High Net Worth Families

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IRS Addresses a Section 1031 Exchange of Aircraft

While we usually think of real property as the asset most often exchanged under Section 1031 of the Internal Revenue Code, the provisions of that are by no means limited to real property. It is not at all unusual for a taxpayer who owns a private airplane to structure an IRC Section 1031 exchange when he purchases a new airplane and sells his current airplane. Through a properly structured IRC Section 1031 exchange, the taxpayer can avoid paying tax on the gain realized from selling his current airplane in return for taking a tax basis in the new airplane that is the carried-over tax basis of his prior airplane, increased by the additional cash he spends to acquire the new airplane.

In order to qualify for IRC Section 1031 treatment, the aircraft to be sold must have been used by the taxpayer either in a trade or business or held for investment-related purposes. If the aircraft was used only for personal purposes, it will not qualify for an IRC Section 1031 exchange. The reality with most private aircraft is that they are used for a combination of business or investment and personal reasons: The airplane may be flown to business meetings and used to fly the family to a vacation destination.

In Chief Counsel Advice 201605017, the IRS addressed this dual use of private aircraft and concluded that the airplane could not be bifurcated into a business or investment asset and a personal asset. It was either one or the other. The Chief Counsel told the field office that if it concluded that the taxpayer's business or investment use of the aircraft was less than 50 percent of the total use, it should conclude that the aircraft was a personal use asset and did not qualify for IRC Section 1031 treatment. A footnote cautions that a finding of more than 50 percent business or investment use does not in itself automatically cause the aircraft to be considered a business or investment asset. No examples are given in which an airplane used more than 50 percent of

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the time for business or investment purposes should nevertheless still be considered a personal asset ineligible for IRC Section 1031.

The Chief Counsel Advice does not constitute legal authority that must be followed by taxpayers. It does, however, set forth a position that is likely to be adopted by IRS auditors in the field.

How Many Ways Can You Lose Your Charitable Contribution Deduction?

We have written extensively about the very strict rules that must be followed in order for a taxpayer to deduct a charitable contribution. We have repeatedly pointed out that the IRS and the courts are very unforgiving of even minor "foot faults." Taxpayers recently took extreme measures to lose an otherwise good charitable contribution deduction.

In *Gemperle v. Commissioner* (TC Memo 2016-1), the taxpayers donated a facade easement with respect to a certified historical structure in which they lived. One of the requirements to obtain a charitable contribution deduction for this donation is that the taxpayer obtain a qualified appraisal. IRC Section 170(h)(4) requires that the appraisal be obtained and "attached" to the taxpayer's tax return on which the contribution deduction is claimed. In this case, the taxpayers obtained the appraisal but they (or their return preparer) failed to attach a copy to their tax return.

Following an IRS audit that resulted in the deduction being disallowed, the taxpayers took the matter to the U.S. Tax Court. The Tax Court upheld the disallowance of the deduction and imposed the 40 percent substantial valuation misstatement penalty because the appraisal report was not attached to the taxpayers' income tax return. As we have written countless times, you must follow to the letter all the rules surrounding charitable contribution deductions. There is simply no margin for error in this area.

Bad-boy Loan Guarantee Causes Deductions From Nonrecourse Loan to Be Reallocated

In a recent Internal Litigation Memorandum, the IRS found that a nonrecourse loan to a partnership containing certain "bad boy" guarantees required the loan to be treated as a recourse loan for federal income tax purposes. As a result, the tax basis resulting from the loan, and deductions related thereto, were allocable only to the partners who provided the guarantees. Debt that is treated as nonrecourse is allocated among all the partners for tax-basis purposes.

The loan was generally a nonrecourse loan; however, there were seven nonrecourse carve-out provisions. The terms of the loan required payment (for which the guarantors were liable) of the entire outstanding principal balance of the loan, together with all interest thereon, and any other amount due and payable, if:

1. the borrowers fail to obtain the lender's consent before obtaining subordinate financing or transfer the secured property;
2. any borrower files a voluntary petition in bankruptcy;
3. any person in control of any borrower files an involuntary bankruptcy petition against a borrower;
4. any person in control of any borrower solicits other creditors to file an involuntary bankruptcy petition against a borrower;
5. any borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding;
6. any person in control of any borrower consents to the appointment of a receiver or custodian of assets; or
7. any borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

Although the memo indicates that “one or more” of the conditions was sufficient to cause the otherwise nonrecourse loan to be re-characterized, the IRS informally advised that it was only condition 7 that caused the concern. The IRS views condition 7 — the guarantee in the event of an assignment for the benefit of creditors or admitting to being insolvent or an inability to pay debts as they become due — as a payment guarantee, indicating that lenders have been able to enforce these provisions in that capacity. According to the informal advice, the other bad-boy conditions in the memo are not an issue and do not cause a re-characterization.

Practitioners have been critical of the memo, even if it is limited to condition 7. There is little difference between condition 7 and many of the other conditions. They should all be considered contingent and extremely remote. If these conditions were not remote, it is unlikely the loan would be made.

IRC Mitigation Provisions Prevent Taxpayer Windfall From Trust Distribution

The IRS normally cannot assess additional income tax against a taxpayer after three years from the date the tax return for the year in question was filed. Similarly, after that period a taxpayer can no longer amend his return to claim a refund. In order to prevent the IRS or the taxpayer from being “whipsawed” by inconsistent positions on the tax treatment of items, the IRC contains certain provisions that can extend the statute of limitations to prevent these inequities. These are often referred to as the “mitigation” provisions of the IRC. The rules are extremely complex, but we can illustrate a recent example of their use without getting bogged down in too much detail.

In *Costello v. Commissioner* (TC Memo 2016-33), a brother and sister were the beneficiaries of a trust created by their deceased father. The trust received distributions from an IRA the father had during his lifetime and distributed the amount received equally to the two beneficiaries. The trust reported the IRA distribution as income and took an offsetting deduction for the distribution to the beneficiaries, so the trust did not owe any tax. The beneficiaries reported the distribution as income and paid tax on it. This treatment was consistent, as the income had been subject to tax one time, at the beneficiary level.

On audit, the IRS determined that the income must be taxed to the trust and disallowed the deduction for the distribution to the beneficiaries. The trust paid the resulting income tax on the IRA distribution. The IRS made corresponding adjustments to the beneficiaries’ returns and sent them refund checks. The treatment was still consistent. The IRA distribution had been taxed one time, now at the trust level.

At this point, the trustees filed a refund claim on behalf of the trust, asserting that the IRS reached the wrong result in its audit and that the trust should have been entitled to a deduction for its distribution of the IRA proceeds to the beneficiaries. The IRS accepted the refund claim and refunded to the trust the tax that it had paid. Now nobody had paid tax on the IRA distribution, which was not consistent and clearly not a correct result. When the IRS tried to assess tax against the beneficiaries it was too late, as the three-year statute of limitations had closed for the year the beneficiaries received the distribution. (Warning to California taxpayers: The statute of limitations is four years for California returns!)

Enter the mitigation provisions. The Tax Court determined that the IRS could benefit from the mitigation provisions because the trust and the beneficiaries, related parties, adopted inconsistent positions. The trust’s claim that it was entitled to a distribution deduction was inconsistent with the beneficiaries not paying tax on the distribution, and resulted in a double exclusion of taxable income. The court determined that this circumstance was covered by the mitigation provisions, and the IRS was permitted to assess tax against the beneficiaries, even though the statute of limitations had expired for the year in which they received the distribution. A windfall for the taxpayers was averted.

The mitigation provisions are intended to be neutral and can also work for the benefit of taxpayers. Assume that in year one, a cash-method taxpayer erroneously includes in his tax return interest income that was accrued at the end of year one, but was not paid to the taxpayer until year two. Upon an audit of year two, the IRS requires the taxpayer to include the interest income item in year two and pay the resulting tax. By the time the audit is completed, the statute of limitations for year one has closed. Under normal circumstances, the taxpayer would not be able to obtain a refund of the tax paid in year one, so he would end up paying tax on the same income item in both years one and two, resulting in a double inclusion of taxable income. This result is inequitable and not intended. In this case, the mitigation provisions come to the aid of the taxpayer and allow him to obtain his year one refund. In this example, the IRS was the party maintaining the inconsistent position, as it required the taxpayer to pay tax on the income in year two after the taxpayer had already paid tax on the same income in year one.

Taxpayer Proves Material Participation Under the Passive Loss Rules

If a taxpayer sustains losses from a "passive activity," those losses can only offset income from other passive activities and cannot be used to offset income from investments or from active businesses of the taxpayer. A passive activity is a business activity in which the taxpayer has an ownership interest but does not "materially participate." In addition, most activities involving the rental of property, such as real property, also constitute passive activities without regard to the level of the taxpayer's participation.

There are several ways in which a taxpayer can meet the "material participation" requirement, the most common of which is to spend over 500 hours in the activity during the year. A taxpayer can also materially participate by spending over 100 hours in the activity if no other individual spends more time than the taxpayer. In both cases the question often arises, how does a taxpayer prove how much time he spent? The best practice is to do what lawyers and accountants do. They keep time sheets where they record the matters on which they work each day and the amount of time they spend on each matter. Most of the working world, however, is not accustomed to keeping detailed time sheets.

In *Leland v. Commissioner* (TC Memo 2015-240), the taxpayer was a lawyer who also owned a farm. While the actual farming work was done by an area farmer under a crop-share arrangement, the taxpayer was still required to spend considerable time both working at the farm and on farm business. He sought to prove his material participation in farming activities by proving that he spent more than 100 hours and nobody else spent more time.

The record of the case shows that the taxpayer did not keep contemporary time sheets. The court noted that the regulations allow a taxpayer to prove his participation by any "reasonable means." In this case, the taxpayer reconstructed records of his participation in preparation for the trial by reference to a calendar he kept and credit card receipts and invoices for purchases he had made related to the farm. The taxpayer used this information to construct logs he presented to the court. He also testified at the trial regarding the time he spent on the farming activity. The court determined that the taxpayer met his burden of proof as to his own time. He was also able to prove that his tenant farmer spent less time than he did. The taxpayer was allowed to deduct losses from the farm against his other income.

While this taxpayer prevailed, we continue to believe that keeping contemporary time records is the better practice. Most people keep some kind of calendar. It is not much extra work to note in your calendar the amount of time you spend on an activity each day.

Assets of Family Investment Partnership Included in Decedent's Estate

In *Estate of Sarah D. Holliday v. Commissioner* (TC Memo 2016-51), the IRS was successful in its attempt

to include the decedent's share of investment assets held by a family limited partnership in her gross estate for estate tax purposes. The inclusion precluded the estate from obtaining the benefit of valuation discounts for lack of control and marketability that likely would have been allowed if the family partnership had been respected.

The partnership was formed in 2006. The decedent was the only family member who transferred any assets to the partnership. She transferred cash and marketable securities and obtained a 99.9 percent interest as a limited partner and a 0.1% interest as a general partner through a limited liability company of which she was initially the sole member. Following the formation of the partnership, the decedent sold her interest as the general partner to her two sons and made a gift of a 10 percent limited partnership interest to an irrevocable trust. These transfers left the decedent with an 89.9 percent interest as a limited partner.

In 2007, the partnership made a pro rata distribution to all its partners. No other distributions were made prior to the decedent's death in 2009. Section 5 of the partnership agreement provided: "To the extent that the General Partner determines that the Partnership has sufficient funds in excess of its current operating needs to make distributions to the Partners, periodic distributions of Distributable Cash shall be made to the Partners on a regular basis according to their respective Partnership Interests."

Upon audit of the decedent's federal estate tax return, the IRS took the position that the assets transferred to the partnership by the decedent should be included in her gross estate under IRC Section 2036. This section includes in a decedent's gross estate any asset the decedent transferred during her lifetime if she retained the right to the possession or enjoyment of, or the right to the income from, the property. There is an exception, however, if the transfer of the asset was a bona fide sale for adequate and full consideration.

The Tax Court first looked to see if the decedent had retained one of the proscribed rights, noting that this retention could be either express or implied. The IRS argued, and the court agreed, that there was an implied agreement with the general partner that if the taxpayer ever needed a distribution, one would be made. One of the sons testified at the trial that no additional distributions were made because "no one needed one." The court concluded from this testimony that if the decedent needed a distribution, one would have been made. As a result, the court concluded that the decedent was "unconditionally" entitled to receive distributions in certain circumstances.

The court next had to determine whether the transfer was a bona fide sale for adequate and full consideration, noting that in the context of family partnerships, this means there must have been a significant nontax reason for the creation of the partnership that was an actual motivation for creation of the partnership and not just a theoretical justification. The transferor must also receive a partnership interest with value proportionate to the value transferred.

The decedent's estate offered three nontax reasons for the formation of the partnership. It first argued that the partnership would protect the decedent from extortion by trial attorneys if someone working at the decedent's home was injured. The court did not accept this reason as legitimate, noting that the decedent had never been sued, was living in a nursing home when the partnership was created and had substantial assets outside the partnership.

The estate next argued that the partnership would protect the decedent from the undue influence of caregivers. The court did not consider this a legitimate reason either, because the decedent's two sons were keeping a close watch over her and one of them had a power of attorney to conduct her financial affairs.

Finally, the estate said that the partnership would preserve the transferred assets for the benefit of the decedent's heirs. The court was not persuaded by

this reason, in part because the decedent did not participate in any discussions regarding the formation of the partnership or what type of entity it should be. The court concluded that the transferred assets should be included in the decedent's gross estate, thereby depriving the estate of a multitude of valuation discounts.

The court also found there were additional factors that indicated there was no bona fide sale. First, the partnership was not the result of an arm's-length transaction because the decedent was the only initial party. Second, the partnership maintained no books and records and held no meetings. Third, various provisions of the partnership agreement that called for periodic distributions and compensation to the general partner were ignored.

We think this case is a closer call than many of the cases in which the IRS has prevailed. In this case, the taxpayer avoided a number of the common pitfalls. The partnership was not created on the decedent's deathbed, she did not transfer anywhere near all her assets and she received only one distribution prior to her death, which was a distribution that was shared by all the partners. She clearly did not need to rely on distributions from the partnership to pay her living expenses.

The court seemed to base its finding that the decedent retained the right to income on the language of the partnership agreement and an implied agreement with the general partner to make distributions whenever the taxpayer needed a distribution, which the court said gave her an unconditional right to receive distributions from the partnership. This case shows, yet again, how important it is to avoid prearranged or implied agreements to make distributions to the taxpayer. If there had not been an implied agreement, perhaps the court would have reached a different result if the general partner had full discretion over whether distributions were to be made, rather than being required to make distributions when funds were available.

Film Production Worker Classified as Independent Contractor

Individuals who perform services are classified either as an employee or an independent contractor, depending on certain criteria. The more control the recipient of the services exercises over the manner in which the service provider performs his services, the more likely it is that the service provider will be classified as an employee.

The classification has a variety of consequences for both the provider and recipient of the services. For example, the service recipient must withhold income and payroll taxes from payments made to employees and must pay the employer share of payroll taxes. If the worker is an independent contractor, the recipient of the services does not have to withhold payroll and income taxes, or pay any payroll taxes on behalf of such worker.

For the service provider, there are benefits and detriments to each classification. A worker classified as an independent contractor must pay both the employer and employee shares of payroll taxes, so an independent contractor essentially pays double the payroll taxes of an employee. The main benefit to being classified as an independent contractor is that any expenses the worker incurs in connection with his performance of services can be deducted on Schedule C of his federal income tax return. Schedule C deductions reduce the worker's adjusted gross income and are not subject to the alternative minimum tax or any of the many deduction limitations to which itemized deductions are subject. Expenses incurred by an employee are deductible only as miscellaneous itemized deductions, which means they are not deductible in computing the alternative minimum tax, are subject to the 2 percent of adjusted gross income floor on itemized deductions and are subject to the phase-out of itemized deductions as adjusted gross income increases.

The classification of a film industry production worker for purposes of deducting his business expenses was recently at issue in *Quintanilla v. Commissioner* (TC Memo 2016-5). The taxpayer worked on more than 150 television commercials that were filmed during the years at issue. He reported his income and business expenses on Schedule C, taking the position that he was an independent contractor. The IRS said he was an employee and should have deducted his expenses as itemized deductions on Schedule A.

The Tax Court began its analysis by stating the overriding principle that "an independent contractor is one who works for another but according to his own manner and method, free from direction or right of direction in matters relating to performance of work save as to results." On most of the taxpayer's jobs, he was hired to build sets for the commercial shoots. He was expected to provide his own tools, which is one of the hallmarks of an independent contractor. On a typical project, the production company would give the taxpayer a sketch of the set that was needed, then he decided how best to build it. He also had the risk that he could lose money on a project, if his expenses exceeded the amount for which he had agreed to do the work. Also relevant was the fact that many production companies used his services; no single project took longer than a month to complete.

The primary factor favoring the IRS' position was that the taxpayer was a union member and many of his jobs were done for prices set through collectively bargained contracts. The taxpayer testified that he joined the union only to obtain health insurance benefits. He did not receive other union benefits, such as paid vacation time. Since the preponderance of the factors indicated that the taxpayer should be classified as an independent contractor, the court found in favor of the taxpayer.

Worker classification is a big-dollar issue that gets a lot of IRS attention. Most often it comes up on the employer side, when an employer classifies a large group of workers as independent contractors, and upon audit the IRS takes the position they should have been classified as employees. If the IRS prevails, the employer may owe payroll and withholding taxes for many previous years.

Another way we often see this issue arise is when a company is being sold. During the due diligence process, the buyer's legal and accounting advisors might determine that a large group of workers should have been treated as employees rather than as independent contractors. This concerns the buyer, because if the IRS audits the company, a large liability for payroll and withholding taxes could result. The buyer will always demand to be indemnified by the seller against such liability, and in addition may demand an escrow holdback of a portion of the purchase price for some period after the closing.

The worker classification issue demands caution because the consequences of an incorrect classification can be monetarily significant. An employer can get an IRS determination as to the proper classification of workers by filing Form SS-8. A worker who wishes to know if he has been properly classified can also file Form SS-8 and obtain a determination from the IRS.

Department Attorneys in the Field

Chris Campbell has been appointed to the California Franchise Tax Board's Advisory Board. The board meets at least once a year and provides a forum for the executives of the Franchise Tax Board to get feedback, solicit input, find out about issues and problems, and discuss possible solutions. There are approximately 20 people on the board, about half of whom work for government (e.g., the California legislature, other state agencies or the IRS). The other half includes a professor, accountants, industry representatives and, currently, two practicing lawyers. Chris is a partner in our Los Angeles office.

Marc Owens recently spoke at the Washington Nonprofit Legal & Tax Conference on the topic "IRS Audits: What to Expect When the Bear Comes Out

of Hibernation." In April, he will speak at the 2016 Representing and Managing Tax-Exempt Organizations conference on the topic "Correcting Tax Mistakes: When and How?" The American Health Lawyers Association magazine, AHLA Connections, just published an article by Marc titled "Obergefell, Bob Jones and the IRS." Marc is a partner in our Washington office.

Diara Holmes recently spoke at the Washington Nonprofit Legal & Tax Conference on the topic "Working With Company Foundations: Self-dealing Traps for the Unwary." In June, she will speak at the National Association of College & University Attorneys Annual Meeting on the topic "Federal Tax Issues in Higher Education." Diara is a partner in our Washington office.

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