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High Net Worth Family
# TAX REPORT
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CONTENTS

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## California Enacts Legislation Requiring Out-of-State Retailers to Collect Use Tax

On June 28, 2011, Governor Brown signed ABx1 28, which will require certain out-of-state retailers to collect and remit California's use tax. California imposes a use tax on purchases made outside of California for the purpose of using the item in California. The use tax is intended to back up the sales tax and stop people from purchasing items outside of California in order to avoid California's high sales tax. The tax is imposed on the purchaser but the state has a lot of trouble collecting it because many people do not properly report their out-of-state purchases and pay the use tax that they owe on those purchases. The revenue loss for states has become very significant with the explosion of massive internet retailers such as Amazon. A lot of goods that consumers used to purchase in California subject to sales tax are now being ordered from companies like Amazon with no sales or use tax being paid.

States know that the most effective way to collect their use tax is to require the out-of-state retailer to collect it for them. The problem for the states is that in order to pass muster under the commerce clause of the United States Constitution, an out-of-state retailer must have certain minimum contacts with California before California can impose a requirement to collect its sales or use tax. Lawyers refer to this as "nexus." States have been stretching to enact laws requiring sales or use tax collection by companies having only very minimal tangible or physical connections to the state. New York took the lead on this issue and some other states have followed suit. California has now joined the fray.

Out-of-state retailers who have offices or stores in California were previously required to collect use tax on their sales made outside of California where the goods were delivered within California. Revenue and Taxation Code Section 6203 now also requires an out-of-retailer to collect the California use tax if a related company or affiliate performs any services within California in connection with the retailer's sales made outside of California and delivered to California purchasers. In addition, a retailer will now be required to collect the use tax if it has an agreement to pay a fee to someone in California for the referral of sales to it, whether by an internet based link, website, or otherwise. This requirement only applies if the retailer had cumulative sales resulting from these agreements in the prior twelve months in excess of Ten Thousand Dollars ($10,000) and had total sales to California purchasers in excess of Five Hundred Thousand Dollars ($500,000) during the prior twelve months. It is this provision that was designed to require Amazon and other large internet retailers to collect California use tax.

There have been a number of articles and news reports about Amazon terminating its California based commission agents because of this new law. The law took effect upon the governor's signature, but will be challenged in court. Amazon is also working on a ballot referendum to put the measure before the voters, and so far has refused to collect the California use tax from its customers. We will keep you apprised. In the interim, if you have any questions about the California legislation, please contact Chris Campbell in our tax group.

## SEC Finalizes Rules Exempting Family Offices from Requirement to Register as Investment Adviser

Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), family offices typically avoided registering under the Investment Advisers Act of 1940 ("Advisers Act") by relying on the exemption provided for private advisers. This exemption was available to advisers who during the preceding 12 months had less than 15 clients and did not hold themselves out to the public as an investment adviser. Dodd-Frank repealed this exemption but in doing so, added a new exclusion for family offices to be defined by the Securities and Exchange Commission ("SEC"). On June 22, 2011, the SEC issued its final rules defining a family office that is excluded from registration under the Advisers Act.[1]

To qualify for exclusion from registration as a family office, the office must satisfy three requirements: i) it must only advise "family clients;" ii) it must be wholly owned by family clients and controlled by family members and family entities; and iii) it must not hold itself out to the public as an investment adviser. The final requirement is not an issue for most true family offices. The critical parts of the rules are determining who is a family client and the ownership/management requirement.

### Family Client

An excluded family office can provide investment advice only to "family clients." Under the new rules family clients include: i) family members; ii) former family members; iii) key employees; iv) former key employees; iv) non-profit organizations solely funded by family clients; v) estates of family members, former family members, key employees and former key employees; vi) certain trusts; and, vii) companies wholly owned by family clients and operated for the sole benefit of family clients. These categories will be examined in more detail below.

#### *Family members and former family members*

Family members include all lineal descendants of a designated common ancestor who is no more than 10 generations removed from the youngest generation being advised by the family office. Descendants include adopted children, stepchildren, foster children and individuals that were a minor when another family member became their legal guardian. Also included are spouses and spousal equivalents, which are defined by the rule as a "cohabitant occupying a relationship generally equivalent to that of a spouse." The definition of "spousal equivalents" seems broad enough to include same-sex Registered Domestic Partners under California law and other states having similar provisions. In the preamble to rules, the SEC states that the Defense of Marriage Act does not prohibit it from according family member status to spousal equivalents. Its reasoning is that the rule does not define "spouse" and "spousal equivalent" is a separate category of family member under the rules. Under the definition provided by the SEC, the couple must cohabit the same dwelling. If the SEC issues any further clarification on this point, we will keep you apprised. Former family members are treated as family members and include ex-spouses or equivalents and their children. Under the final rule,

[1] *17 CFR § 275.202(a)(11)(G)-1 (2011).*

former family members may continue to invest new funds through the family office after they become a former family member.

The common ancestor may be a deceased person. As the family expands and younger generations come under the management of the family office, the office is permitted to designate a younger generation member as the new common ancestor. Note, however, that such a re-designation of the common ancestor to a younger generation family member may require the office to drop certain branches of the family as clients. Normally, a family office should choose as the common ancestor, the youngest ancestor whose lineage will permit servicing all of the family members for which office wishes to provide service. Picking the youngest such ancestor will maximize the time before a new ancestor has to be chosen.

There is also a useful inadvertent transfer rule. Suppose a family member dies and leaves assets that are under management of the family office to a non-family member? The rule permits those assets to continue to be managed for the non-family member for up to one year after the transfer of legal title to the assets to the non-family member. This grace period will permit the non-family member time to make his own arrangement for the management of those assets and the family office time to assist the orderly transition of that non-family member's assets.

### *Key employees and former key employees*

The family office may permit key employees to invest through it. A key employee is an executive officer, director, trustee, general partner or person serving in an equivalent capacity of the family office or affiliated family office. Affiliated family offices are multiple family offices controlled by one family. The SEC was made aware that some families have more than one family office operation. It also includes any non-clerical employee who as part of his regular duties participates in investment activities for the family office or affiliated family office and has done so for at least 12 months. An investment by a key employee includes one in which his spouse or spouse equivalent holds a joint, community property or other shared ownership interest. A former key employee may keep his investment with family office but may not make any new investment through the family office unless such investment was contractually committed at the time his employment terminated.

### *Non-profit organizations*

This is an important and somewhat complex category of family clients. It includes charitable foundations, trusts and other organizations for which all of the funding currently held by such entity comes from family clients. This category includes charitable lead and remainder trusts whose only current beneficiaries are family clients and charitable or non-profit organizations funded exclusively by family clients. The non-profit organization does not have to have been formed by a family member if all currently held funding came from family clients.

A non-profit organization that has received funding from non-family clients may continue to be advised by the family office until December 31, 2013, provided the office does not accept further non-family contributions after August 31, 2011 unless made in fulfillment of a pledge made prior to August 31, 2011. The preamble to the rules sets forth a means by which such an organization can purge itself of non-family client contributions. If a non-profit organization has accepted non-family contributions, any spending by the organization in the year of such contribution or subsequent years may first be allocated to the non-family contributions. Only the non-family contributions need be purged through spending; earnings on the non-family contributions can be ignored. If the organization can purge itself of any non-family contributions by December 31, 2013, it may continue to be advised by the family office.[2]

### *Estates of family members, former family members, key employees and former key employees*

The family office may continue to represent the estate of a deceased family member or former family member, even if the estate will ultimately be distributed to non-family members. The office may also represent the estate of a key employee, or former key employee, provided that in the case of the estate of a former key employee, no new investment can be made through the family office.

[2] *See Footnote 66 to SEC Release No. IA-3220; File No. S7-25-10.*

### *Trusts*

The rule regarding trusts distinguishes between irrevocable trusts and revocable trusts. In the case of irrevocable trusts, the office may manage investments for the trust if the only current beneficiaries are other family clients. Contingent beneficiaries do not have to be family clients. If a non-family contingent beneficiary becomes a current beneficiary, the involuntary transfer rule would apply and the office could manage the investments for the trust for one year thereafter. The office can also manage investments for an irrevocable trust that is funded solely by family clients and all current beneficiaries are other family clients and charities or non-profit organizations.

A revocable trust's investments can be managed by the family office if family clients are the sole grantors. Finally, a trust may have its investments managed by the family office where each trustee or person authorized to make decisions is a key employee and each settlor or other person who has contributed assets to the trust is a key employee or spouse or former spouse who at the time of contribution holds a joint, community property or other shared ownership interest with the key employee.

### *Family companies*

The family office may manage investments for any company wholly (directly or indirectly) owned by and operated for the sole benefit of, one or more family clients. The company does not have to be managed or controlled by family clients; however, no degree of non-family client ownership is permitted.

### Ownership and control of the family office

The other important requirement is the ownership requirement. The office must be wholly owned by family clients and must be exclusively controlled (directly or indirectly) by one or more family members and/or family entities. This rule permits key employees (which are included in the definition of family client) to hold an ownership interest in the family office entity, however it does not permit key employees to have management control of the family office. The definition of family entity, for purposes of this provision excludes key employees. Control means the power to exercise a controlling influence over the management or policies of the company, unless such power is solely the result of being an officer of the family office.

### Grandfathering provisions

In certain limited situations, some family office operations in existence on January 1, 2010 may be grandfathered from the registration provisions of Dodd-Frank even if they do not meet the new family office requirements. A family office will continue to be exempt from registration if on January 1, 2010, in addition to family clients, it provided investment advice to natural persons who at the time of their investment were officers, directors or employees of the family office who invested before January 1, 2010 and are accredited investors under Regulation D. It also includes management of investments for any company owned exclusively and controlled by one or more family members. Please note that to the extent a family office is exempt from the definition of "investment adviser" by virtue of the grandfathering provision, the family office will nevertheless be deemed an investment adviser for purposes of certain antifraud provisions of the Advisers Act, namely Sections 206(1)(2) and (4) thereunder.

There is another grandfather provision that will be beneficial to some family offices. If the office has previously received an exemptive order from the SEC, determining it to not be subject to the registration requirements of the Advisers Act (pre-Dodd-Frank), it may continue to operate under that exemptive order.

### Window for Compliance

The SEC recognized that family offices would need some time to determine if they will continue to be excluded from registration and possibly to re-configure their operations to make them excluded or to register under the Advisers Act if they do not. Therefore, the rules also provide that any company existing on July 21, 2011 that provides investment advice to members of a single family is exempt from registration until March 30, 2012 as long as during the preceding twelve months it had fewer than 15 clients and did not hold itself out to the public as an investment adviser.

What you need to do

You should immediately review the operations of your family office to determine whether it will qualify or can be re-configured to qualify, for exclusion from registration under the SEC rules or whether it will need to register or seek an exemptive order from the SEC. We are happy to assist you in the process. Please contact your usual attorney in our group and he or she will put you in touch with our experts in this area.

## Court Finds Defined Value Formula Clause Effective to Limit Gift Tax

In a recent case, the Tax Court has approved the use of a defined value formula clause to limit the amount of any gift for which the taxpayer could be subject to the payment of a gift tax. In *Hendrix v. Commissioner (June 15, 2011)*, the taxpayers wanted to transfer stock of an S corporation to trusts for their daughters. Transfers of interests in closely held businesses are inherently difficult to value, and there is always a risk that the IRS will argue for a higher value than assumed by the taxpayer, yielding an unwelcome gift tax liability. In an attempt to remedy this problem, taxpayers have attempted to make gifts of a specific dollar amount of shares, rather than a specific number of shares. The number of shares given is adjusted based upon the value for the shares that is ultimately determined following any IRS review of the transaction.

Mr. and Mrs. Hendrix transferred a fixed number of shares in a family owned corporation to trusts for their daughters and to a charity, as tenants-in-common. Under the transfer agreement, the trusts for the daughters were to receive a fixed dollar amount of the stock, and the charity was to receive the balance. The trustees of the trusts and the charity were to agree on the value of the shares in order to determine how many shares each received. An arbitration procedure was set out in case they could not agree. Mr. and Mrs. Hendrix, took no part in the determination of the value of the stock. Their expectation was that if the IRS determined a higher value for the shares, the charity would get more shares and the trusts for the daughters would get less shares. The taxpayers would not have made a taxable gift because the only value kept by the trusts was the value of shares that the taxpayers intended to give.

The IRS asserted that the stock was worth more than the amount agreed to by the trusts and the charity. The IRS also asserted that the formula gift provision was not effective to control the amount transferred to the trusts, and accordingly assessed a significant gift tax against Mr. and Mrs. Hendrix. The IRS argued that the formula clause was not valid because it was not reached at arms' length and also was void as being contrary to public policy.

The court found the agreement was reached at arms' length, and also found that the formula clause did not violate any public policy. In fact, the court noted that a clause such as this had the effect of encouraging gifts to charity because a charity would receive any excess value of the stock above the amount that the donors intended to transfer to the trusts for their daughters. The court found that this case was similar to the prior *McCord* case, in which the United States Court of Appeals for the Fifth Circuit had upheld a similar formula clause.

The IRS relied on two prior cases, *Commissioner v. Procter* and *Commissioner v. Ward*, but in those cases any value ultimately determined to be above the stated amount that was to be transferred to the donee was to be returned to the taxpayer. The courts in those cases determined that the formula clauses did violate public policy because they removed any incentive for the IRS to challenge the donors' valuation, because any increase in valuation would simply be returned to the donor and no taxable gift ever would result. The *McCord* and *Hendrix* cases differ in that any excess value goes to a charity rather than reverting to the donor. This is a fine distinction because any effort by the IRS to increase the value of the transferred asset still will not result in any gift tax being collected; only a transfer to a charity. One could still argue that where such a clause is used, the IRS has no incentive to audit the transaction and challenge the valuation used by the donor. A similar case, *Petter v. Commissioner*, was also decided in December, 2009 in favor of the donor taxpayer. The case was heard by the Court of Appeals for the Ninth Circuit in June, 2011 and a decision is pending.

## The Six-Year Statute of Limitations: The Issue That Will Not Go Away

It has become obvious that an enormous amount of potential tax collections must be at stake in connection with audits when the IRS has proposed to assess the taxpayer after the normal three-year statute of limitations has expired, but prior to the expiration of the extended six-year statute of limitations. Normally, the IRS must assess any additional tax it believes is owed within three years after a taxpayer files his return. However, if the taxpayer omits from the return an amount of gross income that exceeds 25% of the gross income reported on the return, the IRS has six years within which to assess additional tax. The question that refuses to go away is how long the IRS has to assess a tax when a taxpayer sells an asset and reports the correct amount of sales price but overstates his tax basis in the asset; does such overstatement of basis amount to an "omission" of gross income? We have reported on cases addressing this issue in virtually every of edition of this newsletter for the last several years. The issue became important because a number of the tax shelter transactions that were broadly marketed purported to increase the tax basis of an appreciated asset prior to the sale of that asset.

After early taxpayer litigation successes, in 2009 the IRS issued "self-help" regulations which say that an overstatement of tax basis does constitute an omission from gross income. The Tax Court immediately rejected this IRS attempt at self-help in the middle of ongoing litigation. However, a case decided by the Supreme Court earlier this year now appears to be shifting the tide in favor of the IRS. In our last edition, (Vol. 6., No. 1, April, 2011), we reported on the *Grapevine Imports* case and how the court changed its view on that case based upon the Supreme Court's decision in *Mayo Foundation v. United States, (January, 2011)*. There, the Supreme Court said a tax regulation is valid and must be upheld if: i) the statute it purports to interpret is ambiguous; and ii) the regulation is a reasonable interpretation of the statute. The fact that the regulation was issued by the IRS during the course of a litigation to help its own position is not relevant in connection with the determination of its validity.

Now, two more courts have upheld the applicability of the six-year statute of limitations to overstated basis cases based on the regulation and the *Mayo* case. In Intermountain Insurance Services of *Vail v. Commissioner*, the Court of Appeals for the District of Columbia has reversed a prior Tax Court decision in the taxpayer's favor and upheld the regulation. In *Salman Ranch v. Commissioner*, the Court of Appeals for the Tenth Circuit has reversed the Tax Court and also upheld the validity of the IRS' regulation.

At this point there is a significant split among the various circuits of the Court of Appeals. The District of Columbia Circuit, Federal Circuit, Seventh Circuit and Tenth Circuit have upheld the regulation, while the Fourth Circuit and Fifth Circuit have held the regulation to be invalid. One taxpayer has filed a petition to bring this issue before the Supreme Court and there is a good chance that this issue ultimately will be resolved there.

## Phase in of Foreign Account Tax Compliance Act (FATCA) Requirements

The Treasury Department and the IRS issued a notice announcing plans to "phase in" the requirements of FATCA in response to numerous comments regarding the practical difficulties of implementing FATCA, including the time required to develop the necessary compliance, reporting and withholding systems and possible coordination with various foreign governments.

FATCA was enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, and requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. To avoid FATCA withholding, a participating FFI must enter into an agreement with the IRS to identify U.S. accounts, report certain information to the IRS regarding U.S. accounts, and withhold a 30% tax on certain payments to non-participating FFIs and account holders who are unwilling to provide the required information. FFIs that do not enter into an agreement with the IRS will be subject to withholding on certain types of payments, including U.S. source fixed or determinable, annual, or periodical (FDAP) payments, including interest and dividends, gross proceeds from the disposition of U.S. securities and passthru payments.

Notice 2011-53, summarized below, describes the timeline for the phase in of the FATCA requirements.

- Registration of FFIs Beginning in 2013: An FFI must enter into an agreement with the IRS by June 30, 2013 to ensure that it will be identified as a participating FFI in sufficient time to allow U.S. withholding agents to refrain from withholding beginning on January 1, 2014. The effective date of an FFI Agreement will be July 1, 2013 for agreements entered into before such date. The effective date of an FFI Agreement entered into after June 30, 2013 will be the date the FFI enters into the FFI Agreement.

- Participating FFI Due Diligence: A participating FFI will be required to put in place account opening procedures to identify U.S. accounts among accounts opened on or after the effective date of its FFI Agreement. A participating FFI will be required to have completed the private banking procedures (as described in Step 3 of Section 1.A.2 of Notice 2011-34) for all pre-existing private banking accounts that have a balance or value of at least $500,000 within one year of the effective date of its FFI Agreement. A participating FFI will be required to complete the private banking procedures for pre-existing private banking accounts with a balance or value of less than $500,000 by the later of December 31, 2014 or one year after the effective date of its FFI Agreement. For all other pre-existing accounts, a participating FFI must complete the required due diligence procedures within 2 years of the effective date of its FFI Agreement.

- Reporting: An account for which a participating FFI has received a Form W-9 from the account holder (or, with respect to an account held by a U.S. owned foreign entity, from a substantial U.S. owner of such entity) by June 30, 2014, must be reported to the IRS as a U.S. account by September 30, 2014. A participating FFI that does not elect to be subject to the same reporting standards as a U.S. financial institution with respect to such accounts will not be required to report the gross receipts and gross withdrawals or payments from the account for the first year of reporting. A participating FFI that elects to be subject to the same reporting standards as a U.S. financial institution for such accounts does not have to report the gross receipts and gross withdrawals or payments from the account or the account balance as of December 31, 2013 (or the account balance immediately before closure if the account was closed after the effective date of the FFI Agreement). For each account for which the participating FFI is not able to report the required information (e.g., because the account holder has not waived any applicable reporting restrictions), the FFI will report the account among its recalcitrant account holders. The reporting with respect to recalcitrant account holders identified by June 30, 2014, will be required to be filed with the IRS by September 30, 2014.

- Withholding: For payments made on or after January 1, 2014, withholding agents will be obligated to withhold only on U.S. source FDAP payments. For payments made on or after January 1, 2015, withholding agents will be obligated to withhold on all withholdable payments (including both U.S. source FDAP payments and gross proceeds from the disposition of U.S. securities). Participating FFIs will not be required to withhold with respect to passthru payments made before January 1, 2015 and the obligations to compute and publish such participating FFI's passthru payment percentage will not begin before the first calendar quarter of 2014.

- Published Guidance: Treasury and the IRS anticipate issuing proposed Treasury regulations implementing FATCA by December 31, 2011 and publishing final Treasury regulations implementing FATCA and final versions of the associated FFI Agreement and reporting forms for use by withholding agents in the summer of 2012.

## Estate Prevails in Dispute Over Valuation of Interest in a Closely Held Business

The taxpayer prevailed in a significant estate tax valuation case in *Estate of Louise Paxton Gallagher (June 28, 2011)*. Mrs. Gallagher died owning 3,970 units of Paxton Media Group, which her estate valued at $34,936,000 on her estate tax return. Upon audit, the IRS determined a value of $49,500,000. Paxton Media Group was a limited liability company under state law but it had elected to be treated as an S corporation for income tax purposes.

After the audit was commenced but before the trial in the Tax Court started, the estate obtained two more appraisals which valued the units at $26,606,940 and $28,200,000, respectively. A pre-trial appraisal done by the IRS derived a value of $40,863,000, so there were a number of values in play when the case came before the Tax Court.

The IRS valuation expert used two methods to value the company: i) a market approach; and ii) an income approach (more technically referred to as the "discounted cash flow" method). The market approach derives the value of a closely held company by comparing its earnings to the earnings of similar public companies, adjusted for differences in size, marketability and other factors. The discounted cash flow approach discounts to present value future cash flows that the business is expected to produce for the owners. The IRS expert accorded each approach equal weight and averaged the results obtained by these two methods in determining a value of $40,863,000.

The taxpayer's expert used the discounted cash flow approach and relied on the market approach only to verify the reasonableness of the value he derived. The court first determined that it would not rely on the IRS' expert use of the market approach because it did not believe that the public companies used to establish value were sufficiently similar to the closely held business being valued. The court determined that only the discounted cash flow approach should be used to value this business.

In applying the discounted cash flow approach, the court analyzed the application of that approach by both of the appraisers and used certain assumptions and methodologies from each, and on some factors picked its own assumptions. The court in effect took information from the valuations and computed its own number. Some of the factors that had to be evaluated included: i) adjusting the income statement information for non-recurring items; ii) the rate at which revenue was expected to grow; iii) the company's future operating margin; iv) the income and expenses that would be generated outside of the core business; v) the need for capital expenditures; vi) working capital levels that will be required; and vii) the appropriate discount rate to use to determine the present value of future cash flows.

The court's treatment of the appropriate discount rate was interesting in that both parties' experts used the "weighted average cost of capital," which employs a weighted average of the companies' borrowing cost and the return that would be expected by an equity investor. The court noted that it had previously expressly disapproved of this method for valuing small companies that had little possibility of going public. Nonetheless, because both of the experts had used this method, the court applied it as well. Ultimately, the court determined a discount rate of 10%, which is the same number derived by the IRS' expert witness.

The court also addressed the experts' differing opinions on whether the earnings produced by the business should be reduced by a hypothetical corporate tax rate, because the S corporation itself did not pay any corporate income taxes. The reason to make such an adjustment is based on the assumption that a future buyer would likely operate the company as a C corporation, so its earnings would be subject to corporate income tax following such a sale. The taxpayer's expert witness believed such a theoretical tax burden should be applied to reduce future projected earnings. Naturally, this would result in a lower valuation for the company, which is what the taxpayer sought. The court rejected this argument and determined that the corporation should be valued in its status at the time of the decedent's death. S corporation shareholders enjoy a lower total tax burden compared to shareholders of C corporations, and that benefit should enhance the value of the S corporation.

After a tentative value had been determined by discounting the future expected cash flows, the taxpayer's expert then added a premium to account for the value of being an S corporation. He likely did this only because he had previously attempted to reduce the value of the corporate earnings by a theoretical corporate income tax. That adjustment presumably lowered the value of the company more than the premium he proposed to add increased it. The court determined that the value of being an S corporation was fairly taken into account simply by not imposing a theoretical corporate tax on the projected future earnings so no premium needed to be added.

Finally, the court addressed the appropriate discounts to reflect the fact that block being valued represented a minority interest in the company and the fact that the block was not readily marketable. The court determined that a 23% discount should be applied to the minority interest and a 31% discount for lack of marketability. The final value determined by the court for the block being valued was $32,601,640.

An interesting aspect of this case is that in applying the discounted cash flow method of valuation, in most instances the court followed the assumptions used by the IRS' expert rather than those used by the taxpayer's expert. Yet, the value determined was significantly lower than that claimed by the IRS expert, and even lower than what the taxpayer had claimed on the estate tax return that was filed. The reason is that the court completely disregarded the value determined by the IRS expert using the market approach, where the company is compared to public companies in similar businesses. The value the IRS had determined under the market approach was considerably higher than the value that resulted from the discounted cash flow method.

If you have a matter where a business interest needs to be valued by a valuation expert, it would be a good idea to have your expert study this opinion carefully. It contains a lot of useful information about how the Tax Court approaches valuation issues.

## Individual Achieves Business Bad Debt Deduction

In the recent case of *Dagres v. Commissioner, (March 28, 2011)*, the taxpayer accomplished something that is relatively hard to do. Todd Dagres convinced the Tax Court that a loan he had made that went bad should give rise to a business bad debt deduction. Normally, when an individual loans money to someone and does not get paid back, he is entitled to a deduction for a "non-business bad debt," which is treated as a short term capital loss. Capital losses can only be deducted against capital gains, except for $3,000 per year which can be deducted against ordinary income. Taxpayers who do not have capital gain income receive virtually no benefit from a non-business bad debt deduction.

A business bad debt deduction is taken against ordinary income and therefore has greater value to an individual taxpayer. In order for an individual taxpayer to receive a business bad debt deduction, he must establish that the loan was made in or acquired in connection with his trade or business. If you run a grocery store as an individual proprietor and extend credit to your customers, any credit losses would be business bad debts. If you loan money to your cousin and he does not pay you back, your loss would be a non-business bad debt.

Todd Dagres was a venture capitalist who completed transactions through various entities. He loaned $5,000,000 to a business associate who had fallen on hard times. He believed the associate would continue to be a valuable source of leads for possible deals. Upon making the loan, Mr. Dagres had an understanding with the borrower that the borrower would tell Mr. Dagres about any investment opportunities of which he became aware. The hard times continued for the borrower, and Mr. Dagres eventually wrote-off most of the loan. He claimed a business bad debt deduction and the IRS challenged that characterization.

The Tax Court had to determine in what capacity Mr. Dagres made the loan. He worked as an employee of the management company that managed the venture capital funds on behalf of their general partners. If the loan was made in his capacity as an employee, then the deduction, even if related to his business of being an employee, would be a miscellaneous itemized deduction, the utility of which is severely limited. He also was an investor in the funds. If the loan was made in his capacity as an investor, it would be a non-business bad debt. Finally, Mr. Dagres was a member of the LLC's that were the general partners of the venture capital funds. The court found that the loan was made related to his activities as a member of the general partner LLC, which was responsible for finding deals and raising capital for the funds. The court found that this activity was a trade or business of the LLC's and therefore a trade or business of Mr. Dagres as a member.

While the success of Mr. Dagres in the Tax Court is very unusual, if you have made a loan that has gone bad, it is worth taking a few moments to think through whether the loan had a connection to some business activity in which you are engaged. This case shows that an individual can have a trade or business that is less obvious than running a grocery store.

## Co-op Shareholder Cannot Deduct Amount of Assessment to Repair Damage

A recent Tax Court case serves to point up one of the distinctions between owning your home outright and owning your home through the ownership of shares in a residential cooperative corporation ("co-op"). If you own your home outright, and it sustains sudden damage, the cost of repairs usually gives rise to a casualty loss deduction, subject to certain limitations. In *Alphonso v. Commissioner, (March 16, 2011)*, the taxpayer was a shareholder in a residiential co-op. A retaining wall collapsed and the shareholders were assessed the cost of repairs. The taxpayer claimed a casualty loss for the amount of her assessment. The IRS disallowed the deduction on the basis that the loss was suffered by the co-op and the co-op, rather than the shareholders, was the proper party to take any deduction for the loss.

The Tax Court agreed with the IRS. The court pointed out that IRC Section 216 specifically passes through to the shareholders the deduction for real property taxes and interest expense incurred by a co-op. All other expenses incurred by a co-op are deductible only by the co-op and not by the shareholders. The deductions for interest expense and property taxes are the primary tax deductions associated with home ownership. For these deductions, the shareholder of a co-op is treated the same as an outright owner. It is only in the rarer case in which a casualty loss occurs on the property that the distinction becomes relevant.

## Loans from Corporations to Shareholders Must be Carefully Documented

Transactions between a closely held corporation and its shareholders are subject to scrutiny, and a recent case reminds us of the importance of proper documentation. In *Knutsen-Rowell, Inc. v. Commissioner (March 16, 2011)*, the husband and wife who were the sole shareholders of two corporations removed funds from the corporations' operating accounts to pay their personal expenses. These withdrawals were not reported as income on the taxpayers' income tax returns. The IRS treated the distributions as dividends from the corporation and proposed a tax deficiency.

In the Tax Court, the taxpayers argued that the distributions were loans to themselves from the corporations. The court rejected this assertion because nothing had been done to document the distributions as loans. The court reviewed the criteria used to determine if a distribution is a loan: i) is there a written promissory note?; ii) is interest charged?; iii) is there a fixed schedule for repayment?; iv) was collateral given to secure the loan?; v) were payments actually made on the loan?; vi) did the borrower have a reasonable prospect of repaying the loan, and did the lender have sufficient funds to make the loan?; and vii) did the parties conduct themselves as if the transaction was a loan? In this case, none of these criteria was satisfied. The court found the distributions to be constructive dividends that should have been included in the taxpayers income.

Taking loans from a controlled corporation is risky at best. If you do it, it is critical that the loan be carefully documented, and that the criteria listed above be followed. The IRS takes a dim view of taxpayers extracting money from closely held corporations without paying tax on the withdrawn funds. In this case, the IRS asserted the 75% civil fraud penalty against the taxpayers. The court did not impose the fraud penalty but did impose the 20% accuracy penalty. The IRS only asserts the civil fraud penalty in cases it considers to be egregious. This was apparently one of those cases.

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