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High Net Worth Families

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What You Need to Know About Corporate Inversions

It seems like every day brings news of another possible corporate inversion transaction. The news reports usually describe these transactions as another United States corporation moving or relocating outside of the country. While the management of the U.S. company tries to downplay the tax impact, most of these transactions *are* largely driven by tax savings – for the corporation. While they may lower taxes for the corporations that are inverting, these transactions generally result in tax bills for many shareholders.

The U.S.-based company does not actually move offshore in an inversion transaction. Instead, the company agrees to acquire a foreign corporation and structures the acquisition so that the U.S. company becomes a subsidiary of the foreign company it is acquiring. The shareholders of the U.S. company exchange their shares for shares of the foreign corporation. Since the U.S. company usually has a larger market capitalization than the foreign corporation, at the completion of the transaction the former shareholders of the U.S. company often end up owning more than 50 percent of the shares of the foreign corporation that was acquired. The foreign corporation must have sufficient market capitalization so that the U.S. shareholders do not end up owning 80 percent or more of the foreign corporation, or it will be treated as a U.S. corporation for income tax purposes and the inversion will not have accomplished anything. (Some of the proposals being discussed in Congress to stop inversions would lower this threshold to 50 percent.)

Transactions involving the exchange of stock for stock of the acquiring company are normally structured in a manner that allows the U.S. shareholders to exchange their stock without having to recognize any tax gain that may be inherent in their shares. A different rule applies, however, where the shares are exchanged for shares of a foreign corporation in which the U.S. shareholders will receive more than 50 percent of the stock. In that case, the exchange is taxable to the U.S. shareholders. The taxes may be significant if a shareholder owns a large block of stock, the shareholder has held it for a very long time and it has a low cost basis.

While the shareholders are given an opportunity to vote on the transaction, many of the outstanding shares may be owned by pension funds and other institutions that are not sensitive to tax considerations. Individual shareholders may be forced into a transaction that will result in a large tax bill. If you are charitably inclined, donating the shares of a corporation that is likely to be inverted may be a smart move. You can give the shares to a charity without recognizing your tax gain and still receive a charitable contribution deduction for the full fair market value of the shares, subject to the applicable percentage limitations.

If you want to consider a charitable contribution of shares of a company likely to invert, you must make the contribution before the transaction has received all necessary approvals and the charity is legally required to exchange the shares for shares of the foreign corporation. If you wait too long, the gift will be treated as one in which you sold the shares and then gave the resulting cash to the charity. The safest course is to donate the shares before the shareholders of the U.S. company have approved the transaction.

Concerned that Congress would not be able to act on inversion transaction in an expeditious manner, the IRS on September 22 issued Notice 2014-52. The Notice provides that regulations will be issued under five different sections of the Internal Revenue Code in order to make inversions more difficult to implement and to reduce the tax benefits of inverting. The regulations will be effective for inversion transactions completed on or after September 22, 2014.

The regulations will make it more difficult for a U.S. corporation to invert by tightening the rule that the former shareholders of the U.S. company cannot own 80 percent or more of the foreign acquirer after the inversion. The bulk of the regulations will make inversions less beneficial by making it more difficult for the new foreign parent to utilize the tax-deferred foreign earnings of the acquired U.S. company. We will continue to monitor this area and keep you apprised of any further developments.

Taxpayer Avoids Penalties by Relying on Professional Advice

In the recent Tax Court case of *Vision Monitor Software LLC v. Commissioner (September 3, 2014)*, the Tax Court disallowed a taxpayer's deduction for losses incurred by a partnership in which he was a partner because he did not have sufficient income tax basis in his partnership interest to deduct those losses. The taxpayer claimed that he obtained the needed basis by contributing his own promissory note to the partnership. The court denied the basis and pointed out that there is considerable previous case law that says a taxpayer does not have any tax basis in his own note.

The IRS also sought to impose the 20 percent substantial understatement penalty. One defense against the imposition of this penalty is the taxpayer's reliance on professional advice. The partnership's longtime attorney, who is a certified tax specialist, recommended the note contribution as a means of increasing the partners' tax basis in the partnership. He gave this advice orally rather than in writing. In order to use reliance on professional advice as a defense against the substantial understatement penalty, the taxpayer must establish that (1) the advisor was a competent professional who had sufficient experience to justify reliance; (2) the taxpayer provided the advisor with the necessary and accurate information on which to base his advice; and (3) the taxpayer actually relied in good faith on the advisor's judgment.

The court found all three of these conditions were satisfied and granted the taxpayer relief from the penalty. While there is no requirement that the relied-on advice be written, getting professional advice in writing is certainly the better practice. Whether the taxpayer acted reasonably in relying on this advice when several cases had already held that a taxpayer did not have any tax basis in his own note is a good question. The advisor made a weak argument that another case – one that granted the basis to the taxpayer – applied in this case, but the court held it was not applicable because the case was based on very different facts. The court nevertheless determined that the advice given by this advisor would seem reasonable to the taxpayer, who did not have deep knowledge of the tax law.

IRS Streamlines Offshore Voluntary Disclosure Program

On June 18, 2014, the IRS announced new Streamlined Filing Compliance Procedures (Streamlined Programs) and changes to the existing Offshore Voluntary Disclosure Program (OVDP). These programs are intended to help taxpayers correct any failures to report foreign financial assets and income (and to fix other tax compliance issues). The following provides a summary of the key features of the new Streamlined Programs and the changes made to the existing OVDP.

Streamlined Programs — There are two different Streamlined Programs – one for U.S. taxpayers residing outside the United States, and one for U.S. taxpayers residing in the United States. These two programs have many of the same requirements. For example, both programs require (1) either an original or an amended U.S. tax return, depending on the circumstances, for the three most recent years for which the due date for the return has passed (including extensions); (2) payment of any tax shown as due on the returns submitted under the program plus interest; (3) Foreign Bank Account Reports FBARs electronically filed for the most recent six years for which the filing deadline has passed; and (4) a written statement (on the form required by the IRS) signed under penalties of perjury that certifies, among other things, that the taxpayer's failure to report offshore accounts and income was due to non-willful conduct. For this purpose, the IRS has defined non-willful conduct as conduct that is due to negligence, inadvertence, mistake or a good faith misunderstanding of the law. On the other hand, willfulness is generally understood to mean a voluntary, intentional violation of a known legal duty.

In addition to the requirements mentioned above, U.S. taxpayers residing in the United States generally must pay an offshore penalty equal to 5 percent of the highest aggregate balance/value of the taxpayer's foreign financial assets during the past six years. The offshore penalty does not apply to U.S. taxpayers that (1) do not have a U.S. abode and (2) have been physically outside the U.S. for at least 330 days for any one or more of the most recent three years for which the due date for the return has passed. If a U.S. taxpayer successfully completes one of the Streamlined Programs, the IRS agrees to waive any failure-to-file and failure-to-pay penalties, accuracy-related penalties, information-return penalties, and FBAR penalties for the amounts reported under the one of the Streamlined Programs. This waiver does not apply if the taxpayer's original noncompliance was the result of fraud or willful misconduct, however. In addition, the IRS does not provide any confirmation as to whether the taxpayer has successfully completed a Streamlined Program.

OVDP — For taxpayers who do not meet the eligibility requirements for the Streamlined Programs, the OVDP still may be an option. The change recently made by the IRS to the current OVDP was to increase the 27.5 percent offshore penalty to 50 percent in the case of taxpayers who had accounts with any bank or facilitator identified by the U.S. Department of Justice as being under investigation or as cooperating with a government investigation.

Warning — Once a taxpayer makes a submission under one of the Streamlined Programs, the taxpayer is no longer eligible for the OVDP. Similarly, a taxpayer who submits an OVDP disclosure letter after July 1, 2014, is disqualified from participating in the new Streamlined Programs. If the IRS has initiated a civil audit or criminal investigation of the taxpayer, regardless of whether the audit or investigation relates to undisclosed foreign financial assets, and regardless of whether the taxpayer knows about the audit or investigation, that taxpayer will not be eligible for any of the IRS's disclosure programs mentioned above. Taxpayers should seek professional tax advice before entering into one of the IRS's disclosure programs.

IRS Issues Additional Guidance as to When Construction Begins for Production Tax Credit

As described in prior newsletters, a taxpayer is entitled to a production tax credit (PTC) with respect to sales of electricity from certain qualified facilities where construction of the facility began before January 1, 2014. The IRS had previously provided two methods to determine when construction began on a qualified facility – a physical work test and a 5 percent safe harbor test.

Recognizing that uncertainty as to whether particular projects will qualify for the PTC has delayed outside investment, the IRS has issued additional guidance. The new guidance clarifies that the physical work test focuses on the nature of the work performed, not the amount or cost. Assuming the work performed is of a significant nature, there is no fixed minimum amount of work or monetary or percentage threshold requirement.

The IRS also clarified that a taxpayer may begin construction of a facility with the intent to develop it at a certain site but thereafter transfer equipment and other components of the facility to a different site, where development is completed and the facility is placed in service. The work performed or amounts paid or incurred by the taxpayer before 2014 may be taken into account for purposes of determining when construction began with respect to the facility.

The IRS also clarified rules relating to transfers of equipment between unrelated parties. If a facility is transferred by a developer to an unrelated taxpayer, the work performed or amounts paid or incurred by the developer before 2014 are taken into account if the facility consists of more than just tangible personal property but not if it consists solely of tangible personal property (including contractual rights to the property under a binding written contract).

The new guidance adds another safe harbor in the case of a single project comprising multiple facilities. In this case, if the taxpayer paid or incurred at least 3 percent of the total cost of the project before January 1, 2014, the safe harbor will be deemed satisfied with respect to any number of individual facilities as long as the aggregate cost of those individual facilities at the time the project is placed in service is not more than 20 times the amount paid or incurred by the taxpayer before 2014 and the continuous efforts test is met (or deemed met) under prior guidance. For example, assume Developer incurs $30,000 in costs prior to January 1, 2014, to construct a five-turbine wind farm that will be operated as a single project. In October 2015, Developer places the project in service. The total cost of the project is $800,000, with each turbine costing $160,000. Since Developer incurred at least 3 percent (but less than 5 percent) of the total cost before 2014 and satisfied the continuous efforts test by placing the project in service before 2016, Developer may claim the PTC on electricity produced from three of the turbines ($480,000 cost of the three turbines is less than 20 x $30,000 incurred before 2014; that would not be the case based on four turbines).

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The End of the Year Is Rapidly Approaching

Now is a good time to think about year-end tax planning in multiple areas. Many people take advantage of the annual exclusion from gift tax that is available to each person to make gifts each year. For 2014, the annual exclusion amount is $14,000, and this amount can be given to an unlimited number of donees. You can also make direct payments of tuition and medical expenses for an individual without incurring any liability for gift tax. These payments are not subject to and do not count against the $14,000 annual exclusion amount.

Interest rates also remain very low, but many think increases are on the horizon. Intra-family sales of assets can be structured with loans bearing interest at the Applicable Federal Rate (AFR). For October 2014, the AFR for loans with a maturity of more than three but less than nine years is 1.85 percent for loans requiring annual payments of interest. For loans with a term of nine years or more, the rate is 2.89 percent with annual payments of interest. For very short-term loans of not more than three years, the rate is .38 percent for loans requiring annual payments of interest. Certain other wealth transfer strategies also benefit from a low interest rate environment. Included among these are grantor retained annuity trusts (GRAT). For September 2014, the discount rate used to compute the required annuity payment is 2.2 percent.

It may be advantageous to pay deductible expenses and make charitable contributions before year-end unless you have reason to believe your tax bracket will be significantly higher next year. Many itemized deductions are impacted by the alternative minimum tax, so you will have to prepare, or work with your accountant to prepare, a reasonably accurate tax projection.

Depending on your age, you may want to either make deductible contributions to retirement accounts or be required to take minimum distribution amounts out of the plan. Penalties apply where a required minimum distribution is not taken.

Finally, if you have realized capital gain income, you may wish to see if you have investments or other assets with unrealized losses you could sell to reduce your taxable gain. If you sell stock or other securities at a loss and wish to repurchase the same stock or securities, you can do so if you wait for 30 days after your sale. If the same stock or security is purchased within 30 days before or after your sale, the loss will not be deductible.

IRS Changes Rules Regarding IRA Rollovers

The IRS has issued Announcement 2014-15, which provides that the IRS will be following the decision in *Borrow v. Commissioner, TC Memo 2014-21*. That case holds that the one-rollover-per-year rule under Section 408(d)(3)(B) applies to all of a taxpayer's IRAs, not to each IRA separately. This is a change in the IRS position, and the IRS has indicated that it will be rewriting Publication 590 to reflect this change. This means that the one-rollover-per-year rule (applied on a 12-month basis, not a calendar-year basis) is now going to apply on a taxpayer basis, rather than an IRA by IRA basis. Note that there is no limit on the number of direct transfers. The IRS has announced that it will not apply the new rule to any rollover that involves an IRA distribution occurring before January 1, 2015.

Tax Court Addresses Income, Estate and Gift Tax Issues Related to Personal Goodwill

In the recent case of *Bross Trucking, Inc., TC Memo 2014-107*, the Tax Court again considered whether the shareholder of a corporation was possessed of personal goodwill relative to the business of the corporation. The case is important because the existence of personal goodwill may enable a shareholder of a C corporation that is selling its assets to receive a significant part of the purchase price directly from the buyer, rather than through the corporation. If a C corporation sells its assets, the corporation pays tax on any gain realized, and if the after-tax proceeds are distributed to the shareholders, they may realize additional gain and pay additional tax at their level. If the shareholder can establish that he owns personal goodwill related to the corporation's business, he can sell that goodwill directly to the buyer and avoid any corporate tax on that component of the sales price.

A sale was not at issue in the Bross case. Mr. Bross was the sole shareholder of Bross Trucking, which provided trucking services to construction companies, many of which were owned by members of his family. Bross Trucking was charged with several regulatory violations and was in danger of having its trucking operations shut down, so Mr. Bross decided that Bross Trucking should cease its trucking business. To ensure continued availability of trucking services for his construction companies, Mr. Bross' sons formed a new trucking company. No assets were actually transferred from Bross Trucking to the new company, but about 50 percent of its employees were former employees of Bross Trucking.

On audit, the IRS took the position that Bross Trucking distributed its goodwill to its shareholder Mr. Bross, who then made a gift of that goodwill to his sons. This distribution would cause the corporation to recognize a tax gain because the goodwill had significant value but no tax basis. The Tax Court determined that Mr. Bross personally owned any goodwill that existed. There were a few keys to this conclusion. The court found that Mr. Bross developed numerous personal relationships with customers and suppliers that were important to the business of Bross Trucking. Mr. Bross had no employment agreement in place with Bross Trucking that prohibited him from competing with the corporation. In the court's view, this meant that any goodwill attributable to those relationships was owned by Mr. Bross and not by Bross Trucking. Additionally, Bross Trucking could not really have goodwill of any significant value, given that it was on the verge of being shut down by the regulators.

Finally, the court considered whether there could have been a transfer of goodwill associated with the workforce in place at Bross Trucking by virtue of the fact that 50 percent of the new company's employees had previously been employed by Bross Trucking. The court determined there was no transfer of a workforce in place because the new company hired its own employees and there was no plan or program for such an employee transfer. Also, the other 50 percent of the employees of the new company, including a number of key employees, did not previously work for Bross Trucking.

The IRS also contended that Mr. Bross made a gift to his sons of the goodwill assets he received from Bross Trucking. The court held he did not transfer any goodwill to his sons because he did not receive any goodwill from Bross Trucking. This does not mean that Mr. Bross could not have made a gift of his own personal goodwill in the trucking business to his sons. The court's apparent reasoning for there being no gift by Mr. Bross of his own goodwill was its factual finding that the new company developed its own customers through the contacts the sons had and the company did not use any of Mr. Bross' goodwill.

Tax Court Attributes Significant Value to Personal Goodwill in Estate Tax Valuation Case

Two months after the Tax Court decided the *Bross Trucking* case, it addressed the significance of personal goodwill in valuing the stock of a closely held corporation, STN.Com Inc. in *Estate of Franklin Z. Adell*, TC Memo 2014-155. The decedent, Franklin Adell, owned all of the shares of STN stock. His son Kevin was the president of STN and was instrumental in the development of its business.

STN provided cable uplinking for its only customer, the Word, which was a 24-hour, urban, religious programming station. Kevin had prior experience with religious programming and used his connections to garner the support of various religious leaders in launching the Word.

In valuing the STN shares for Franklin's estate tax return, the estate appraiser used the discounted cash flow method, projecting future revenue for the five years subsequent to death. In determining the projected cash flow during that period, the estate's appraiser reduced the cash flow by an economic charge for Kevin's personal goodwill because STN's revenue was dependent upon Kevin's relationships. Kevin had no employment agreement with STN and was not subject to a covenant not to compete. The appraiser quantified the economic charge at between 37 and 44 percent of sales. There is no explanation in the decision as to how this very sizable charge was derived.

The Tax Court accepted this valuation, concluding that because Kevin was free to leave STN and compete against it, the large economic charge taken was warranted. This economic charge had an enormous impact on the value of STN, reducing the value by more than 70 percent from what it would have been without the economic charge.

This adjustment for personal goodwill was enormously beneficial to the estate, resulting in a final valuation which was about one-third of the IRS appraiser's value. The reduction attributable to Kevin's personal goodwill is conceptually similar to a loss of key person discount. However, the decisions authorizing such a discount have generally quantified that discount at 5 to 15 percent. The economic charge applied in the Adell case is tantamount to a loss of key person discount of more than 50 percent.

It remains to be seen whether this valuation approach to personal goodwill could supplant the much more modest loss of key person discount in the future. However, the taxpayer victories in *Bross Trucking* and *Adell* could also turn into a double-edged sword. The IRS asserted in *Bross Trucking* that the transfer of personal goodwill was a taxable gift. The court did not reject that possibility entirely, but found that the facts did not support that such a transfer was made. However, suppose Kevin Adell had used his personal relationships to help establish his children in a new cable uplinking venture. The rationale behind *Bross Trucking* and the quantification of personal goodwill endorsed in the *Adell* decision could result in the IRS asserting that Kevin Adell's assistance to his children amounted to a multi-million-dollar taxable gift.

California Franchise Tax Board Expands Concept of Doing Business in California for Out-of-State Corporations

In a legal ruling issued in July, the California Franchise Tax Board held that where the only contact with California an out-of-state corporation has is as a member of a limited liability company that is doing business in California, the out-of-state corporation is doing business in California for the purposes of the $800 minimum franchise tax imposed each year on corporations incorporated in, or doing business in, California. The ruling does not draw any distinction between member-managed and manager-managed limited liability companies.

The State Board of Equalization had held in a 1996 case that a limited partner of a limited partnership doing business in California is not considered to be doing business in California merely as a result of being a limited partner, if it had no other contacts with the state. The FTB apparently feels that limited liability companies are different from limited partnerships, although this distinction is murky at best in the case of a non-managing member of a manager-managed limited liability company. It remains to be seen whether this ruling will pass judicial muster for the nexus required under the United States Constitution in order for a state to be able to tax the income of a non-California-based taxpayer.

Recent Case Emphasizes Importance of Keeping Records of the Tax Basis of Assets

A Tax Court case that was recently affirmed by the United States Court of Appeals highlights the importance of keeping good records of the income tax basis of your assets. In the case of *Hoang v. Commissioner*, the taxpayer did not report any gains from securities sales on his 2006 income tax return.

The IRS, however, received copies of 1099s issued in the taxpayer's name by various brokerage firms. The IRS assessed tax based on a taxable gain equal to the total proceeds reported on the 1099s. In the Tax Court, the taxpayer was given the opportunity to provide evidence of his income tax basis in the securities sold, but he declined to do so. The Tax Court determined, and the Court of Appeals agreed, that the IRS was correct in determining the gain as the full amount of the proceeds received from the sales.

The mandatory broker reporting of tax basis will greatly alleviate these issues as to investments held in brokerage accounts. As to other asset classes, however, it is up to taxpayers to keep records of the adjusted income tax basis of their assets and to prove the basis if called upon to do so in an audit.

Court Holds That Land Sold Was Inventory That Gave Rise to Ordinary Income

We normally think that selling a parcel of land one has held for a long period of time will result in capital gain income subject to federal income tax at a lower rate than ordinary income. A recent court decision reminds us that this is not always the case. Mr. Allen purchased a parcel of real property in 1987. He admitted during pretrial discovery that he purchased the property with the intent of developing it for sale. He attempted to develop the property through 1995 but was not successful. He then spent four years looking for financial partners and developed multiple sets of plans for the development of the property. In 1999, Mr. Allen sold the property to a developer under an agreement that called for him to receive a specified amount each time the developer sold a lot from the property. Mr. Allen received the final installment payment in 2004.

Mr. Allen reported the sale on his tax return as giving rise to a long-term capital gain. Following an audit, the IRS determined that Mr. Allen always intended to sell the property and worked to do so from the date he acquired the property. Therefore, in the IRS's view, the property was "held primarily for sale" and was not a capital asset in Mr. Allen's hands.

As a starting point, most kinds of property are capital assets under the definition contained in the Internal Revenue Code. The Code also contains a number of exceptions, however. One exception is any property that is held by the taxpayer primarily for sale. It is well established that when somebody buys a tract of land and then subdivides it and sells individual lots, those lots are not capital assets because the taxpayer bought the land with the intention of selling it. This is a very subjective area because most of the time when somebody purchases an investment, he or she hopes to realize a gain by selling it at some point, yet sales of assets held for investment do give rise to capital gain income in most cases. The court attempts to draw distinctions between situations where a taxpayer purchases something and it appreciates over time and situations where the taxpayer attempts to add value by working to transform the nature of the asset.

The case ended up in the United States District Court for the Northern District of California. The court determined that Mr. Allen purchased the property with the intent to develop and sell it and was actively involved in attempting to develop the property for the sale of lots. While Mr. Allen claimed that he had abandoned his development efforts, the court found that he had not done anything to demonstrate when or why his intent changed with respect to the property.

An interesting aspect of the court's analysis centers on the fact that Mr. Allen made only a single sale with respect to the property. It is a commonly held view that one cannot be viewed as holding property primarily for sale if the owner disposes of it in a single-sale transaction. The court noted that any notion of a "one-bite" rule, in the words of the court, has been rejected in other cases.

The takeaway from this case is that if you purchase property intending to develop it but later change your mind, you need to do something visible and provable that will document your changed intention regarding the property. For example, if you had applied for a subdivision map or other entitlements, withdrawing your application could be used later as evidence of your changed intention regarding the property. This case reminds us that selling the property in a single-sale transaction may not be enough to generate capital gain income, even where the property had been held for 12 years.

Another Taxpayer Mistake Causes Loss of Charitable Contribution Deduction

It has become unusual for a month to go by without the tax news reporting another case where a taxpayer has lost a charitable contribution deduction due the failure of the taxpayer to follow all of the rules relating to the particular deduction. We have written about this before but it continues to be in the news, and it is apparent that the IRS is continuing to scrutinize closely deductions for charitable contributions. In order to obtain a deduction, the taxpayer must follow a series of very particular rules. A series of court cases indicates there is virtually no margin for error.

A recent case in this area deals with conservation easements. In *Seventeen Seventy Sherman Street, LLC (TC Memo 2014-124)*, the Tax Court disallowed the taxpayer's charitable contribution deduction because the taxpayer failed to take into account the value of property received back in the transaction. In computing his charitable contribution deduction, the taxpayer must subtract from the gross amount of his gift the value of anything that the taxpayer receives back as a result of making the gift.

The property item that caused the taxpayer to lose his deduction was much less common than the kinds of things normally received, such as attendance at a banquet or the value of goods or services purchased at a charitable auction. In this case the taxpayer dedicated a conservation easement over property the taxpayer owned and hoped to develop. In consideration for the granting of the easement, the taxpayer received a zoning change for the property. The taxpayer did take the value of the zoning change into account in determining the value of the easement for purposes of computing his income tax deduction.

The taxpayer also received a recommendation from the local planning and development agency to the planning board that the taxpayer's request for a variance from the view preservation ordinance be approved. The taxpayer did not put any value on this recommendation or make any corresponding reduction to the amount of his contribution deduction. The court determined that the recommendation was a bargained-for consideration that, based on the record in the case, was very important to the taxpayer. The taxpayer had not submitted any evidence as to the value of the recommendation; therefore, the court was unable to determine whether the value of the easement granted was greater than the value of the consideration received back by the taxpayer. In short, the court could not determine whether the taxpayer had given anything, so it did not allow any deduction.

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