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June 18, 2010

Subject: **General Estate and Gift Tax Developments: March 2010**

1. **Court Holds That LLC Interests Are Future Interests in Property That Are Not Eligible for Annual Exclusion From Gift Tax**

Major References: [*Fisher v. U.S., F. Supp. 2d \(Docket No. 1:08-cv-0908-LJM-TAB\) \(S.D Ind. 3/11/10\)*](#)

Prior AALU Washington Reports: 10-45; 03-69

2. **U.S.-U.K. Income Tax Treaty Does Not Entitle U.K. Private Foundation to Reduction of § 4948 Excise Tax on U.S.-Source Dividends**

Major References: [*CCA 201010027*](#)

MDRT Information Retrieval Index Nos.: 2500.00; 7400.021; 7400.022; 7400.024

**SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO
THE CONCLUSION OF THIS WASHINGTON REPORT.**

This Washington Report summarizes a few of the more important cases and rulings in the estate and gift tax areas which were decided or reported by the courts and the Internal Revenue Service in March of 2010, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

Cases

1. ***Fisher v. U.S.***, __ F. Supp. 2d __ (Docket No. 1:08-cv-0908-LJM-TAB) (S.D Ind. 3/11/10)

A Federal District Court in Indiana has ruled in a suit for a refund of federal gift taxes that certain LLC interests transferred by the taxpayers (husband and wife) to their children over a three-year period were not eligible for the annual exclusion from gift tax because the LLC operating agreement restricted their right to distributions of the LLC's capital proceeds and their ability to transfer their interests.

In 2000, 2001, and 2002, taxpayers John W. Fisher and Janice B. Fisher (“Taxpayers”) transferred 4.762% membership interests in Good Harbor Partners, LLC (“Good Harbor”), to each of their seven children (the “Fisher Children”). From the date of Good Harbor's formation through the 2002 transfer, Good Harbor's principal asset was a parcel of undeveloped land that borders Lake Michigan in Leelanau County, Michigan. When filing their gift tax returns, Taxpayers initially claimed the annual exclusion pertaining to each transfer. However, upon audit, the Government assessed a deficiency of \$625,986.00 in additional gift tax owed, asserting that the gifts of the LLC interests were not gifts of a “present interest” in property as required by Internal Revenue Code section 2503(b).

The operating agreement (the “Agreement”) of Good Harbor gave all power to run the company to a Management Committee, which was required to appoint a “General Manager” to supervise Good Harbor's day-to-day operations. The Agreement further provided that “[T]he timing and amount of all distributions shall be determined by the General Manager.”

The Agreement provided that Good Harbor’s “Capital Proceeds” are distributed as follows: first, to the payment of all expenses associated with a “Capital Transaction;” second, to the payment of Good Harbor's debts and liabilities; and third, to establish reserves which the General Manager deems necessary for future investments, capital improvements, debts, expenses, liabilities, or obligations. Any balance leftover “shall be distributed to the Interest Holders in proportion to their Percentages.”

The Agreement also provided that the Fisher Children can transfer their “Interest[s]” in Good Harbor if certain conditions of transfer are satisfied. The Agreement defines “Interest” as “a Person's share of the Profits and Losses of, and the right to receive distributions from, the Company.” Under the Operating Agreement, this was the only interest that the Fisher Children could unilaterally transfer.

Among the conditions of transfer is a provision granting Good Harbor a right of first refusal at a price equal to the amount of the prospective transferee's offer (“right of first refusal”), payable with notes amortizable over a 15-year period. The Fisher Children may disregard Good Harbor's right of first refusal only in the event of a transfer to Taxpayers or their descendants by birth or adoption.

Taxpayers made three arguments in support of their assertion that the transfers of interests in Good Harbor to the Fisher Children were gifts of “present interests in property,” as follows:

First, Taxpayers argued that, upon transfer, the Fisher Children possessed the unrestricted right to receive distributions of Good Harbor's Capital Proceeds. The Court, however, found that, under the Agreement, any potential distribution of Good Harbor's Capital Proceeds to the Fisher Children was subject to a number of contingencies, all within the exclusive discretion of the General Manager. “Accordingly, the right of the Fisher Children to receive distributions of Good Harbor's Capital Proceeds, when such distributions occur, is not a right to a “substantial present economic benefit.”

Second, Taxpayers argued that, upon transfer, the Fisher Children possessed the unrestricted right to possess, use, and enjoy Good Harbor's primary asset, the Lake Michigan beach front property. However, the Court noted there is no indication from Good Harbor's Operating Agreement that this right was transferred to the Fisher Children when they became "Member[s]" and "Interest Holder[s]." (There was some indication that Taxpayer's children exercised this "right" with respect to the property prior to the transfer.) "Regardless, [stated the Court], the right to possess, use, and enjoy property, without more, is not a right to a 'substantial present economic benefit.' . . . It is a right to a non-pecuniary benefit."

Third, Taxpayers asserted that, upon transfer, the Fisher Children possessed the unrestricted right to transfer unilaterally their interests in Good Harbor. The Court, however, noted that this right was subject to substantial restrictions, *i.e.*, the right of first refusal, which would result in receipt of consideration payable only over a 15-year period, thus negating the possibility of presently realizing a substantial economic benefit from the property.

Accordingly, the Court concluded that the transfers of interests in Good Harbor from Taxpayers to the Fisher Children were transfers of future interests in property and, therefore, not subject to the gift tax exclusion under section 2503(b)(1).

For other cases that disallowed the annual exclusion from taxable gifts on the grounds that the property transferred was not a "present interest" *see Price v. Commissioner, T.C. Memo.* 2010-2 (January 4, 2010), discussed in our Bulletin No. 10-45 and *Hackl v. Commissioner*, 118 T.C. 279, 294 (2002), *affd.* 335 F.3d 664 (7th Cir. 2003), discussed in our Bulletin No. 03-69.

In *Price*, the Tax Court ruled that gifts of limited partnership interests to the donors' children were not eligible for the gift tax annual exclusion in the years at issue because the partnership agreement restricted the donees' access to the income and capital of the partnership so severely that their interests could not be viewed as "present" interests in property.

In *Hackl*, the Tax Court held that gifts of units in a limited liability company (LLC) were gifts of a future interest that did not qualify for the annual exclusion. "The Court rejected the taxpayers' argument that a gift that takes the form of an outright transfer of an equity interest in a business or property is necessarily a gift of a present interest."

The *Hackl* Court held that to establish entitlement to an annual exclusion under section 2503(b), a taxpayer must --

establish that the transfer in dispute conferred on the donee an unrestricted and non-contingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom. * * *

This test was cited with approval in *Fisher*.

We have noted in the past that planners sometimes lose sight of the forest for the trees. The taxpayers in *Fisher* and *Price* probably entered into an extremely restrictive partnership/LLC agreement in order to obtain substantial discounts to the value of the transferred interests. They then attempt also to take advantage of the gift tax annual exclusions that, in some transactions, may be relatively small in relation to the overall valuation of the gifted property. Although there was no indication that this was the case in *Fisher*, it has, in the past, caused the IRS to raise an issue with the annual exclusion.

Chief Counsel Advice

2. CCA 201010027

In CCA 201010027, the Office of Chief Counsel advised that the U.S.-U.K. income tax treaty does not entitle a U.K. private foundation to a reduction of the private foundation excise tax on its U.S.-source dividends. Upon receipt of this “tentative” conclusion, the private foundation withdrew its request for a private letter ruling.

In CCA 201010027 the IRS Office of Chief Counsel considered whether a foreign private foundation, which was a resident of the United Kingdom and recognized as tax-exempt by the IRS, should benefit from the U.S.-U.K. Income Tax Treaty ("the Treaty") with respect to an excise tax on its U.S.-source dividends. The Treaty generally provides for a 50% reduction of the U.S. tax rate on U.S.-source dividends received by a U.K. resident, reducing the income tax rate from 30% to 15%.

In the CCA, a foreign organization was established as a charitable trust in the United Kingdom to foster and promote certain types of research. The organization was recognized as a charity for U.K. tax purposes by the U.K. tax authorities, and was also recognized by the IRS as an organization described in section 501(c)(3) of the Revenue Code (a "tax-exempt organization") and as a private foundation within the meaning of section 509(a).

As a foreign private foundation, the organization was subject, under section 4948, to a 4% "excise tax" on a foreign private foundation's gross investment income, including U.S.-source dividends, derived from sources within the United States. [Section 1443(b) also imposes a withholding tax on items of income paid to a foreign organization that are subject to the excise tax under section 4948(a). The withholding tax is equal to the four percent of the excise tax imposed.]

The IRS explained that the Treaty provides that U.S. excise taxes, including the 4% tax imposed under section 4948, are included as "covered taxes" to which the Treaty applies. The Treaty also provides, in relevant part, that dividends may be taxed in the "Contracting State" (in this case, the U.S.) of which the company paying the dividends is a resident, but, if the beneficial owner of the dividends is a resident of the other Contracting State (in this case the U.K.), the tax so charged may not exceed 15% of the gross amount of the dividends.

Thus, under the applicable part of the Treaty, the United States has retained the right to impose a 15% tax on the gross amount of U.S.-source dividends, and this provision applies for both income tax and excise tax purposes. However, under its internal law, the United States does not impose a tax greater than 4% on U.S.-source dividends received by a foreign private foundation. Thus, even though the excise tax under §4948(a) is a covered tax within the meaning of Article 2 of the Treaty, the United States has retained its right to impose the 4% tax (which is smaller than 15%) on U.S.-source dividends and the Treaty provides no benefit to a foreign private foundation with respect to such income. The IRS therefore concluded that the foreign private foundation remained subject to the 4% excise tax imposed under §4948(a) (and also to the 4% withholding tax under §1443(b)).

The CCA did not discuss the impact of Regs. § 53.4948-1(c)(3), which states:

(3) Whenever there exists a tax treaty between the United States and a foreign country, and a foreign private foundation subject to section 4948(a) is a resident of such country ..., if the treaty provides that any item ... of gross investment income (within the meaning of section 4940(c)(2)) shall be exempt from income tax, such item ... shall not be taken into account by such foundation in

computing the tax to be imposed under section 4948(a) for any taxable year for which the treaty is effective. [Emphasis supplied.]

However, this regulation merely provides that if income of a type that is gross investment income for private foundation purposes is *exempt* from income tax under a treaty, then such income will be considered exempt from the private foundation tax if derived by a private foundation that is a resident of the treaty country. In the case of U.S.-source dividends, such income is in fact not exempt from tax under the Treaty (except for substantial shareholders). The U.S. income tax is simply reduced from 30% to 15%, and not exempted. Thus, the regulation probably would not apply with respect to U.S.-source dividends derived by a foreign private foundation.

We note that, in general, if a taxpayer withdraws a letter ruling request (which may be done at any time before it is signed by the IRS) or if the IRS declines to issue a letter ruling, the Service generally will notify, by memorandum, the appropriate official in the operating division that has examination jurisdiction of the taxpayer's tax return. In doing so, the Service (in this case, the office of Chief Counsel) may give the its views on the issues in the request for consideration in any later examination of the return. In this case, the Senior Technical Reviewer of the Internal Branch of the Office of Chief Counsel was notifying the Director of the Exempt Organizations Division of its tentative adverse conclusion on the requested ruling.

Any AALU member who wishes to obtain a copy of any of the items discussed in this Washington Report may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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