High Net Worth Families

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Loeb & Loeb LLP is pleased to announce Diara M. Holmes and Marcus S. Owens, former director of the IRS Exempt Organizations Division, have joined the firm's nationally-recognized Charitable Giving and Tax-Exempt Organizations Practice as partners in the Washington, D.C. office. The pair will expand Loeb's tax-exempt organizations practice as they counsel some of the nation's most prominent nonprofit organizations on transactional planning, tax controversy, investigations and governance matters. With 25 years of government service, including 10 years as director of the EO Division, Mr. Owens brings unrivaled depth to our tax and exempt organizations practice areas. His distinguished background, together with Ms. Holmes' extensive experience advising nonprofits in private practice in New York, California and D.C., will be invaluable as we continue to address the unique challenges facing our nonprofit clients. You can obtain additional information about Mr. Owens and Ms. Holmes on our website through the below link.

http://www.loeb.com/news-announcementsandpressreleases-loebdclateralsowensandholmes

Recent Case Illustrates Importance of Keeping Legal Entities in Good Standing

A recent United States Tax Court case illustrates the importance of keeping legal entities in good standing. *In Medical Weight Control Specialists (TC Memo 2015-52)*, the taxpayer corporation received a statutory notice of deficiency from the IRS. Upon receipt of such a notice, a taxpayer has a period of 90 days within which to file an appeal in the Tax Court. The taxpayer filed its petition with the Tax Court within the required period.

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The corporation's privileges had previously been suspended by the state of California because it had not paid some required state taxes. After the petition was served on the IRS, the IRS moved to dismiss the petition because the corporation had been suspended by the state of California. Subsequent to the filing of this motion by the IRS, the corporation became reinstated under California law. Notwithstanding the subsequent reinstatement, the court held that the petition should be dismissed because the corporation's powers were suspended during the 90 day window for it to file a Tax Court petition. In the Court's view, that meant that the corporation did not have the power or authority under state law to file a petition. Therefore the court did not have any jurisdiction over the case.

We routinely see instances where legal entities have been suspended by their state of incorporation for a variety of reasons, including the nonpayment of required taxes or failing to file required returns or reports. This often happens when the purposes for which the entity was formed have been completed and the owners simply do not bother to go through the formal dissolution procedures. In many circumstances this does not turn out to be of any consequence. However, as this case illustrates, serious problems may arise if the entity is facing a tax deficiency and needs to file an appeal in the Tax Court.

In California, entities continue to be subject to the $800 minimum franchise tax for each tax year until they are formally dissolved. With applicable penalties and interest, these amounts can become significant over time. Under some circumstances the state may seek to collect these taxes from the owners of the entity. The best and safest procedure is to keep all legal entities in good standing with their states of incorporation and each state in which they are registered to do business, and then formally dissolve them when they have served their purpose.

Estate Loses Charitable Contribution Set-aside Deduction

The Tax Court recently denied an estate the charitable contribution set-aside deduction allowed under IRC Section 642(c)(2). Under certain circumstances an estate is allowed a form of charitable contribution deduction that is not available to individuals or other types of entities. An estate may take a charitable contribution deduction for amounts that the governing instrument, typically a will, require to be permanently set aside for certain charitable purposes. These amounts are not required to actually be paid to a charity in the same tax year for which the deduction is claimed. The applicable regulations require that in order to claim this deduction "the possibility that the amount set aside will not be devoted to such [charitable] purpose or use is so remote as to be negligible."

In the recent case of *Estate of Belmont (Tax Court, February 19, 2015)*, Ms. Belmont died and her will provided that, except for a small specific gift to her brother, all of the income and principal of her estate was to go to a charitable organization. The brother filed a lawsuit against the estate, alleging that he was entitled to receive a condominium owned by the estate in which he was living at the time of Ms. Belmont's death. While the litigation was pending, the estate filed an income tax return claiming a deduction in the amount of $220,000 pursuant to the charitable set-aside provision. The amount deducted represented the estate's net income for that tax year. The brother ultimately prevailed in the litigation and the estate had to expend significant sums for legal fees and to satisfy the judgment. As a result, it was not able to transfer to the charitable foundation the $220,000 that had been deducted in 2008.

Upon audit, the IRS disallowed the estate's charitable contribution deduction on the basis that the estate should have been aware of the very real possibility that the litigation would prevent it from honoring its commitment to the charitable foundation. The Tax

Court agreed with the IRS and repeated a standard it had applied in a previous case. The court said that for a contingency to be "so remote as to be negligible," it had to be such that persons generally would "regard it as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction." For purposes of preparing its return, the estate should have made a judgment regarding the possibility that the funds set aside would have to be used for another purpose. Consequently, the Tax Court denied the estate's charitable contribution set-aside deduction.

Tax Court Has Another Opportunity to Decide Character of Gain Realized from Sale of Real Property

The sale of real property by a taxpayer most frequently gives rise to capital gain income, which is subject to income tax at preferential rates if the taxpayer had a more than one-year holding period in the property sold. However, if the real property sold is considered to be held primarily for sale to customers in the ordinary course of a trade or business, any gain realized is subject to the higher income tax rates imposed on ordinary income. In the recent Tax Court case of *Si Boo LLC (TC Memo 2015-19)*, the taxpayer was in the business of buying tax lien certificates at public auctions. The main source of profit from this activity arose because most people whose property had become subject to a tax lien certificate will redeem the certificate before they lose title to the property. The applicable state law required that they pay a substantial penalty to the holder of the tax lien certificate in order to redeem their property. These penalties provided a substantial return on the investments made by the taxpayer in purchasing the tax lien certificates.

On a number of occasions, however, the owner of the property did not redeem it within the statutory period. In those cases, the taxpayer was able to obtain a tax deed and thereby become the owner of the property. Once it acquired ownership, the taxpayer routinely sold the property. In one of the years that was at issue in the case, the taxpayer sold 175 parcels of real property it had obtained through its ownership of tax lien certificates on those properties. On these facts, the Tax Court had little trouble deciding that the real property sold had been held primarily for sale in the ordinary course of the taxpayer's business. The taxpayer's only real argument was that its 175 sales were relatively small compared to the more than 6,500 tax lien certificates the taxpayer had acquired. The court did not believe this to be a relevant factor and focused solely on the fact that 175 sales in a year were more than sufficient to indicate that the taxpayer was engaged in the business of selling real property.

The court had two more pieces of bad news for this taxpayer and its members. First, because the sales were dealer dispositions, they did not qualify for installment sale reporting under IRC Section 453. Second, because the gains from the sale of real property arose in the course of a business, the members of the taxpayer had to pay self-employment taxes on their profits, in addition to income taxes.

Exchanges of Works of Art under IRC Section 1031

As art prices reach dizzying heights, especially in the contemporary art space, California collectors who wish to sell are faced with a capital gains tax approaching 45%. Many sophisticated collectors are familiar with IRC Section 1031 which permits tax-free exchanges of real estate, and are surprised to discover that it is possible to accomplish a tax-free exchange of art under the same section.

Although the availability of IRC Section 1031 for art exchanges is clear, there are some unique issues facing the collector who wishes to take advantage of the section:

1. The threshold criterion for effecting a Section 1031 exchange is that the owner must be an investor. An investor is someone who purchases property

primarily to make a profit. While virtually every art collector will say that he or she wants to make a profit on the art that he or she purchases, for most collectors, the profit motive is secondary to the intangible benefits of collecting art. It may be possible for the collector to segregate a group of works of art and have those works be treated as investment assets for purposes of IRS Section 1031 exchanges, while maintaining a portion of an art collection as a "collection" that is not eligible for Section 1031 treatment.

2. Another element of a Section 1031 exchange is that the property exchanged must be "like kind." In the real estate context, virtually any type of real property asset is deemed to be like kind to any other real property asset. For example, raw land can be exchanged for an apartment building or an apartment building can be exchanged for a commercial building. There is very little authority as to what constitutes like kind for works of art. What authority there is suggests that the IRS is not prepared to treat all works of art as like kind. For example, a painting is not like kind to a sculpture. It is not clear whether a watercolor is like kind to an acrylic, or whether a collage in a frame is like kind to a painting in a frame. In a somewhat related area dealing with involuntary conversions under IRC Section 1033, the IRS has taken a fairly narrow view. The standard under IRC Section 1033 is somewhat different than the like kind standard of IRC Section 1031. Under Section 1033, the replacement property must be "similar or related in service or use to the property converted." Under this standard, the IRS determined in a private letter ruling *(PLR 8127089)* that works of art in a particular medium cannot be replaced with works of art in any different medium. It is not certain that the IRS will be so restrictive in interpreting IRC Section 1031, but there is a risk that it will be.

3. A third element of a like kind exchange is that the property that is acquired must be held for investment. If the collector is an investor with respect to the work of art that is given up, it is likely, although by no means certain, that the property that is acquired will be held for investment.

4. The last element of a successful 1031 exchange involves the mechanical requirements for the exchange. Generally, the exchange requires a qualified intermediary to hold the proceeds of the sale of the work that is being given up, and to purchase the work that is being acquired. A qualified intermediary is more like an escrow company that is in the business of facilitating tax-free exchanges, but which does not act as a dealer. If the collector receives the proceeds from the sale, the fact that the collector uses the proceeds to purchase art will not satisfy the technical requirements of a Section 1031 exchange. Likewise, an investor who gives a work to a dealer for sale, and then gets a "credit" with the dealer against a subsequent purchase of art, does not qualify for Section 1031 exchange treatment unless the dealer is a qualified intermediary, which is not very common. Depending on the complexity of the transaction, the fees for a qualified intermediary usually are between $750 and $1,500, which is well worth the service that a qualified intermediary provides to make certain that the exchange complies with the various technical requirements.

If there is a successful Section 1031 exchange, the basis of the exchanged work carries over to the acquired work. The imposition of income tax is delayed until the acquired work is sold or avoided if the owner dies owning the work, and the estate receives a new income tax basis equal to the work's fair market value.

While the ability to accomplish a Section 1031 exchange for works of art is usually more challenging than accomplishing an exchange of real estate, the possibility of a successful exchange should not be overlooked if the heavy income tax burden on sales of art is to be postponed or avoided.

IRS Explains Mortgage Interest Deduction When Home Has Multiple Owners

Interest paid on a secured loan the proceeds of which were used to acquire the taxpayer's primary residence is deductible to the extent incurred on the first $1 million of the loan's principal balance. Where a home has multiple owners, questions arise about the sharing of the interest deduction among the co-owners. In a recent Chief Council Advice (201451027), the IRS set forth some helpful guidance.

The IRS determined that each co-owner may deduct the portion of the interest that he or she actually pays. The fact that a person has a 50% ownership interest in the home does not necessarily limit that person to a deduction of 50% of the total interest if he or she pays more than 50% of the total interest on the home loan. For example, if you own a home jointly with one of your children or grandchildren and pay all of the interest on the loan, you may take a deduction for all of the interest that you pay (subject to the $1 million principal limit), even though you have only a 50% ownership interest in the home. In this situation, you should be aware that your payment of all of the interest would result in your making a taxable gift to your child or grandchild of the portion of the interest that is not attributable to your ownership interest in the home. If you are an equal co-owner with your child or grandchild and you pay all of the interest on the loan, half of the interest that you pay would be considered a gift for gift tax purposes.

If the co-owners pay the interest out of a joint account, there is a presumption that each paid half of the interest. This could arise, for example, where a married couple pays interest on their home mortgage from a joint account, but file separate income tax returns. Absent any evidence to the contrary, it would be presumed that each spouse paid half of the interest and was entitled to a deduction for half of the interest. This circumstance could also arise where an unmarried couple owns a home together and maintains a joint bank account which is used to pay interest on their home mortgage.

Life After Death: No Longer Inconceivable

It has always been possible for a child conceived during the lives of both parents to be born after one of them dies (usually the father). The after-born child has long been treated the same as any other child for many legal purposes. As the ways in which people bear children have expanded beyond the traditional model (husband and wife, natural conception), the law has gradually responded by recognizing inheritance rights for various categories of children once disfavored. Until recently, however, the law has provided little guidance on the inheritance rights of a child conceived after death. A number of states, including California and New York, have enacted legislation that deals with some of the potential scenarios. We recently circulated a client alert covering this legislation. The alert can be accessed through the link below.

http://www.loeb.com/publication-clientreport-20150409-lifeafterdeathnolongerinconceivable

California Film and Television Tax Credit Program Expanded

The California income tax credit for film and television production has been significantly expanded. The funding allocated for such credits has been increased from $100 million to $330 million for each fiscal year. Eligibility for the credit has also been expanded to include big-budget feature films, one-hour TV series episodes and TV pilots. Previous budget caps for studio and independent films have been eliminated.

Credits were previously assigned through a lottery system. Under the new program, projects will be ranked and credit allocations will be received by the highest ranked projects. The principal criteria in the ranking system will involve the projection of "jobs ratio" formula. Under the new system, credits will also be allocated multiple times in each year instead of just once annually.

The first credit application period for non-independent television projects only will be May 11 – 17, 2015. Non-independent projects are productions undertaken by a publicly traded company or a subsidiary of a publicly traded company. There will be $55.2 million in tax credits available for new television series, television pilots, movies of the week, and miniseries. Credits of $27.6 million will be available for relocating the production of a television series to California. Credits will be allocated after July 1, 2015, and principal photography may not begin prior to receiving a credit allocation.

From July 13–25, 2015, application may be made for credits for the production of feature films and all independently produced projects. $48.3 million will be available in credits for feature films and $6.9 million will be available for independent projects. Credit allocations will be issued after August 3, 2015, and principal photography may not begin prior to receiving a credit allocation.

The basic requirement to be eligible for any credit is that 75% of the principal photography days must be entirely within California or the production must spend 75% of its total budget in California. Additionally, principal photography cannot begin prior to receiving a credit allocation.

Non-independent productions receive a 20% credit. Non-independent feature films must have a $1 million minimum budget and, while there is no maximum budget, the credit allocation applies only to the first $100 million in qualified expenditures. Movies of the week and miniseries must have a $500,000 minimum budget. New television series must have a $1 million minimum budget for each episode and each episode must have 40 minutes or more of running time, excluding commercials.

There are two types of productions that qualify for a 25% tax credit. A television series, without regard to episode length, that filmed its most recent season outside of California may receive a 25% credit in the first year that the filming is moved to California. After the first year the credit is reduced to 20%. A minimum budget of $1 million per episode is required. Certain independent films having at least a $1 million minimum budget also may qualify for the 25% credit.

The 20% credit may be increased to 25% in some cases. Filming within the state of California but outside of the Los Angeles metropolitan area is one of the ways a production can qualify for the 5% credit increase. Having the music written and recorded in California, as well as the production of visual effects in California, can also lead to a 5% credit increase; however, the total credit cannot exceed 25%.

California Superior Court Holds that Out-of-State Corporation Was Not Engaged in Business in California

The California Superior Court recently rebuffed the attempt of the Franchise Tax Board to impose tax on a non-California corporation that the FTB claimed was doing business in California. In *Swart Enterprises, Inc. v. California Franchise Tax Board*, the taxpayer was an Iowa Corporation whose only activity in California was holding a small membership in a California limited liability company. Despite the fact that the taxpayer was not the manager or managing member of the limited liability company, the FTB determined that the mere ownership of the membership interest was sufficient to cause the Iowa corporation to be engaged in business in California.

The court's reasoning in finding for the taxpayer was that as a member of a limited liability company it had no interest in any specific property within California owned by the limited liability company; it was not personally liable for the LLC's obligations; and it played no role in the management of the limited liability company.

The economic effect of the taxpayer's victory may be minimal. While it will not have to pay the $800 minimum franchise tax that is imposed each year on corporations doing business in California, it will still be required to pay California income tax on any income that is allocated to

it from the limited liability company which had its source within California.

Keeping Important Information Organized and Accessible

When a family member dies or becomes disabled, a difficult emotional time can be made even more difficult by a lack of access to important information. Critical information may be unavailable because it was known only to the decedent or to the disabled individual. Our Trusts & Estates group has developed a Personal Affairs Organizer, a form designed to assist you in compiling that information so that it will be readily available when it is needed. The completed Organizer includes key contacts, critical information regarding assets, liabilities, insurance, and the location of important papers, a list of digital accounts and passwords, a list of recurring house and other expenses, including automatic charges and withdrawals, and information your family will need for funeral and burial arrangements and to complete a death certificate. If you would like a copy of the Organizer for your personal use, please contact any of the attorneys in the Trusts & Estates group.

Estate Planning for Your Digital Assets

If you use a computer, you likely have digital assets that should be addressed as part of your estate planning. Access to digital assets is governed by an evolving and complicated technical and legal framework, including federal and state computer fraud and abuse acts; copyright, privacy, and data protection laws; and terms of service agreements. New laws are attempting to clarify the authority of a decedent's personal representative (a "fiduciary") to access a decedent's digital assets after a person has died, which is necessary for the fiduciary to marshal, collect, report, and distribute the estate assets, as well as to prevent identity theft and fraud. While the current legal landscape continues to present challenges for accessing digital information after a person dies, you can take steps during your lifetime that may significantly ease the administration of these assets in your estate. We recently published a client alert containing important information about protecting your digital assets. That alert can be accessed through the following link. http://www.loeb.com/publication-clientreport-20150408-estateplanningdigitalassets

Proposals to Repeal IRC Section 1031 Again Pending in Congress

Once again, proposals to limit or repeal entirely IRC Section 1031 are pending in Congress. President Obama's budget for the 2016 fiscal year includes a provision that would limit the amount of capital gain that can be deferred under IRC Section 1031 to $1 million. Congressman David Camp (R-Michigan), the chairman of the House Ways and Means Committee, has put forth a proposal to repeal Section 1031 entirely.

This is not the first time that attempts have been made to repeal the like-kind exchange provisions of IRC Section 1031. We will keep you posted on all future developments regarding these proposals.

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