# High Net Worth Families

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CONTENTS

**Vol. 12, No. 2**

Preparing for the New Partnership Audit Regime . . . 1

Prospect for Meaningful Tax Reform Remains Uncertain. . . 2

Shareholder Loan Guarantee Does Not Increase Tax Basis of Shares of S Corporation. . . 3

Court of Appeals Rejects Estate's *Graegin* Loan and Limits Valuation Discount . . . 4

Tax Court Follows Allocation Determined by Los Angeles County Assessor . . . . . . . . 5

New York Budget Legislation Includes Tax Changes . . . . . 5

New Jersey Expands Angel Investor Credit . . . . . . . . . 6

Another Death Bed Limited Partnership Formation Fails to Accomplish Its Objectives . . . 6

The Future of Discounts? . . . 8

Other Regulations Reviewed under the Executive Order. . . 8

Case on Worker Classification Has Important Consequences for Employers and Employees . . 8

Tax Court Addresses Phantom Stock Plan . . . . . . . . . . . 9

Tax Court Allows Modification of Variable Prepaid Forward Sale Contract . . . . . . . . .10

California Supreme Court Determines That a Transfer of Interests in a Legal Entity Can Trigger Application of the Documentary Transfer Tax. . . 11

California Board of Equalization Determines Corporations Were Doing Business in California. . 13

## Preparing for the New Partnership Audit Regime

With the recent re-proposal of the Treasury Regulations relating to the new partnership audit rules, hopes for a deferral of the effective date of the new rules have waned. The new rules, which were enacted as part of the Bipartisan Budget Act of 2015, will become effective for tax years beginning after December 31, 2017, and make significant changes to the current rules.

Under the new rules, audits with respect to items of income, gain, loss, deduction and credit from a partnership are generally conducted at the partnership level, and the partnership (not any of the partners) is liable for any deficiency based on an assumed tax rate. As a result, the partners in the year in which the adjustment is made (called the "adjustment year") bear the cost, rather than the individuals who were partners in the year that was audited (called the "reviewed year").

There are two general methods under the statute to put the burden back on the reviewed year partners. First, a partnership that has 100 or fewer partners (taking into account certain look-through rules), each of which is an individual, a C corporation (including a foreign entity that would be a C corporation if it were domestic), an S corporation or an estate of a decedent, may elect out of the new rules. Partnerships and trusts are not qualified partners for this purpose. As a practical matter, this election out will not be available to private equity or hedge funds, which typically have partnership members. Family partnerships often have trusts as members and frequently involve multiple partnership tiers so they cannot elect out either. Entities that are disregarded under the income tax law are not eligible entities. This would include grantor trusts, including revocable living trusts, and single member limited liability companies. For other partnerships, it raises questions for clients as to whether they want to prohibit nonqualified partners and disqualifying transfers so as to come within this exception, and what to do if they already have such partners.

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If the partnership does not (or cannot) elect out, it may still elect to require the deficiency based on the partnership level adjustments to be paid by the reviewed year partners. In such case, however, the interest rate charged by the IRS will generally be increased by 200 basis points.

In the audit, the partnership is represented by a partnership representative who may or may not be a partner. All partners are bound by the partnership level adjustment. Net downward adjustments will not result in refunds but will reduce the partnership's income otherwise allocated to the partners in the adjustment year. Special rules apply to misallocations between partners.

Partnership agreements, including limited liability company agreements and operating agreements for LLCs that are treated as partnerships for federal income tax purposes, should be amended to take into account the new rules if they do not already contain such provisions. Agreements for newly formed partnerships and limited liability companies should spell out how the new rules will be applied. In addition, partners entering existing partnerships need to assure themselves that provisions are in place that will prevent them from becoming responsible for the payment of taxes that relate to tax years before they became partners. If you have partnership or limited liability company agreements, please contact us so that we can review them to determine if new or revised provisions should be added based on these new rules.

## Prospect for Meaningful Tax Reform Remains Uncertain

The prospect for meaningful tax reform legislation being enacted this year remains uncertain at best, and many would say it is even doubtful. The Republicans in Congress have still not achieved anything approaching a consensus among themselves as to the provisions that should be enacted. For most bills in the Senate, the rules of the Senate provide that 60 votes are required to bring cloture, or stop the debate on a bill and bring it to a vote. Even if all 52 Republican senators came to an agreement on tax reform, they would still need to attract eight votes from Democratic (or the two independent) Senators in order to bring the legislation to a vote.

This means that any tax reform will most likely have to be enacted through the budget reconciliation process. Under the process of budget reconciliation that is set forth in the Congressional Budget Act of 1974 ("Budget Act"), each year Congress is required to pass a concurrent budget resolution (by majority vote) by April 15, setting forth revenue, spending and deficit targets. It then must enact or change any laws necessary in order for revenue, spending and deficit expectations to match those of the concurrent budget resolution. Since such laws need to be enacted to meet the targets of the budget resolution, the Budget Act provides for a streamlined process that strictly limits the debate that can occur on legislation necessary under the budget resolution. Because debate is limited, a vote to stop debate is not required and such legislation can be passed by a majority vote. At this juncture Congress has not even passed its budget resolution which should have been passed by April 15.

Revenue measures enacted under the budget reconciliation process have important limitations that often mean permanent tax reform cannot be achieved through the reconciliation process. A provision that often comes into play is contained in Section 313 of the Budget Act (known as the "Byrd Amendment") and prohibits the enactment of any legislation that will increase the deficit for any fiscal year beyond the "budget window." The Budget Act requires the budget window to cover, at a minimum, the year for which the budget is being enacted, beginning on October 1 of that year, and the following four fiscal years.

For example, a bill enacted under the reconciliation process that reduces revenue more than it reduces spending can be on the books for the budget window only for that year, and then must sunset. A

recent example is the temporary elimination of the estate tax and other tax cuts enacted during the administration of President Bush in 2001. The estate tax was gradually reduced in the years after 2001 and eliminated entirely for 2010. Because these provisions were enacted through budget reconciliation, they were required to expire at the end of the budget window, which in this case was 2010. There is no maximum period provided in the Budget Act for the budget window, but recently Congress has limited the budget window to 10 years. The Republicans in the current Congress have considered extending the budget window to 20 or even 30 years so tax reform measures enacted can remain in force longer.

Tax reform enacted through the budget reconciliation process can be permanent if it is neutral to the deficit or reduces the deficit. Legislation would be neutral to the deficit if it reduces revenue and spending by equivalent amounts and would reduce the deficit if it reduces spending more than revenue. Tax reform could even be revenue neutral and not require spending cuts if it has offsetting tax reductions and increases; however, tax reform is rarely revenue neutral. Absent any of these circumstances, any tax reform enacted would again be limited to not more than about 10 years. We will continue to apprise you of any significant developments in this area.

## Shareholder Loan Guarantee Does Not Increase Tax Basis of Shares of S Corporation

One of the key distinctions between partnerships and S corporations is the way indebtedness of the entity impacts the income tax basis of a partner or shareholder. In the case of a partnership, debt incurred by the partnership generally increases the income tax basis of the partners in their partnership interests, whereas in the case of an S corporation, debt incurred by the S corporation does not increase the shareholders' income tax basis in the stock of the S corporation. The income tax basis of a partner or shareholder is relevant for several important reasons. First, a partner or shareholder cannot deduct losses that are passed through from the entity except to the extent of the income tax basis in their interest or shares. In addition, the tax basis of a partner or shareholder serves as a limitation on the amount of money that can be distributed by the entity to the partner or shareholder without causing them to recognize tax gain.

There is a long history of attempts by S corporation shareholders to increase their tax basis by guaranteeing a loan that has been made to the corporation. In most all cases, these attempts have failed. Recently, in the case of *Phillips v. Commissioner* (TC Memo 2017-30, 4/10/17), the Tax Court had an opportunity to address this question yet again in a slightly different context. Mrs. Phillips owned 50% of the shares of an S corporation called Olson & Associates of NW Florida, Inc. ("Olson"). Olson was in the business of developing residential real property in northern Florida. In connection with its developments, Olson borrowed up to $191 million from various lenders. The lenders required Mrs. Phillips and the other shareholder to guarantee these loans. During the recession that swept the country in 2007–2008, many of Olson's development projects failed and the real property collateralizing the loans became worth significantly less than the loan amounts. As a result, the lenders called on the guarantees of the shareholders and obtained judgments against the shareholders totaling $105 million when they failed to pay.

Mrs. Phillips claimed that due to the judgment against her, the tax basis of her shares of Olson should be increased by the amount she was obligated to pay to the lenders under the judgments. This increase in tax basis enabled her to deduct significant losses from Olson that she otherwise would not have had sufficient tax basis to deduct. The IRS denied these deductions on the basis that the loan guarantee and related judgments did not increase her tax basis.

The Tax Court agreed with the IRS. The court looked to its precedents, finding that it has consistently held that there must be an actual economic outlay by the shareholder in order for the shareholder to increase his tax basis. A guarantee, even one reduced to judgment by the creditor, does not amount to an economic outlay until the guarantor makes a payment to the creditor. Therefore the court denied Mrs. Phillip's loss deductions based on lack of sufficient income tax basis.

If an S corporation needs to borrowed funds for its business, the better way to create tax basis for the loan proceeds is for the shareholders to borrow the funds from the lender and contribute or loan the funds to the S corporation. Either a contribution or loan from the shareholder will create income tax basis.

### Court of Appeals Rejects Estate's *Graegin* Loan and Limits Valuation Discount

In *Estate of Koons III v. Commissioner* (11th Cir. 4/27/17), the Court of Appeals for the 11th Circuit affirmed a prior Tax Court decision and handed the taxpayer estate a double loss. John Koons owned 46.9% of the voting stock and 51.5% of the nonvoting stock of CIC Investment Corp. ("CIC"), which bottled and distributed Pepsi products and sold vending machine items. The stock of CIC not owned by Mr. Koons was owned by his children and trusts for their benefit. On December 15, 2004, CIC agreed to sell its business to Pepsi for $352 million in order to settle an ongoing dispute.

Mr. Koons developed a plan to place the sales proceeds into CI, LLC ("CI"), which would then serve as a family investment vehicle to be run by professional advisors. The children objected to this plan and conditioned the sale of their CIC shares on receiving an offer from CI to redeem their interests after the sale to Pepsi closed. CI made redemption offers to the children on December 21, 2004. The sale to Pepsi closed on January 10, 2005, and the sales proceeds went into CI. Mr. Koons died on March 3, 2005, at which time his revocable trust owned a 46.94% voting interest and 51.59% nonvoting interest in CI. The redemption of the children's interests closed on April 30, 2005, following which Mr. Koons' revocable trust owned 70.42% of the voting interest and 71.07% of the nonvoting interest in CI.

Mr. Koons' estate borrowed $10 million from CI to pay part of the estate taxes that were due. It executed a promissory note bearing an annual interest rate of 9.5%. No payment was due on the note for 18 years and thereafter interest and principal were to be paid in 14 installments through 2031. On Mr. Koons' estate tax return a deduction in the amount of $71 million was claimed as an administration expense, for interest that would become payable on the loan. The authority for deducting such interest is the *Graegin* case decided by the Tax Court in 1988. Loans of this nature are commonly referred to as "*Graegin* loans."

The estate tax return also claimed a 31.7% discount in the valuation of the interest in CI due to lack of marketability. The Court of Appeals affirmed a prior holding of the Tax Court that had denied the deduction for the interest on the loan and also concluded that the marketability discount should be limited to 7.5%. The rationale for denying the interest expense was that under the *Graegin* case, such interest is a necessary interest expense only where the estate can show it would have been required to sell assets at a loss to pay the estate tax. In the *Graegin* case, the principal asset of the estate was stock of a closely held corporation and the loan was necessary in order to avoid a forced sale at a substantial discount. In the case of Mr. Koon's estate, its principal asset was its significant interest in CI which held over $200 million of highly liquid and saleable assets. Mr. Koons' revocable trust held over 70% voting control over CI following the redemptions of the children and could have voted to approve any distribution necessary to enable the payment of estate taxes. Therefore incurring the interest expense was not necessary for the administration of the estate or the payment of estate taxes.

On the issue of the correct valuation discount for the CI interest, the key question was whether the revocable trust held a controlling interest. The redemptions of the children had not closed at the time of Mr. Koons' death so the trust literally did not hold a controlling interest. However, given the children's level of unhappiness over CI, the court concluded that the redemptions would almost certainly be completed so the trust effectively held a 70% interest. By holding a controlling interest, the trust could have forced CI to distribute its assets so it would never sell its membership interest for any amount less than the value of its proportionate share of those assets. The offers made before Mr. Koons' death to redeem the interests of the children, coupled with the children's expressed dislike for CI, were fatal to any attempt to obtain a significant valuation discount.

## Tax Court Follows Allocation Determined by Los Angeles County Assessor

Purchasers of improved real property to be used in a business or held for investment face an immediate issue in that the total purchase price paid for the property must be allocated between the land, which is not subject to a deduction for depreciation, and the improvement, which is depreciable property for income tax purposes. The amount allocated to each component must equal its fair market value. Taxpayers frequently base their allocation on the property tax bill for the property, which typically shows a value breakdown between land and improvement.

In the recent Tax Court case of *Nielsen v. Commissioner* (TC Summary Opinion 2017-31, 5/8/17), the taxpayer owned property in Los Angeles and claimed depreciation deductions on the full purchase price of the property which included the land as well as the buildings located on the property. The IRS found this error on audit and the case ended up in the Tax Court because the taxpayers and the IRS could not agree on how the price should be allocated between the land and the buildings. The IRS had based its adjustments on allocations obtained from the Los Angeles County Assessor. The Tax Court determined that the allocation from the Assessor was more reliable than any of the evidence presented by the taxpayer in supporting his theory.

Absent extenuating circumstances, the allocation on a property tax bill between land and improvements should provide a reasonable basis for determining the portion of the purchase price of a property upon which depreciation can be claimed, at least in Los Angeles County.

## New York Budget Legislation Includes Tax Changes

On April 10, 2017, Governor Cuomo signed budget legislation for the State of New York that includes several tax provisions. The following are the most significant tax measures.

*Maximum marginal rate*. New York's highest marginal tax rate is 8.82% on individuals with taxable income in excess of $1,000,000 ($2,000,000 on a joint return). This rate was scheduled to expire at the end of 2017 and the highest rate would have reverted to 6.85%. The budget legislation extends the 8.82% rate through 2019.

*Limit on charitable contributions*. Certain limits that New York imposes on the deduction for charitable contributions were set to expire at the end of 2017; however, these limits were extended through 2019. For individuals with income between $1,000,000 and $10,000,000, the limit is 50% of the federal deduction; for those with income over $10,000,000, the limit is 25% of the federal deduction.

*Sale by nonresidents of interests in an entity that owns an interest in a co-op*. If a nonresident of New York sells an interest in a legal entity, he is not subject to tax in New York unless more than 50% of the value of the assets of the entity are New York real property. The budget legislation added a provision that treats shares of a co-op located in New York as real property for purposes of this provision.

*Nonresident seller of partnership interest taxed if buyer elects to step-up tax basis*. Under a new provision contained in the budget legislation, if a nonresident sells a partnership interest in a partnership that owns assets that would generate New York source income if the assets were sold, the nonresident will now be required to treat the transaction as an asset sale subject to New York tax if the partnership makes a Section 754 election or if the buyer acquires all of the partnership interests, and the buyer benefits from an increase to the tax basis of the partnership's assets. Purchase and sale agreements will need to address this election as the making of the election may cause the seller to become subject to taxes in New York that would not be payable absent the election.

*Sales and use tax loopholes are closed*. A new provision restricts certain related parties from benefitting from the purchase for resale exemption from the imposition of sales tax. Previously a person might have an entity purchase tangible property, including works of art, that would normally be subject to sales tax. The entity would claim the purchase for resale exemption. Then the entity would re-sell the property to the related party at a lower price to limit the amount of sales tax payable. The use tax law was also tightened up to restrict the purchase of tangible property outside of New York in a non-New York entity, followed by the entity relocating to New York.

*Extension of film credits*. The Empire State film tax credit and post-production tax credit, which were set to expire after 2019, have been extended through 2022.

*New life sciences credit*. New life sciences businesses are eligible for a new credit with a maximum annual allocation of $10,000,000. New certified life sciences businesses would receive a 15% (20% for small companies) credit on all qualifying research and development expenditures in New York, up to $500,000 per taxpayer in any tax year.

*Increase in research and development credit*. The research and development credit is increased from 3% to 6% of qualified expenditures in New York.

## New Jersey Expands Angel Investor Credit

The State of New Jersey offers a tax credit equal to 10% of a taxpayer's qualified investment in a New Jersey emerging technology business. The definition of qualified investment has been expanded and now allows an investment in a holding company if the holding company in turn transfers the funds contributed by the taxpayer to an emerging technology business in New Jersey. If a corporation is an S corporation under New Jersey tax law, the corporation may pass the credit on to its shareholders based on their proportionate ownership. Both of these changes are retroactive to tax years beginning after 2011.

An emerging technology business is a company with fewer than 225 employees, with at least 75% of them work in New Jersey. The company must use qualified research expenses to pay for research conducted in New Jersey, conduct pilot scale manufacturing in the state, or conduct technology commercialization in the state in one of the following fields: i) advanced computing; ii) advanced materials; iii) biotechnology; iv) electronic device technology; v) information technology; vi) life sciences; vii) medical device technology; viii) mobile communications technology; or ix) renewable energy technology. The recent legislation added the category of carbon footprint reduction technology.

## Another Death Bed Limited Partnership Formation Fails to Accomplish Its Objectives

In *Estate of Nancy H. Powell* (148 TC 18, 5/18/17), another taxpayer at death's door failed to achieve any estate savings through the creation and funding of a limited partnership called NHP Enterprises, LP ("NHP"). Nancy Powell's son Jeffrey, acting under a power of attorney for his mother, formed NHP on August 6, 2008, and on August 8, he transferred cash and securities to

it in the amount of $10 million. Jeffrey was the general partner, holding a 1% interest, and Mrs. Powell's revocable trust held a 99% interest as a limited partner. The partnership agreement allowed the general partner to determine the amount and timing of distributions. NHP could be dissolved with the consent of all partners.

On August 8, Jeffrey, purporting to act under his power of attorney, transferred the 99% interest held by Mrs. Powell's trust to a charitable lead annuity trust ("CLAT") that would pay an annuity to the Nancy N. Powell Foundation each year, for the remainder of Mrs. Powell's life. Upon Mrs. Powell's death, any assets remaining in the CLAT were to be divided equally between Jeffrey and his brother. Mrs. Powell died a week later on August 15. A small gift was reported on a gift tax return filed after Mrs. Powell's death for the claimed value of the remainder interest in the trust going to Mrs. Powell's sons at her death.

The IRS proposed both a gift tax deficiency and an estate tax deficiency as a result of the above events. Before the Tax Court, the IRS took the position that the assets transferred to NHP were includible in Mrs. Powell's estate under IRC Sections 2036(a)(1), 2036(a)(2), or 2038. Section 2036(a)(1) includes property transferred by a decedent during their lifetime if the decedent retained the possession, enjoyment or right to income from the property. Section 2036(a)(2) includes property transferred where the decedent retained the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

According to the IRS, Section 2036(a)(1) applied because there was an implied agreement under which Mrs. Powell retained the possession, enjoyment or income from the property that was transferred to NHP. The court did not address this argument or the possibility of inclusion under Section 2038, because it found that Section 2036(a)(2) applied. This alone is significant because it is the first time the court has applied the (a)(2) provision to include assets transferred to a family partnership without concluding they could also be included under Section 2036(a)(1). Here, the court never took up the 2036(a)(1) arguments and instead based inclusion directly on Section 2036(a)(2). Adding to the significance of the court's finding, the inclusion under 2036(a)(2) was determined even though the decedent never had anything other than a limited partnership interest, because she could vote with the general partner to dissolve the partnership and thereby control the disposition of the assets.

In the Tax Court, the estate conceded that Section 2036(a)(2) would have applied if the decedent had retained any interest in NHP at her death because she, in conjunction with Jeffrey, could dissolve the partnership and thereby control the disposition of the assets transferred to it. The estate's argument was that this provision could not apply because prior to her death she was divested of her entire interest through the gift of her interest to the CLAT.

The Tax Court determined that the divestiture argument failed for two reasons. First, the power of attorney did not authorize Jeffrey to make a gift in excess of the annual exclusion amount provided in Section 2503(b). Even if the gift had been valid, Section 2036(a)(2) would still be applicable through the operation of Section 2035(a). This section provides that if a decedent makes a transfer, retains a power that would result in inclusion under any of Sections 2036, 2037, 2038 or 2042, and within three years of his or her death relinquishes the proscribed power, the value of the transferred property is included in the decedent's gross estate.

The court determined that the gift of the interest in NHP to the CLAT amounted to the relinquishment of the decedent's retained power to dissolve NHP and control the disposition of its assets. Since the gift occurred within three years of the death of Mrs. Powell, Section 2035(a) pulled the value of the transferred assets back into her estate.

The court's willingness to apply Section 2036(a)(2) where the decedent held only an interest as a limited partner makes the retention of any interest in

a family partnership, whether general or limited, by a family member who transfers assets to it a high risk proposition, since most partnerships can be dissolved if the partners act together to do so. Furthermore, any transfer of the interests in such a partnership to other family members should occur more than three years before the likely death of the family member making the transfer in order to protect against inclusion under Section 2035. That said, this case is a classic example of the old maxim that "bad facts make bad law." The case may be appealed. In many family partnership situations the bona fide sale exception will prevent IRC Sections 2036 or 2038 from being applicable.

### The Future of Discounts?

In our August 2016 newsletter, we cautioned that the ability to discount an interest in an entity (partnership, LLC, or corporation) might be eliminated when family members control the entity before and after. New proposed regulations under Internal Revenue Code Section 2704 would have significantly limited the ability to take valuation discounts for transfers of family entities. On April 21, 2017, President Trump issued Executive Order 13789, a directive designed to reduce tax regulatory burdens. The order instructed the Secretary of the Treasury to review all "significant tax regulations" issued on or after January 1, 2016, and submit two reports, followed promptly by concrete action to alleviate the burdens of regulations that meet criteria outlined in the order. On July 7, 2017, Treasury identified the proposed 2704 regulations as one of eight identified as burdensome. Now Treasury has until September 18, 2017, to recommend actions and reforms to mitigate the burdens of the regulations identified as significant regulations and burdensome.

### Other Regulations Reviewed under the Executive Order

In addition to the Section 2704 proposed regulations discussed above, several other recently promulgated regulations have been identified for review under Executive Order 13789. These include temporary regulations under IRC Section 337(d) which would have imposed tax on the gain in assets of a C corporation that come to be owned by a Real Estate Investment Trust. Also selected for review are temporary regulations under IRC Section 752 dealing with partnership liabilities including bottom dollar guarantees, and regulations under Section 385 which would restrict the ability of multinational taxpayers to use interest payments on debt to reduce the amount of the group's income subject to tax in the United States. The other regulations selected for review include regulations issued under Section 103, defining a political subdivision; Section 7602, expanding the group of people who have access to material produced pursuant to a summons; Section 987, dealing with foreign currency gains; and Section 367, dealing with transfers of goodwill and going concern value to foreign corporations.

### Case on Worker Classification Has Important Consequences for Employers and Employees

The Tax Court decided a case in April on the proper classification of employees that is likely to have far reaching consequences for both employers and employees. An employer sometimes classifies its workers as independent contractors rather than as employees because if they are independent contractors the employer is not required to withhold income and payroll taxes and is not required to pay the employer's share of any payroll taxes. This classification, if correct, saves the employer money. The IRS has aggressively audited employers and in many instances has reclassified workers as employees.

One consequence of such a reclassification is that the employer becomes liable for the income and payroll taxes owed by the employee as well as the employer's share of payroll taxes. For large employers this can be a very substantial amount. The employer can avoid liability for the employee's income and payroll taxes if it can demonstrate that the employee paid the taxes he owed, even though there was no withholding of such taxes by the employer. The question is, how does the employer prove that the employee paid his taxes?

This was the subject of *Mescalero Apache Indian Tribe v. Commissioner* (148 TC No.11, 4/5/17). The Mescalero Apache Tribe employed hundreds of workers and classified some as independent contractors. Upon audit, the IRS reclassified many of these workers as employees. The Tribe was able to demonstrate that a significant number of the reclassified workers had paid their taxes. It was able to get them to complete IRS Form 4669. On this form, the employee lists the payments he received from the employer, the schedule and line of his tax return he used to report the payments, and makes a statement that all taxes due on the return have been paid. The Tribe had 70 former workers whose status was reclassified to employee by the IRS whom it could not find. It requested the IRS to provide it with information about the tax payments of these 70 workers, but the IRS refused.

The Tribe then filed a motion in the Tax Court to compel discovery and obtain the information about the 70 workers from the IRS. The IRS objected on the basis that IRC Section 6103 prohibits the IRS from disclosing income tax return information. There is an exception that allows disclosures in judicial and administrative tax proceedings, but the statute is not clear as to whom such information may be disclosed. In this case the court determined that the IRS could disclose information from the workers' tax returns to the extent it would address whether the worker had paid his taxes on the amounts he received from the Tribe. This case takes on added importance as precedent as it was reviewed by the entire court. The IRS may still refuse to provide this type of information to employers because there are courts of appeal not relevant in this case that have held such information cannot be disclosed.

For an employer the case provides additional authority that it may be able to obtain information from the IRS to demonstrate that its workers paid their taxes. For workers who are classified as independent contractors, the case means that if they are reclassified by the IRS as employees, the employer may be able to access their tax return information through the IRS if they don't willingly provide Form 4669.

## Tax Court Addresses Phantom Stock Plan

In a recent case involving a motion for summary judgment, the Tax Court drew some interesting conclusions about a phantom stock plan. Phantom stock is not real stock. It is a form of deferred compensation paid to an employee and its value tracks the performance of the company stock. If the stock increases in value, the employee's phantom stock account becomes more valuable. If the stock's value declines, the employee's account becomes less valuable. Gary Hurford worked for the Hunt Oil Company, which had a phantom stock deferred compensation program. When Gary died in 1999, his account was worth $6,411,000, which was reported on his estate tax return. He left the account to his wife, Thelma. Reporting the phantom stock on Gary's estate tax return did not result in a tax basis increase because phantom stock is treated as "income in respect of a decedent," which does not get the benefit of a basis increase at death.

Upon inheriting the account, in 2000 Thelma transferred it to a partnership called Hurford Investments No. 2, Ltd. ("HI-2") which had been created to hold this asset. This is where the first mistake occurred. Thelma should have reported the value of the phantom stock account at the time of the transfer to HI-2 as ordinary income under IRC Section 691(a)(2). She did not report any income; however, HI-2 reported short term capital gain in the amount of $6,411,000. This was also not correct but at least the government got its tax money. The IRS later agreed that HI-2 obtained a tax basis of $6,411,000 by virtue of having reported the short term capital gain.

Thelma died in 2001. In a prior Tax Court case, it was determined that the value of the phantom stock account was included in Thelma's estate for estate tax purposes because of certain interests she was found to have retained. The value of the account on the date of her death was $9,600,000.

In 2004, which was five years after Gary's death, the phantom stock holding was terminated under the plan. This means that an account was created in the name

of HI-2 that had an initial value equal to the value of the phantom stock account in 2004. This account could still grow or decline with the value of Hunt Oil Stock though not as much. Any growth could not exceed the 90 day Treasury rate. In 2006, Hunt Oil elected to cash out this account and paid HI-2 the sum of $13,000,000, the account's value at the time.

Two questions had to be addressed that ended up back in the Tax Court. How much gain resulted and was the gain ordinary income or capital gain? The court addressed these questions in *Hurford Investments No. 2, Ltd., v. Commissioner* (Docket No 23017-11, 4-17-17). The IRS had previously agreed that HI-2 had a tax basis in the account of $6,411,000 as a result of having paid tax on that amount in 2000. HI-2, however, argued that its basis should be increased to the fair market value at Thelma's death in 2001, which was $9,600,000. The court held that because the account had been included in Thelma's estate for estate tax purposes, its basis was the fair market value at Thelma's death, so HI-2 benefited from a basis increase of over $3,000,000.

The court's resolution of the capital gain vs. ordinary income question was interesting. Everyone agreed that at Gary's death in 1999, the account represented ordinary income under IRC Section 691 and continued such characterization under Thelma's ownership. The court pointed out, however, that the character of property can change. When Thelma transferred the account to the partnership, Section 691 ceased to apply. Thelma should have recognized the value of the account as ordinary income at that time and thereafter the account was no longer governed by Section 691. The court then turned to Section 1221 to review the definition of a capital asset. A capital asset is defined as property other than certain specific types of property that are excluded. Because the account did not fall under any of the exclusions, the court concluded that in the hands of HI-2 it was a capital asset.

HI-2 had one more hurdle to clear to obtain capital gain treatment. It had to demonstrate that the account was disposed of in a "sale or exchange" transaction in order for capital gain income to result. The IRS argued that Hunt Oil closing the account in 2006 and paying HI-2 its balance did not amount to a sale or exchange transaction. HI-2 even agreed that the closing of the account was not a sale or exchange transaction but argued that IRC Section 1234A afforded it capital gain treatment nonetheless. This section provides that gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is a capital asset shall be treated as gain or loss from the sale of capital asset. The Code itself provides the necessary sale or exchange treatment.

The court agreed that Section 1234A applied. HI-2 had the right to liquidate the account at any time after 2004 and prior to 2006 when Hunt chose to liquidate the account. Hunt's action amounted to the termination of HI-2's right to sell the account back to Hunt, and therefore Section 1234A applied and capital gain resulted from an asset that started life as ordinary income.

## Tax Court Allows Modification of Variable Prepaid Forward Sale Contract

In 2007, Andrew McKelvey, the founder of Monster Worldwide, Inc., entered into variable prepaid forward contracts ("VPFC") with Bank of America ("B of A") and Morgan Stanley. Under these contracts, the banks paid Mr. McKelvey an agreed upon sum of money. The B of A contract can be used to illustrate the issue in the case. Mr. McKelvey received the cash sum of $51 million from B of A and in return agreed to deliver a variable number of shares of Monster stock on ten separate future delivery dates from September 11, 2008, through September 22, 2008. The actual number of shares to be delivered was to be based on the stock price on each delivery date. On each delivery date, Mr. McKelvey had the choice of delivering the number of shares based on the price of the stock on that date, or he could deliver an equivalent amount of cash. The uncertainty over how many shares the taxpayer had sold for $51 million, or whether he had even sold any shares, resulted in the sale being an open transaction since his tax gain could

not be computed on the date the contract was entered into. The IRS previously confirmed this result in Rev. Rul. 2003-7, holding that a taxpayer does not have a taxable sale on receipt of the cash from the buyer, but instead when it delivers shares or cash to close the contract.

On July 24, 2008, prior to the first delivery date in September, Mr. McKelvey paid B of A an additional $3.5 million to extend the delivery dates to dates ranging from February 1 through February 12, 2010. This created the tax issue in the case, as the IRS took the position on audit that the extension of the VPFCs amounted to an exchange of the original contracts for new contracts and that was a taxable event for Mr. McKelvey under IRC Section 1001. The Tax Court addressed the question in *Estate of Andrew J. McKelvey v. Commissioner* (148 TC No. 13, 4/1917). Mr. McKelvey died in 2008 after completing the extensions of the contracts.

The estate's first argument was that contracts were not property and therefore Section 1001 could not apply. The essence of the argument was that once the taxpayer had received the cash payment from B of A, he had only obligations under the contracts to deliver either shares of Monster stock or cash, at the option of the taxpayer. The IRS argued that the right to choose between delivering shares of stock or cash was in essence a property right. The court disagreed and determined that the contracts were not property because the taxpayer had only obligations under them.

The court nevertheless went on to evaluate whether the extensions of the contract were exchanges of the original contracts for new contracts. It reviewed the rationale behind the open transaction treatment accorded VPFCs by Rev. Rul. 2003-7. At the inception of the contract, the sale price is known. It is the amount of cash the taxpayer receives from the buyer. What is not known is how many shares are sold, or if any shares are even sold. Without knowing the number of shares sold, the taxpayer's basis in the sold shares cannot be determined so his gain or loss cannot be computed. Further, his gain or loss would be entirely different if he settled the contract by delivering cash. The extension of the delivery dates did nothing to remove any of the uncertainty over the tax basis to be used to compute the taxpayer's gain or loss because it could still not be determined how many shares would be delivered or if the taxpayer would settle the contracts with a cash payment. Thus the rationale for open transaction treatment was still the same and the court did not think imposing a tax event at this point was appropriate.

### California Supreme Court Determines That a Transfer of Interests in a Legal Entity Can Trigger Application of the Documentary Transfer Tax

California imposes a transfer tax on transfers of interests in real property at a rate of 55 cents for each $500 of net value. The tax must be paid whenever a deed is recorded. For the first time, in a closely watched case, the California Supreme Court has held that this transfer tax can apply in some circumstances to the transfer of an interest in a legal entity that owns real property, even if the transfer does not involve any deeds with respect to the real property.

In *926 North Ardmore Avenue, LLC. v. County of Los Angeles* (6/29/17), Beryl and Gloria Averbook owned the property located at 926 North Ardmore Avenue through their revocable living trust. Following the death of Beryl, the property was transferred to a single member limited liability company ("LLC"). The interests in the LLC were transferred to a limited partnership called BA Realty. The 99% limited partnership interests in BA Realty were transferred to four trusts for the benefit of Gloria. The 1% general partnership interest was held by the administrative trust through another single member limited liability company. Upon the completion of these steps, the four trusts and the administration trust owned the interests in BA Realty, a limited partnership. BA Realty owned 100% of the membership interests in LLC and LLC owned the Ardmore Avenue property.

In 2009, three of the four trusts sold their interests in BA Realty (aggregating just under 90%) to two trusts created for the sons of Beryl and Gloria. The trusts paid for the interests with promissory notes and the price was based on an appraisal of the property. It was this sale of interests in BA Realty that gave rise to the issues in the case.

The Los Angeles County Assessor re-assessed the property for property tax purposes based upon there having been a change in ownership. The transfer to the trusts for the sons was a change in ownership because, following the transfer of the property to the LLC and BA Realty, which was exempt under the original co-owners exception, there had been a transfer of more than 50% of the interests in BA Realty. This triggered an ownership change and re-assessment of the property under Revenue & Taxation Code Section 64(d).

Beginning in 2010, the Los Angeles County Recorder began demanding payment of the documentary transfer tax whenever it became aware of a change in ownership re-assessment caused by the transfer of interests in a legal entity. In accordance with that practice, the Recorder demanded payment of the transfer tax. The tax was paid and a claim for refund was made. The claim was denied and the case ultimately ended up before the California Supreme Court.

The taxpayer's main argument was that tax applied only to deeds submitted for recording and could not be applied to transfers of interests in legal entities that own real property. The County argued that the tax applies whenever an interest in real property is sold, whether directly by deed or indirectly through the sale of interests in a legal entity that owns real property.

The Court determined that the tax could apply to certain transfers of interests in legal entities due to Revenue & Taxation Code Section 11925(a), which provides that a transfer of an interest in a partnership does not give rise to the transfer tax if the partnership is continuing. However, if the partnership terminates, the entity is treated as having conveyed the real property and that deemed conveyance is subject to the tax. Therefore, the court determined that under some circumstances a transfer of a legal entity could trigger application of the transfer tax.

The Court concluded that the key to determining application of the transfer tax was to determine whether a change in the beneficial ownership of the property had occurred. The Court reviewed a variety of federal cases interpreting the old deed stamp tax, upon which the California documentary transfer tax is based. The Court determined that the Recorder's practice of imposing the tax when the transfer of interests in a legal entity constituted a property tax change in ownership was consistent with the notion of the transfer of a beneficial interest.

Justice Kruger wrote a strong dissenting opinion in which he pointed out that when the legislature enacted the documentary transfer tax in 1967, it could not have considered basing its application of the property tax entity change in ownership rules because those provisions were not enacted until 1979, following the passage of Proposition 13. He believed that the argument of the taxpayer was correct and the tax can be applied only to actual conveyances by deeds.

It is interesting that the Court did not take what may have been a more direct route to the imposition of the tax found on the face of the statute. Revenue & Taxation Code Section 11925(b) provides that:

*"If there is a termination of any partnership or other entity treated as a partnership for federal income tax purposes, within the meaning of Section 708 of the Internal Revenue Code of 1986, for purposes of this part, the partnership or other entity shall be treated as having executed an instrument whereby there was conveyed, for fair market value (exclusive of the value of any lien or encumbrance remaining thereon), all realty held by the partnership or other entity at the time of the termination."*

This Section provides that if a transfer of an interest in a partnership causes the partnership to terminate pursuant to IRC Section 708, then the partnership is treated as having executed a deed to the property and the tax applies. IRC Section 708(b) provides that if within a 12-month period, a 50% or greater interest in a partnership is sold or exchanged, the partnership is treated as terminating. In this case, an interest of just under 90% was sold so the partnership terminated under IRC Section 708(b) and it seems that the tax became payable under Section 11925(b) of the Revenue & Taxation Code. The Los Angeles County Ordinance enacted to impose the tax mirrors this provision in its Section 4.60.080. The Court noted the termination rule of IRC 708 in a footnote to its opinion but did not make it the basis of its holding. Instead, the Court premised that application of the transfer tax on an entity change in ownership under the property tax rules.

It may be that the Supreme Court did not rely on Section 11925(b) because when the case was before the Court of Appeals the taxpayer had argued that Section 11925(b) did not apply because the partnership, BA Realty, did not actually own any real property. It owned an interest in LLC, which owned the real property. The Court of Appeals accepted the taxpayer's argument on this point and held that the tax applied whenever the transfer of an interest in an entity caused a property tax change in ownership.

## California Board of Equalization Determines Corporations Were Doing Business in California

In two recently released decisions from 2015, the California State Board of Equalization ("SBE") found that two different non-California corporations were doing business in California and therefore subject to the payment of franchise taxes, including the annual minimum franchise tax. In *Appeal of Commercial Financial Services, Inc.*, the SBE found that a Delaware corporation was doing business in California. The primary basis for this finding was that the sole shareholder and President of the corporation resided in California and performed services for the corporation from his home. The corporation also used a California address on its federal income tax return.

In *Appeal of Quad State Mobile Trackmasters*, the SBE held that a Nevada corporation that was principally engaged in business in the State of Wyoming was also doing business in California and therefore subject to the California Franchise Tax. The business of the corporation was repairing heavy machinery, which it did in Wyoming. The corporation was owned by a husband and wife. The wife lived in California, served as the corporate secretary and performed certain services for the corporation. The corporation also used a California address on its federal income tax return. The SBE found these activities were sufficient to cause it to be doing business in California:

*"Here, the evidence in the record supports the finding that appellant was 'doing business' in California in 2010. Appellant's corporate secretary lived in California and engaged in bookkeeping, answering phone calls, sending financial information to appellant's accountant, and making deposits in appellant's California bank account, all on behalf of appellant. As such, appellant was doing business in California."*

These cases clearly demonstrate that it does not take much activity within the State of California to cause a legal entity to be considered to be doing business within the state. The failure to register an entity as doing business and to pay the required Franchise taxes may lead to the imposition of penalties down the road. The safest course is to register and pay the required taxes if there is any possibility of an entity being considered doing business in California.

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