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High Net Worth Family TAX REPORT

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Purchasers of Businesses in Corporate Form Must Be Aware of New IRS Regulations

If you plan to acquire a business by purchasing the stock of a corporation, you need to be aware of two sets of new regulations recently issued by the IRS. The first set consists of final consolidated return regulations applicable to transactions after September 17, 2008, and is relevant only if you purchase the stock of a subsidiary that is included in a consolidated federal income tax return with the selling parent company. The regulations apply when the parties *do not* elect under Internal Revenue Code (hereafter "IRC" or "Code") Section 338(h)(10) to treat the transaction as an asset sale.

If the seller realizes a loss on the sale of the subsidiary stock, then the subsidiary, now owned by the buyer, must reduce valuable tax attributes. Capital and net operating loss ("NOL") carryovers are eliminated first, up to the extent of the loss on sale realized by the seller. If the loss exceeds the amount of such carryovers, then the income tax basis of the subsidiary's assets is reduced. This will reduce your depreciation or amortization deductions and increase your tax gain if you sell any of the assets.

A seller may make two different elections to cause a different result. It can elect not to deduct its loss, in which case the subsidiary keeps its losses and basis; or, the seller can elect to re-attribute the subsidiary's NOL back up to the seller, which reduces the seller's basis in its stock and reduces or eliminates the loss on sale. Any amount of NOL that is re-attributed to the seller is not available to the subsidiary to offset income it earns during the buyer's period of ownership. To avoid unpleasant surprises, it is important for the buyer to negotiate with the seller over the treatment of the seller's prospective loss, or at least protect itself through representations and warranties in the agreement.

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More transactions may be affected by the second set of regulations which is proposed regulations issued on August 25, 2008, under IRC Section 336(e). These regulations would expand the circumstances in which a stock purchase can be treated as an asset purchase for federal income tax purposes, thereby allowing the purchaser to obtain a cost basis in the assets of the target without directly acquiring those assets. The regulations will be effective when published as final regulations.

Generally, when a purchaser acquires the stock of a corporation ("Target"), the purchaser takes a "carried over" basis in Target's assets equal to Target's tax basis in those assets. By contrast, when a purchaser acquires Target's assets, the purchaser takes a cost basis, generally equal to the value of the acquired assets. A cost basis is generally preferable to a carried over basis if the Target's assets are appreciated, since a cost basis will result in larger depreciation and/or amortization deductions.

The tax law has for many years provided two elections (under Code Sections 338(g) and 338(h)(10)) that allow a purchaser of at least 80 percent of the stock of Target over a 12-month period to treat the stock purchase as an asset purchase for federal tax purposes, and thereby obtain a cost basis in the assets without formally acquiring the assets. Both of these elections, however, are generally available only where the purchaser is a C corporation.

Unlike the other Section 338 elections, these new regulations under Section 336(e) do not require the purchaser to be a corporation (although both Seller and Target must be domestic C corporations). Another important difference between the Section 336(e) election and either the Section 338(g) election or the Section 338(h)(10) election is that the Seller makes the Section 336(e) election unilaterally. Such a unilateral election by Seller could have a negative impact on a purchaser that desires to use Target's prior NOLs to offset future income or to use the built-in loss in certain assets to offset other gains. If the acquisition is treated as a stock sale, these NOLs (and any such built-in losses) would generally remain available to Target post-closing (subject to certain limitations). Where the Seller makes a Section 336(e) election to treat the transaction as an asset sale, however, Target would have its prior tax attributes (including the NOLs and such built-in losses) wiped out.

A prospective purchaser should take into account Seller's ability to unilaterally elect to eliminate Target's tax attributes by means of a Section 336(e) election when negotiating the purchase transaction with Seller. While the regulations are not effective until they are finalized, nobody knows when that will be. If you are negotiating now to purchase the stock of a corporation from a seller that is a C corporation, the possibility that this election will become available before your transaction closes should be taken into account. Overall, when finalized, the Proposed Regulations will provide greater flexibility to parties to transactions involving the sale of corporate subsidiaries.

Using an IRA to Pay For Higher Education Expenses

In general, distributions from most tax-qualified retirement plans and IRAs are subject to an additional 10% penalty tax if the distribution occurs prior to the participant's attainment of age 59-½. A noteworthy exception, especially in today's economy where higher education expenses continue to spiral upwards, is the use of IRA funds to pay higher education expenses.

Under current law, the 10% early distribution penalty tax does not apply to IRA distributions that do not exceed the amount of "qualified higher education expenses" for the taxable year of the distribution for the education of the participant, the participant's spouse, or the children or grandchildren of the participant and/or spouse, at an "eligible educational institution".

"Qualified higher education expenses" are tuition, fees, books, supplies and equipment required for the enrollment or attendance (and special needs servic-

es if applicable), as well as reasonable costs incurred for room and board.

An “eligible educational institution” is a college, university, vocational school or other post-secondary educational institution.

Withdrawing money from your IRA may not be the ideal way to pay these education expenses as you do have to pay regular income tax on the withdrawn funds. Nevertheless, if your liquidity has been temporarily impaired by recent market events, it is a potential source from which payments could be made.

New Internal Revenue Code Section 457A to End Deferral of Fee Income from Offshore Funds

Using a foreign corporation or other entity to manage an offshore investment fund created a popular tax deferral opportunity for any United States individual managers who were employed by the foreign entity. The funds were structured so that the foreign entity managing it was not subject to United States income taxes on its earnings from the fund. These management entities were formed in low tax (or no tax) jurisdictions. This enabled them to hold and invest on a pre-tax basis, amounts that would ultimately be paid to the United States individual managers down the road. The United States individuals benefited from years of tax free accumulation of investment returns. The Emergency Economic Stabilization Act of 2008 (Pub. L. 110-343 10/3/08) added Section 457A to the Code to end this deferral opportunity.

Section 457A will preclude the deferral of U.S. federal income tax on compensation received for services performed after 2008 for foreign corporations or partnerships located in tax haven jurisdictions, unless the deferred compensation is subject to a substantial risk of forfeiture. Section 457A will also require fund managers to pay tax on deferred compensation earned for services performed in or prior to 2008 by the later of (i) the last taxable year beginning before 2018, or (ii) the taxable year in which the deferred compensation ceases to be subject to a substantial risk of forfeiture.

Under a limited short-term deferral exception, compensation would not be treated as deferred (and current income inclusion would not be required) under Section 457A if the service provider receives payment of the compensation no later than 12 months following the end of the foreign entity’s taxable year during which the right to payment of such compensation is no longer subject to a substantial risk of forfeiture.

Under Section 457A, compensation is subject to a “substantial risk of forfeiture” only if (1) the service provider’s right to the compensation is conditioned on the performance of substantial future services and (2) the possibility of forfeiture is substantial. A notable consequence of this restrictive definition is that a condition related to a purpose of the compensation (other than future performance of services), such as a performance-based condition, or a condition related to the attainment of specified earnings targets, does not create a substantial risk of forfeiture.

When deferred compensation is required to be included in income under Section 457A, the compensation amount will be increased by the sum of (i) an interest charge computed at the underpayment rate plus 1% on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which it was first deferred or, if later, the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture, and (ii) an amount equal to 20% of the amount of the compensation.

Deferred compensation arrangements which may be subject to Section 457A should be reviewed and revised during 2008 to avoid the worst-case scenario of the current recognition of compensation income without the contractual entitlement to the current payment of that compensation.

Emergency Economic Stabilization Act Contains Numerous Tax Provisions

In addition to the new restrictions on deferred compensation described in the prior article, the Emer-

gency Economic Stabilization Act of 2008 contained numerous other tax provisions. Most of them are of too limited interest to report on here, but there are a few of general interest to high net worth taxpayers. These include:

IRA Charitable Rollover Provisions Extended. The provision that allows an IRA owner to make a direct transfer to a charity without taking the amount transferred into his taxable income was extended through 2009. The amount transferred is not deductible (because it is not included in the owner's taxable income) but it does count against the required minimum distribution that the account owner must otherwise take. In order to qualify: i) the owner of the IRA must be 70 ½ or older; ii) the gift must be made by December 31, 2008 (to fulfill the distribution requirement for 2008) or December 31, 2009 (to fulfill the distribution requirement for 2009); iii) the transfer cannot exceed $100,000 per year; and iv) the charity must be publicly supported. Transfers to private foundations and donor advised funds do not qualify.

To avoid an unpleasant surprise, before you do this make sure your state also permits the tax free charitable rollover. Given its own budget problems, California may not conform its tax law to permit these rollovers.

Alternative Minimum Tax Changes. Consistent with recent history, Congress once again applied a one year patch to prevent the alternative minimum tax ("AMT") from applying to about twenty million middle class families. This is done by increasing the exemption amount and generally is not of interest to high income taxpayers because the exemption amount is phased out as alternative minimum taxable income increases.

Of significance to some high net worth taxpayers is a provision that abates any alternative minimum tax liability that arose in a tax year ending before 2008 that is attributable to the exercise of "Incentive Stock Options" ("ISOs"). When a taxpayer exercised an ISO, the difference between the option strike price and the value of the stock at the time of exercise did not have to be included as income for purposes of the regular income tax but did have to be included for purposes of the alternative minimum tax.

Many people who exercised these options during the technology stock boom became obligated to pay AMT. When the value of the shares quickly plummeted or became worthless, they were often unable to pay the tax. After considerable lobbying by the National Taxpayer Advocate's office, Congress finally addressed the problem by simply eliminating their tax liability. Anyone who actually paid the AMT will receive a refundable credit they can use to obtain a future refund.

Suspension of 50% AGI Deduction Limit. The 50% of adjusted gross income limitation on charitable income tax deductions for individuals has been temporarily suspended through December 31, 2008, for charitable cash contributions dedicated to Midwestern disaster relief efforts. This provision is effective for all cash contributions paid during the period beginning on the earliest applicable disaster date for all States and ending on December 31, 2008. The donor must obtain a written acknowledgement from the charity that the gift was used for relief efforts in one or more Midwestern disaster areas and the donor must elect this treatment with respect to the contribution.

Again, you should also determine whether your state recognizes this provision. On prior occasions when the 50% limitation has been suspended for the federal income tax, California has not conformed its law to that provision.

Extension of 15 Year Amortization for Leasehold Improvements. Qualified leasehold improvements that were placed in service in commercial buildings before January 1, 2008, could be amortized on a straight line basis over 15 years instead of the 39 year period otherwise applicable to the building. This provision has been extended to improvements placed in service before January 1, 2010. The

improvements must also be placed in service more than three years after the date on which the building was first placed in service.

Donations of Appreciated Property by S Corporations. Under a special rule that expired on December 31, 2007, if an S corporation made a charitable contribution of appreciated property, it was permitted to deduct the fair market value of the property (assuming it otherwise qualified) but the shareholder only had to reduce the tax basis of his shares by the adjusted tax basis of the contributed property. This provision has been extended to contributions made on or before December 31, 2009.

Proposed Change to New York Residency Rules for Income Tax Purposes

New York State proposed to eliminate the "temporary stay" exemption for determining whether an individual is a resident for New York State and New York City income tax purposes, effective retroactively to January 1, 2008. An individual who is not domiciled in NY is treated as a resident (subject to NY income tax on his worldwide income) if he maintains a permanent place of abode in NY and is present in NY for more than 183 days during the tax year. Under the current regulations, a place of abode is not considered permanent if it is maintained only during a temporary stay for the accomplishment of a particular purpose.

The change, however, would not affect the requirement in the regulations that the place of abode must be maintained for substantially all of the tax year (which NY has interpreted to mean more than 11 months). As a result, if the proposed change is adopted, an individual who is domiciled, resident and working in Massachusetts, whose job required him to move to NY on January 1, 2008, for a 2 year training program, after which time he will return to his home and job in Massachusetts, will be considered a resident of NY during the 2 years he is here, 2008 and 2009. However, if he moved to NY for the 2 years of training sometime after January 2008, he would only be a NY resident for the middle calendar year, since he would not maintain a permanent place of abode in NY during either the first or last calendar year included in his training period.

Alert to Those Who Serve on Charitable Boards

Charities in California need to be aware of a new law that affects their endowments – the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”). Charities should expect to be asked by their auditors how they intend to comply with Financial Accounting Standards Board (“FASB”) Rule 117-1, which provides guidance on financial statement classification of endowment funds subject to UPMIFA. UPMIFA applies, as did UMIFA, to charities organized as nonprofit corporations and to charities organized as trusts, but only if the trust has a charity as a trustee.

UPMIFA’s predecessor, the Uniform Management of Institutional Funds Act (“UMIFA”) focused on the prudent spending of the net appreciation of an endowment fund. Under UMIFA, a charity could spend from an endowment fund the amount of appreciation above the fund’s historic dollar value (“HDV”) – i.e., contributions – that the charity deemed prudent, after considering the charity’s purposes, but could never spend the HDV. In contrast, under UPMIFA, a charity can spend the amount it deems prudent after considering the donor’s intent that the endowment fund continue permanently, the purposes of the fund itself, and relevant economic factors. UPMIFA discards the HDV concept and emphasizes the purchasing power of the fund, preserving principal while spending according to a reasonable spending rate. Seven criteria guide the charity in its spending: (1) the duration and preservation of the endowment fund; (2) the purposes of the institution and the endowment fund: (3) general economic conditions; (4) the possible effect of inflation or deflation; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; and (7) the investment policy of the institution. California adopted one of the “optional” provisions of the uniform law, creating a rebuttable presumption of imprudence for spending more than 7% of the value of an endowment fund in one year (based on a three-year rolling average), but including a reminder in the statute that

spending below 7% does not create a presumption of prudence.

UPMIFA creates a new concept – “donor-restricted funds” and “board-restricted funds.” The new rules apply to donor restricted funds, not to money set aside by a board as an endowment. Any donor restrictions agreed to by a charity will govern the endowment fund; absent a donor restriction, UPMIFA will apply. Under FASB 117-1, an auditor will be asking the charity’s board to determine the portion of a donor-restricted fund that is classified as permanently restricted, temporarily restricted, or unrestricted under UPMIFA. Because FASB 117-1 will require significant new disclosures on charities’ financial statements, the FASB decided to delay the effective date of this new rule to years ending after December 15, 2008.

UPMIFA applies to charitable funds created both before and after enactment, but provides rules for modification of donor restrictions that clarify how obsolete restrictions may be changed: A donor may release a restriction; a court may permit deviation under a cy pres doctrine, but the change must be consistent with the charitable purposes of the original gift; and in the case of a small (less than $25,000), old (more than 20 years) fund, the charity may apply the cy pres doctrine without court approval, but with notice to the California Attorney General.

New Form 990

The Form 990 (the annual information return filed by public charities) contains many questions regarding the organization's governance as of 2008. Does your charity have a document retention policy? A whistler blower policy? A conflict of interest policy? If you want to be able to answer "yes" to these and other questions and you need help adopting such policies, please contact us.

Taxpayer Wins Case on Application of California Property Tax to Aircraft

In *Auerbach v. Assessment Appeals Board No. 2 for the County of Los Angeles*, the California Court of Appeal upheld the finding of the Superior Court in favor of the taxpayer in a case that addressed the correct value on which property tax should be imposed for a private airplane. The actual taxpayer was CKE Associates, which purchased a Gulfstream G-IV aircraft for $19,200,000. In determining the property tax assessment on the plane, the Los Angeles County Assessor included in the valuation base the theoretical amount of sales tax that would have been paid on the plane.

In actuality, the State Board of Equalization had determined that no sales tax was due because the aircraft qualified for the “common carrier exception.” CKE had entered into contractual arrangements with both Elite Aviation LLC and AVJet Corporation to charter the aircraft when CKE was not using it. Everyone who has purchased a private aircraft is familiar (or should be) with California Regulations Section 1593(c)(1)(B) which provides that you qualify for the common carrier exception to sales tax if, during the first twelve months following your purchase of the aircraft, more than half of the operational use is as a common carrier. CKE demonstrated to the State Board of Equalization that during such test period, 329 out of a total of 521.6 operational hours were charter hours which are considered common carrier use. Thus, the SBE determined that no sales tax was payable by CKE.

Despite this finding by the SBE, the Assessor nevertheless added hypothetical sales tax to the plane’s value for property tax purposes. You have to give Mr. Auerbach credit for being persistent. After losing the case before the Assessment Appeals Board, he appealed to the Superior Court and after losing there appealed to the Court of Appeal. The Court of Appeal, as had the Superior Court and Assessment Appeals Board, held that if sales tax was not payable on the aircraft, it should also not be a part of the assessed value for property tax purposes.

If you own an aircraft on which you did not have to pay sales tax, it is worth looking at your property tax assessment to determine whether your assessed value nevertheless includes a sales tax component.

If it does and the amount is material, you may want to pursue an assessment appeal or at least get the assessed value corrected for the future by discussion with the assessor's office.

California Enacts Some Tax Changes to Address Budget Problems

California enacted several tax law changes related to its most recent budget. The changes most likely to be applicable for high net worth families include:

Net Operating Losses. Net operating losses (NOL) and carryovers may not be deducted in the 2008 and 2009 tax years. An equivalent number of years is added to the carryover period. For losses incurred beginning January 1, 2008, the carryover period is extended to twenty years, although losses incurred in 2008 and 2009 cannot be deducted until 2010. Losses incurred in years beginning on or after January 1, 2011, may be carried back two taxable years. However, the amount of the NOL carryback will be limited to 50% of the NOL for losses incurred in 2011 and 75% of the NOL for losses incurred in 2012. Beginning in 2013, the entire loss may be carried back.

Limited Liability Company Fee is Accelerated. Limited liability companies will no longer be able to pay the fees they owe by April 15 of the following year. From now on, the amount of the fee for the year must be estimated and paid by the 15th day of the sixth month of the tax year and underpayment penalties will be imposed. However, no penalty will be imposed if the estimated fee equals or exceeds the amount of the fee paid by the company in the preceding taxable year.

Automobiles, Boats and Aircraft Must Be Kept Outside of California for Twelve Months to Avoid Payment of Use Tax. If you purchase an automobile, boat or aircraft out of state, the period for which you must use it outside of California to avoid California use tax has been increased from 90 days to one year, although the interstate commerce exception, discussed in a prior article, continues to apply.

Individuals with Income over $1,000,000 Can No Longer Use 110% of Prior Year Tax Exception to Underpayment of Estimated Tax Penalties. To accelerate collection of tax revenue, beginning in 2009, if your adjusted gross income is $1,000,000 or more, you can no longer avoid California underpayment penalties by paying in quarterly installment equal to 110% of your previous year tax liability. This will force taxpayers to do their tax accounting more in real time. The quarterly payments have also been front-loaded in that instead of paying in 25% of the estimated tax amount each quarter, the first two quarterly payments must be 30% and the last two payments will be 20%.

Expanded Withholding on Sales of Real Property. California law currently requires the withholding of 3 1/3% of the gross sales price on the sale of California real property by individuals (whether resident or nonresident) and corporations without a permanent place of business in California. Sales of principal residences are exempted from the withholding requirements. Since 3 1/3% of the gross sales price will result in over-withholding in many cases, a seller may elect to instead have an amount equal to 9.3% of the taxable gain on the sale withheld.

Beginning in 2009, withholding will also be required on sales by non-California partnerships. In the case of non-California S corporations, withholding is currently required but only at the rate of 1.5% of the gain incurred by the S corporation on the sale. Beginning in 2009, the rate will be 10.8% which is the sum of the corporate rate of 1.5% and the individual shareholder rate of 9.3%.

Changes are also made to the way withholding is done in connection with installment sales where the seller is not a California resident. Through 2008, the buyer was required to withhold the entire tax out of the payment made at the time of the sale unless the buyer consented to withholding out of each subsequent installment payment. Beginning in 2009, the withholding out of each installment payment will be mandatory. It is expected that the Franchise Tax

Board will provide additional information prior to the end of the year.

General California Caution. As our next president and the Congress look for ways to stimulate the economy, a variety of tax subsidies designed to increase consumer spending, business capital investment, and jobs growth may be enacted. While the Federal government has a virtually unlimited ability to borrow money, the states do not. California is facing especially troublesome budget problems and has a real need for increased revenue. It is entirely likely that California, and probably many other states as well, will not conform to many of the coming Federal subsidies for purposes of their tax law. This is something of which you must be mindful. We will also try to keep your apprised of these developments.

Certain Real Estate Assets Qualify for Deferral of Estate Tax Under IRC Section 6166

If the interest of a decedent in a closely held business exceeds 35% of his adjusted gross estate, his estate may defer the payment of a portion of the federal estate at low rates of interest. The deferred tax is payable in the number of equal annual installments (up to 10) elected by the estate. To the extent the value of the business is comprised of passive assets, i.e., assets not used in carrying on a trade or business, the deferral is not available.

In *PLR 200845023*, the IRS once again addressed the application of these deferral rules to real estate assets. The decedent owned all of the interest in a limited liability company ("LLC") that owned interests as a tenant-in-common in three parcels of real estate. Even though the LLC did not own the entire parcel, the decedent nevertheless worked full time for the LLC in connection with the management of two (Properties "A" and "B") of the three properties. There was no written agreement with the other co-tenant, but it was understood between them that the decedent would manage the properties. The decedent had no involvement in the management of the third property (Property "C").

The IRS ruled that to the extent the value of the company was attributable to its interests in Properties A and B, those interests constituted a trade or business and qualified for deferral of estate tax under Section 6166. The value of the interest in Property C did not qualify.

IRS Clarifies Uncertain Tax Consequences Resulting from Failed Auctions of Auction Rate Securities

Auction rate securities have been popular finance vehicles, especially among municipalities and other governmental agencies, although they were issued by commercial firms as well. These securities allow a borrower to tap capital markets for the equivalent of a variable rate loan it might have otherwise obtained from a bank.

With a regular bond, if market interest rates change after the bond is issued, or the issuer's credit rating gets better or worse, the price at which the bond trades in the market will increase or decrease. Auction rate securities always trade at par. Typically, every 28 days (sometimes even weekly) auctions are held where the interest rate is re-set to the lowest rate at which all sellers can be matched with buyers. Before this year, these securities were popular with investors because the rates tended to be higher than many alternative short term investments and the securities could always be sold at par every 28 days.

All of this changed in February of this year when, during a single week, nearly 1,000 auctions failed. That means that given the number of sellers, there were not sufficient buyers to purchase the securities, even at the maximum interest rate provided for in the terms of the security. When an auction fails, the investor begins to collect interest at the highest rate provided, but is not able to sell his position. Before February, auctions rarely failed because investment banks and other broker-dealers would step up and buy enough securities to clear the auction. The sudden loss of liquidity in this market caused major consternation and turmoil along with threats of litigation.

Many issuers began to issue settlement offers to forestall litigation. Settlement offers typically give the investor the right to "put" the security to the issuer at par for a period of time. The investor will continue to receive the periodic interest payments until it exercises its put option, either at the maximum rate or, if the auctions begin to succeed, at the periodic rates set by the auctions. Some settlement offers also give the issuer the equivalent of a "call" option to purchase the security at par. This affords the issuer the opportunity to limit its losses where it can re-sell the security to another investor at a small discount to par. Certain settlement offers also permit the holder of these securities to borrow funds from the issuer, secured by the auction rate security.

The various features of these settlement offers raise interesting and uncertain tax issues including whether the holder is still considered the tax owner of the security or whether he has constructively sold it. The IRS has issued *Rev. Proc. 2008-58* to provide some clarity in this area and hopefully further stabilize this market. In the revenue procedure, the IRS said: i) a holder will not be deemed to have sold the security merely because it receives a settlement offer; ii) a holder will not be treated as realizing any taxable income because it receives a settlement offer or receives a loan against the security pursuant to the settlement offer; and iii) if the holder sells the security to the issuer pursuant to a settlement offer, its full amount realized for purposes of its tax gain or loss is the amount of cash paid by the issuer in the transaction. This last point apparently negates any concern that the options themselves contained in the settlement offer are some additional form of valuable consideration.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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