as a change in ownership. Section 65(c) provides that where an interest in a joint tenancy is terminated, any portion of the property that does not go back to the original owner is reassessed. The court held that under this provision, the 50% of the property that went to James in 2007 when he terminated the joint tenancy was properly reassessed at that time.

Taxpayer Does Not Convince Court That She Was a Stock Trader

Most of the expenses incurred by investors related to their investing activity are deductible as miscellaneous itemized deductions. These expenses may include subscription publications and services, fees for investment advice, office-related expenses, and other costs. Miscellaneous itemized deductions are less valuable than other kinds of itemized deductions or business deductions for two primary reasons: i) miscellaneous itemized deductions are not deductible for purposes of computing the alternative minimum tax; and ii) for purposes of computing the regular income tax, they are deductible only to the extent they exceed 2% of the taxpayer's adjusted gross income.

Investors who engage in high-volume trading of stocks and other securities sometimes take the position that they are engaged in a "trade or business" of trading securities. If this position is correct, all their related expenses are deductible as business deductions and not subject to the above limits.

The IRS and the courts take a very strict view of what is required to be engaged in a trade or business as a trader of securities. The taxpayer must engage in a very high volume of trades, must seek to profit from daily or short-term price movements rather than long-term growth, and must engage in trading activity on most days on which the markets are open.

In *Nelson v. Commissioner (November 13, 2013)*, the Tax Court determined that the taxpayer's trading activity was not sufficient to meet the requirements in two different tax years. The taxpayer completed 535 trades in 2005, and 235 trades in 2006. In 2005, the taxpayer traded on 121 out of the 250 days on which markets were open, and in 2006 she traded on 66 out of 250 possible trading days. The court also noted that a significant number of the total trades occurred in a short period and that there were long periods during which no trading occurred.

In other cases where taxpayers have prevailed on this issue, the court found that 1,543 trades in a year and 1,136 trades in a year were substantial. A person seeking to establish that he or she is engaged in a trade or business of trading securities should plan to execute substantially more than 1,000 trades per year and also engage in trading activities on a substantial majority of all days on which the markets are open, with no long gaps with little or no trading activity. Trades should be closed the same day or within a short period. It may also be helpful to keep a daily written record of the time spent trading and researching securities to trade.

Supreme Court Resolves a Split in the Circuit Courts over the Application of a Valuation Penalty Where Deductions Are Disallowed for Lacking Economic Substance

In *United States v. Woods (December 3, 2013)*, the Supreme Court resolved a split among different circuits of the United States Court of Appeals on the application of the valuation and tax basis overstatement penalty. IRC Section 6662(b) imposes a penalty on any tax deficiency that results from a taxpayer's overstatement of either the value or the tax basis of an asset. In Woods, as well as in prior cases, the Fifth Circuit held that where the IRS disallowed a deduction because the transaction that gave rise to it lacked economic substance, it could not also impose the penalty for overstating a tax basis, even if it was the overstated tax basis that gave rise to the deduction.

In these cases, the taxpayer used an artificially inflated asset tax basis to generate a tax loss when the asset was sold. The IRS disallowed the loss on the basis that the transaction giving rise to the loss lacked any economic substance apart from the creation of tax benefits. The reasoning of the Fifth Circuit was that once the IRS determines the transaction lacked economic substance, any loss would be disallowed, whether or not it resulted from an overstatement of the tax basis of the asset. Therefore the tax basis overstatement penalty could not be applied.

Several other circuits had addressed this issue and they concluded that the tax basis overstatement penalty could be applied. These courts found that since the loss resulted from an overstated tax basis, the lack of economic substance and the tax basis overstatement were inextricably linked. The Supreme Court agreed and held the tax basis overstatement penalty could be applied even where the reason for denying a deduction was that the underlying transaction lacked economic substance.

© 2013 Loeb & Loeb LLP. All rights reserved.

Trusts and Estates and Tax Departments

Name	Email	Phone
MICHELLE W. ALBRECHT	MALBRECHT@LOEB.COM	212.407.4181
JOHN ARAO	JARAO@LOEB.COM	310.282.2231
MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
RYAN M. AUSTIN	RAUSTIN@LOEB.COM	310.282.2268
AMY BELL	ABELL@LOEB.COM	310.282.2170
LAURA B. BERGER	LBERGER@LOEB.COM	310.282.2274
LEAH M. BISHOP	LBISHOP@LOEB.COM	310.282.2353
SUSAN G. BLUMENTHAL	SBLUMENTHAL@LOEB.COM	202.618.5009
LIORA BRENER	LBRENER@LOEB.COM	212.407.4108
DEBORAH J. BROSS	DBROSS@LOEB.COM	310.282.2245
TARIN G. BROSS	TBROSS@LOEB.COM	310.282.2267
CHRISTOPHER W. CAMPBELL	CWCAMPBELL@LOEB.COM	310.282.2321
THERESA R. CLARDY	TCLARDY@LOEB.COM	310.282.2058
REGINA I. COVITT	RCOVITT@LOEB.COM	310.282.2344
TERENCE F. CUFF	TCUFF@LOEB.COM	310.282.2181
LINDA N. DEITCH	LDEITCH@LOEB.COM	310.282.2296
RACHEL R. DEMENY	RDEMENY@LOEB.COM	212.407.4135
PAUL N. FRIMMER	PFRIMMER@LOEB.COM	310.282.2383
ANDREW S. GARB	AGARB@LOEB.COM	310.282.2302
ELIOT P. GREEN	EGREEN@LOEB.COM	212.407.4908
RACHEL J. HARRIS	RHARRIS@LOEB.COM	310.282.2175
TANYA A. HARVEY	THARVEY@LOEB.COM	202.618.5024
DAVID M. HODGE	DHODGE@LOEB.COM	310.282.2224
KAREN L. KUSHKIN	KKUSHKIN@LOEB.COM	212.407.4984
THOMAS N. LAWSON	TLAWSON@LOEB.COM	310.282.2289
JEROME L. LEVINE	JLEVINE@LOEB.COM	212.407.4950
JEFFREY M. LOEB	JLOEB@LOEB.COM	310.282.2266
MARY ANN MANCINI	MMANCINI@LOEB.COM	202.618.5006
ANNETTE MEYERSON	AMEYERSON@LOEB.COM	310.282.2156
DAVID C. NELSON	DNELSON@LOEB.COM	310.282.2346
LANNY A. OPPENHEIM	LOPPENHEIM@LOEB.COM	212.407.4115
CAITLIN M. ORR	CORR@LOEB.COM	202.618.5026
RONALD C. PEARSON	RPEARSON@LOEB.COM	310.282.2230
ALYSE N. PELAVIN	APELAVIN@LOEB.COM	310.282.2298
JONATHAN J. RIKOON	JRIKOON@LOEB.COM	212.407.4844
STANFORD K. RUBIN	SRUBIN@LOEB.COM	310.282.2090
LAURIE S. RUCKEL	LRUCKEL@LOEB.COM	212.407.4836
CRISTINE M. SAPERS	CSAPERS@LOEB.COM	212.407.4262
JOHN F. SETTINERI	JSETTINERI@LOEB.COM	212.407.4851
ANDREW K. STEENBOCK	ASTEENBOCK@LOEB.COM	310.282.2242
REBECCA M. STERLING	RSTERLING@LOEB.COM	310.282.2301
MEGAN A. STOMBOCK	MSTOMBOCK@LOEB.COM	212.407.4226
ADAM F. STREISAND	ASTREISAND@LOEB.COM	310.282.2354
ALAN J. TARR	ATARR@LOEB.COM	212.407.4900
STUART P. TOBISMAN	STOBISMAN@LOEB.COM	310.282.2323
JESSICA C. VAIL	JVAIL@LOEB.COM	310.282.2132
NICHOLAS J. VAN BRUNT	NVANBRUNT@LOEB.COM	310.282.2109
GABRIELLE A. VIDAL	GVIDAL@LOEB.COM	310.282.2362
JOHN S. WARREN (Ret.)	JWARREN@LOEB.COM	310.282.2208
BRUCE J. WEXLER	BWEXLER@LOEB.COM	212.407.4081
DANIEL M. YARMISH	DYARMISH@LOEB.COM	212.407.4116