LOEB & LOEB LLP

High Net Worth Families

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Remember to Make Annual Exclusion Gifts, IRA Charitable Rollover Contributions, and Charitable Contributions

We want to remind you to make any annual exclusion gifts before the end of the year. In 2016, each individual can give up to $14,000 to an unlimited number of donees, without incurring any gift tax liability or using any of his or her lifetime exemption from estate, gift and generation-skipping transfer taxes. You may want to consider gifts from you and your spouse to each of your children and grandchildren and to any other individuals to whom you wish to make a gift. The check must be deposited by the donee before the end of the year.

This exclusion is available each year but does not carry over if it is not used in a particular year. To qualify, the gift must be of a "present interest," so the gift should either be a direct cash gift or, if made in trust, it must be to a trust with a "Crummey" provision, and a notification letter should generally be sent to the beneficiary. Trusts for grandchildren must be designed to qualify for the generation-skipping transfer tax exemption annual exclusion.

If you are age 70 ½ or older, you also can make an annual rollover gift of up to $100,000 to a charity directly from your Individual Retirement Account. You do not receive a tax deduction; however, you also do not have to include the amount rolled over to the charity in your taxable income. This is an efficient way to make a charitable gift because it is not subject to the phase-out provisions that apply to itemized deductions on your tax return. A further benefit of a charitable rollover is that it counts against the minimum distribution amount you are otherwise required to withdraw.

This is also an annual opportunity that does not carry over if it is not used in a particular year. The provision allowing rollovers from IRA accounts was originally enacted as a temporary provision, but was made permanent by Congress last year. The gift cannot be made to a donor advised fund, a supporting organization, or a private foundation.

Although the tax law in 2017 is uncertain, two proposals that have been raised would decrease the benefit of a charitable contribution: (1) a lower income tax rate; and (2) a cap on miscellaneous itemized deductions. Consider whether you can use a charitable deduction in 2016. If you can, identify appreciated assets to contribute and obtain the deduction without recognizing income. And most important, be sure to get a receipt from the charity – without it, there is no deduction.

Modest Inflation Adjustments for 2017

A number of provisions of the Internal Revenue Code ("IRC" or "Code") provide for annual adjustments to dollar amounts based on certain inflation criteria. Included among these is the lifetime exemption from estate, gift, and generation-skipping transfer taxes. For 2017, the lifetime exemption will be $5,490,000, which represents a $40,000 increase over the 2016 exemption amount of $5,450,000. The limitation for annual exclusion gifts will remain at its current level of $14,000.

The income tax brackets receive modest adjustments as well. Married individuals filing a joint return will not reach the maximum 39.6% income tax bracket until their taxable income is $470,700, compared to $466,950 for 2016. Single individuals will reach the highest tax bracket at taxable income of $418,700, compared to $415,050 for 2016. Of course, this is all dependent on whether any changes to the income tax law are enacted by the new Congress.

Final Regulations Define Marriage for Federal Tax Purposes

The Treasury Department finalized regulations defining who is considered married for federal tax purposes to reflect the holdings in the Supreme Court decisions in *Windsor v. United States* and *Obergefell v. Hodges*, which upheld same-sex marriages. Under the regulations, the terms "spouse," "husband," and "wife" denote an individual who is legally married to another individual. The terms are gender neutral; they include same-sex, as well as opposite-sex, marriages.

A marriage in the United States is recognized as a marriage for federal tax purposes if the marriage is recognized in the state, possession or territory in which it was entered into, regardless of where the individuals are domiciled. A foreign marriage is recognized if the relationship would be recognized as a marriage in any state, possession or territory of the United States.

On the other hand, individuals who have entered into alternative arrangements not denominated as marriage under the laws of the state, possession or territory of the United States where the relationship was entered into (e.g., registered domestic partnerships and civil unions) are not considered married for federal income tax purposes. The Treasury rejected the requests by some commentators to treat such individuals as married where the rights granted by such alternative status are substantially similar to the rights of married individuals, on the basis that doing so would be too burdensome on the government and the taxpayers, and is contrary to the expectations of the individuals who chose the alternative to entering into a marriage. Moreover, the fact that such couples may face uncertainty in their tax treatment upon the dissolution of such an alternative arrangement is not a reason to change the definition of a marriage. The federal government will continue to look to state laws to define marriage.

Surge of Guidance on Tax Treatment of Certain Rights under IRC Section 1234A

Background. IRC Section 1234A of the Internal Revenue Code has emerged from its relative obscurity and been the subject of several important cases and rulings in 2016. Prior to the expansion of IRC Section

1234A in 1999, taxpayers were often able to choose the tax character of a transaction by using or not using a sale or exchange. IRC Section 1234A was enacted to ensure that gains and losses from an equivalent transaction receive comparable tax treatment.

IRC Section 1234A treats any gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation regarding property that is (or would upon acquisition by the taxpayer be) a capital asset of the taxpayer as capital gain or loss. Despite its broad purposes and compact language, after almost 20 years there are still no regulations. Some of the ways in which IRC Section 1234A has recently been interpreted include:

Merger Termination Fees. The IRS ruled that a break-up fee paid by a taxpayer or acquiring corporation to the target corporation to terminate a merger agreement is a capital loss and not an ordinary deduction. Since the stock in the target corporation to be acquired in the merger would have been a capital asset of the taxpayer, and the merger agreement gave the taxpayer rights concerning such stock, the IRS determined that IRC Section 1234A applied.

Treating the termination fee as a capital loss is a change from the IRS's prior position and the way most taxpayers have reported such a payment. Further, it significantly increases the cost of the break up, by virtually eliminating any tax benefit from the payment. Capital losses are deductible only against capital gains, and operating corporations usually do not generate capital gains.

The IRS has applied the same analysis to treat the target's receipt of a termination fee as capital gain. In such a case, however, the target's capitalized expenses in the course of the transaction prior to termination reduce such capital gain, and if greater than the fee, create a capital loss. Capital gain treatment may be more favorable in the case of a non-corporate taxpayer who may benefit from lower tax rates on net long-term capital gains.

Forfeited Deposit Is Ordinary Income. In the recent case of *CRI-Leslie, LLC*, the Tax Court held that a taxpayer who retained a deposit upon the termination of a contract to sell real property was not covered by IRC Section 1234A and therefore the retained deposit constituted ordinary income. Since the real property constituted IRC Section 1231 property (real property used in a trade or business that was held for more than one year), the court determined it was not a capital asset (even though net gain from the sale of IRC Section 1231 property is treated as capital gain). Since the statute refers only to capital assets, IRC Section 1234A did not apply. Absent a sale or exchange, the income is ordinary income. Many commentators thought the case would be decided differently, since the legislative history contains an example of dealing with real property, which would have been IRC Section 1231 property.

Payments Under Participation Agreement Are Ordinary. The IRS ruled that an amount received by an individual under his or her purchased interest in a settlement agreement constitutes ordinary income. There was no sale or exchange of property. Moreover, IRC Section 1234A did not apply because the payments were received pursuant to the taxpayer's interest; there was no separate cancellation, lapse, expiration or termination.

Abandonment Loss. An abandonment of a capital asset is not specifically listed in the litany of transactions to which IRC Section 1234A applies. In *Pilgrim's Pride Corp.*, the Tax Court held that an abandonment of preferred stock terminated the taxpayer's rights with respect to the stock and, accordingly, came within the requirements of IRC Section 1234A. On appeal, the U. S. Court of Appeals for the Fifth Circuit reversed, holding: "By its plain terms, §1234A(1) applies to the termination of rights or obligations with respect to capital assets (e.g., derivative or contractual rights to buy or sell capital assets). It does not apply to the termination of ownership of the capital asset itself." It remains to be seen whether the Tax Court will continue its position outside the Fifth Circuit.

The case is even more interesting because of the tax avoidance motive for the abandonment. The taxpayer, who had purchased the preferred stock for $100,000,000, turned down an offer to sell the stock for $20,000,000, in favor of the abandonment. The tax saving from the ordinary loss on abandonment exceeded the potential sale price and benefit from a capital loss.

Of course, the receipt of any consideration by the taxpayer, including the transferee taking the property subject to a liability, converts the abandonment into a sale.

Final and Temporary Partnership Regulations Make Changes to Disguised Sale and Liability Allocation Rules

In recent months, the IRS and the Department of the Treasury have issued a number of final, temporary and proposed regulations impacting persons who own interests in entities taxed as partnerships. On October 5, 2016, the IRS and the Department of the Treasury published final, temporary, and proposed regulations that make a number of significant changes to rules under IRC Sections 707 and 752 applying to "disguised sales" of property from a partner to a partnership and allocations of partnership liabilities among partners. Two of the more important changes are highlighted below.

In general, a transfer of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will be treated as a "disguised sale" of property by the partner to the partnership, subject to rules and exceptions provided in the regulations. Among the most important changes to the "disguised sale" rules are new temporary regulations that require the allocation of partnership liabilities among the partners in a manner generally intended to maximize a partner's disguised sale gains. For purposes of the disguised sale rules, all liabilities of a partnership (whether they are recourse or nonrecourse) are generally treated as nonrecourse liabilities and must be allocated to the partners solely in accordance with the partners' allocable share of partnership profits. This rule is effective for any transaction with respect to which all transfers occur on or after January 3, 2017. The rule will impact, among other things, the "debt-financed distribution" exception, which generally provides that distribution of cash to a partner in connection with a property contribution by such partner is not treated as a taxable sale to the extent that the cash is traceable to a partnership liability (incurred within 90 days of the distribution), and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution. As a result of the new temporary regulations, a partner's guarantee or other payment obligation will no longer be taken into account in determining whether a debt-financed distribution to a partner exceeds the partner's allocable share of the liability. Accordingly, any disproportionate leveraged distribution may trigger gain to the extent the liability is incurred in connection with a property contribution to, or distribution from, a partnership.

Temporary regulations issued under Section 752, which are based on proposed regulations issued in 2014, also provide guidance that disregards any "bottom dollar payment obligation" of a partner in determining whether the partner bears the economic risk of loss for a partnership liability, subject to certain exceptions. In general, a bottom dollar payment obligation is a guarantee of a partnership liability that applies to less than the full amount of the liability. This portion of the temporary regulations generally applies to partnership liabilities incurred, assumed or guaranteed on or after October 5, 2016, subject to a limited seven-year grandfather rule and to a binding contract exception.

Partnership Income of a Limited Liability Company Member Was Subject to Self-employment Tax

For the most part, the income received by a limited partner from a limited partnership is not subject to the self-employment tax. There is an exception if a limited partner receives a guaranteed payment for providing services to the partnership. A guaranteed payment is similar to a fixed salary, payable whether or not the partnership has any profits. A member of a limited liability company is treated as a limited partner unless he or she is actively involved in running the business of the company. In *Chief Counsel Advice 20160014*, the IRS Chief Counsel's office addressed what appeared to be a blatant attempt to perform an end run around these rules.

The taxpayer was a franchisee of many restaurant locations operated by a limited liability company. The only members of the company were the taxpayer, his wife, and a trust. The taxpayer spent all his time working in the business and made all of the key decisions for the business. He received a small guaranteed payment that he reported as being subject to the self-employment tax. The rest of his substantial income from the restaurants flowed through to him as partnership income on Form K-1. He took the position that he was a limited partner and therefore this income was not subject to self-employment tax.

The Chief Counsel's office determined that all of his income from the company was subject to self-employment tax. It cited as legal authority the *Renkenmeyer* case, where law firm partners who practice law full time were limited partners in their law partnership. The Tax Court in that case determined that the term "limited partner" for purposes of the self-employment tax was intended to be restricted to persons in the nature of passive investors, not those actively involved in the day-to-day operations of the business.

Section 1031 Exchange Runs Afoul of Related Party Prohibition

In the recent case of *Malulani Group*, the Tax Court held that the taxpayer's attempt to structure an IRC Section 1031 exchange ran afoul of the related party provisions of IRC Section 1031(f). The purpose of these rules is to prevent taxpayers from exchanging low tax basis property with a related party in return for high tax basis property that was owned by the related party. Upon receipt of the taxpayer's low tax basis property in the exchange, the related party would be permitted to substitute the high tax basis from the property it transferred back to the taxpayer. The related party could then sell the formerly low tax basis property and not recognize any tax gain.

To prevent this, IRC Section 1031(f) provides that if related parties engage in an exchange of properties, both parties must hold the property they receive at least two years or else any gain is recognized. An exception is provided in IRC Section 1031(f)(2)(C) if the taxpayer can convince the IRS that the exchange did not have tax avoidance as one of its principal purposes. IRC Section 1031(f)(4) provides that IRC Section 1031 will not apply to transactions or a series of transactions designed to avoid the purposes of IRC Section 1031(f).

In *Malulani Group*, the taxpayer's wholly-owned subsidiary, MBL, sold real property to a qualified intermediary with the intention of locating suitable replacement property and completing a Section 1031 exchange. It looked at and even tried to buy several properties owned by unrelated parties. When none of those attempts succeeded, MBL had the intermediary purchase property from a related party and transfer the property to it to complete the exchange. Although the related party recognized more tax gain on the sale of its property to the intermediary than MBL would recognize from the sale of its property, such gain was offset by a net operating loss.

The taxpayer argued that the related party prohibition should not apply because tax avoidance was not a principal motive. It pointed to the fact that it did not originally intend to acquire property from a related party and in fact did so only after extensive efforts to purchase property from unrelated parties failed.

The court did not accept the taxpayer's analysis. It determined tax avoidance by looking at the taxes the parties actually paid and compared that to the taxes that MBL would have paid if it had simply sold its property and not done a Section 1031 exchange. Under the exchange, MBL recognized no tax gain. The related party, while recognizing more gain than MBL would have recognized from the sale of its property, nevertheless offset such gain with a net operating loss so it did not pay any tax either. Therefore, in the court's view, the transaction as structured resulted in significant tax savings. Based on this, the court determined that the taxpayer did structure the transaction with a tax avoidance motive.

If the related party had not been able to offset its tax liability with a net operating loss, the court likely would have accepted the taxpayer's argument that it did not have a tax avoidance motive, as the related party would have paid more tax than MBL would have paid from the sale of its property. Of course, without the net operating loss, it is not likely the transaction would have been done with the related party.

California State Board of Equalization Rules Against Taxpayer in "Drop and Swap" 1031 Exchange

It is well known that the State of California does not like "drop and swap" 1031 exchanges. A typical drop and swap scenario involves a partnership (or limited liability company) that owns real property it wishes to sell. Some partners would like to receive cash but others would like to defer their tax by engaging in an IRC Section 1031 exchange. To satisfy everyone, before the property is sold the partnership distributes it to the partners as tenants in common. This enables partners who wish to sell for cash to do so, and those who wish to do 1031 exchanges can engage a qualified intermediary for those exchanges.

The main issue presented by these exchanges is whether the partners who do exchanges ever held the property sold for "investment," which is a requirement of IRC Section 1031. The issue is most likely to arise when the property is sold very soon after the partnership distributes it to the partners. A very brief holding period could be considered inconsistent with the notion of holding property for investment purposes. The IRS originally attacked these types of transactions but eventually gave up after losing the *Magneson* and *Bolker* cases. The California Franchise Tax Board, however, was not so easily deterred. It launched a major project to identify and challenge drop and swap exchanges.

Very recently, the California State Board of Equalization ("SBE") heard a drop and swap case, *In re Giurbino*. A partnership entity, Aim LLC, entered into an agreement to sell its real property and an escrow was opened in the name of Aim LLC. Subsequently, the property was deeded to the members of the LLC and they completed the sale days later. Aim LLC originally filed its tax return reporting the gain recognized from the sale of the property. Some members reported their share of the gain on their income tax returns; however, the Giurbinos reported inconsistently and took the position they had completed a 1031 exchange. More than four years after the sale, and likely while the audit was ongoing, the Aim LLC tax returns were amended to reflect that the property had been distributed before the sale to the members of Aim LLC.

On this terrible set of facts, it was not a surprise that the SBE held in favor of the FTB, and determined that no 1031 exchange had occurred. However, the basis of the SBE holding is important for future cases. The SBE did not hold in favor of the FTB on the basis that the members of Aim LLC did not hold the property for investment. Rather, the SBE determined that, in substance, Aim LLC was the seller of the property rather than the LLC members. The key statement by the SBE is that by the time the property was deeded to the members of Aim LLC “the sale of the property was practically certain to be completed.”

This holding will not prevent the SBE from finding for the taxpayer in a future case with a better set of facts. Clearly, the property should be transferred to the partners or members well in advance of any documents being signed related to the sale of the property. All such documents should list the partners as the sellers and the partnership should not be a party to any of them. The property should also be transferred to the partners or members as far in advance of the sale as possible in order to provide the partners with a good position that they held the property for investment, should the FTB rely on that argument to challenge the transaction.

Assets of Family Limited Partnership Included in Transferor’s Estate

In *Estate of Edward Beyer v. Commissioner*, the Tax Court held that substantial assets that Edward Beyer had transferred to a family partnership he formed (“EGBLP”) were included in his estate for estate tax purposes pursuant to IRC Section 2036. The decedent, Mr. Beyer, formed EGBLP on October 10, 2003. The partnership was initially formed between two revocable trusts established by Mr. Beyer. His living trust held a 99% interest as a limited partner, and a management trust, of which he was also the grantor, held a 1% interest as the general partner. While a substantial amount of securities was transferred to the partnership, the Exhibit A which was supposed to show the contributions and percentage interests of the partners was never completed.

On December 30, 2005, the living trust sold its 99% interest to an irrevocable trust that Mr. Beyer had also created for a promissory note in the amount of $20,866,725. Mr. Beyer died on May 19, 2007. Upon audit of his estate tax return, the IRS relied on IRC Section 2036 to include the assets of EGBLP in the estate of Mr. Beyer. Section 2036 applies if a decedent had made a transfer of assets unless the transfer was a bona fide sale for full and adequate consideration and also retained i) the right to the possession or enjoyment of, or the right to the income from, the transferred property; or ii) the right to designate the persons who shall possess or enjoy the property or the income therefrom.

The Tax Court first considered whether the transfer of assets by Mr. Beyer to EGBLP constituted a bona fide sale for adequate consideration. Prior cases have established that in the context of a family partnership, the bona fide sale exception applies only if the taxpayer can demonstrate that the partnership was created for a legitimate and significant nontax reason and the taxpayer received a partnership interest proportionate to the value of the property transferred. The primary nontax reason alleged by Mr. Beyer’s estate was that the partnership was used to keep intact a block of 800,000 shares of Abbott Laboratories, where Mr. Beyer had worked as the chief financial officer. The court did not accept this reason as legitimate because Mr. Beyer’s trust could have provided that the block was to be held intact after his death. Also, nothing in the partnership agreement of EGBLP required the partnership to continue to hold the stock following the death of Mr. Beyer.

The estate also alleged that a key purpose of the partnership was to transition the management of Mr. Beyer’s financial assets to his nephew, Craig Plassmeyer. Mr. Beyer never married and had no children. The court did not accept this reason because, even before the partnership was formed, Mr. Beyer had appointed Mr. Plassmeyer as his attorney-in-fact under a power of attorney to manage many of his financial assets. Mr. Beyer also could have named Mr. Plassmeyer as a co-trustee of his living trust. The court found that the partnership was not necessary.

Having concluded that the bona fide sale exception did not apply, the court next turned to whether any implicit agreement between Mr. Beyer and the partnership continued to allow Mr. Beyer the use or enjoyment of, or income from, the assets transferred to EGBLP. The court found there was such an agreement based on two main incidents. In 2007, after Mr. Beyer's living trust had sold its interest in EGBLP, it nevertheless received $659,660 from EGBLP which was used to pay Mr. Beyer's gift tax liability for 2005. After the death of Mr. Beyer, the trust received $9,945,000 from EGBLP to pay Mr. Beyer's estate tax liability.

As to the second distribution, the estate argued that it was irrelevant because it occurred after the death of Mr. Beyer and Section 2036 requires inclusion only where the right to use the assets or receive the income occurred during the lifetime of the transferor. The court did not accept this argument. It found that Mr. Beyer knew that his transfers to the partnership did not leave his estate with sufficient liquid assets to pay his estate tax when he died. Further, the court noted that the estate made no attempt to borrow against the promissory note it had received from the irrevocable trust for the sale of the 99% interest in EGBLP. These two distributions were considered by the court to establish that Mr. Beyer had an implicit agreement in place to access the assets of the partnership even after he sold his interest.

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