ARNSTEIN & LEHR LLP
Attorneys at Law

Federal Tax Law Update

Final Regulations Issued Under Section 409A Nonqualified Deferred Compensation Plans

Section 409A was added to the Internal Revenue Code ("Code") through the American Jobs Creation Act of 2004. Section 409A generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

On December 20, 2004, the IRS issued Notice 2005-1 setting forth initial guidance with respect to the application of Section 409A, and supplying transition guidance. Proposed regulations under Section 409A were published on October 4, 2005. The IRS have also issued six additional notices providing transition guidance with respect to Section 409A: (1) Notice 2005-94 (transition guidance with respect to 2005 reporting and withholding obligations); (2) Notice 2006-4 (transition guidance with respect to certain outstanding stock rights); (3) Notice 2006-33 (transition guidance with respect to the application of Section 409A(b)); (4) Notice 2006-64 (interim guidance with respect to payments necessary to meet Federal conflict of interest requirements); (5) Notice 2006-79 (additional transition relief); and (6) Notice 2006-100 (transition guidance with respect to 2005 and 2006 reporting and withholding obligations).

On April 17, 2007, the IRS published the final Section 409A regulations, which generally adopted the structure and format of the proposed regulations. The final regulations exclude the types of plans described in Section 409A(d)(1) from the definition of a nonqualified deferred compensation plan, as well as certain other arrangements that were also set forth in the proposed regulations. The final regulations generally provide that a nonqualified deferred compensation plan, for purposes of Section 409A, does not include a qualified plan, a bona fide sick leave or a vacation plan, a disability plan, a death benefit plan, or certain medical expense reimbursement arrangements.

Definition of Nonqualified Deferred Compensation Plan. The final regulations provide that a nonqualified deferred compensation plan is a plan that provides for the deferral of compensation. The final regulations further provide that a plan generally provides for the deferral of compensation if, under its terms and the relevant facts and circumstances, a service provider has a legally binding right, during a taxable year, to compensation that is or may be payable to (or on behalf of) the service provider (e.g., employee or in some cases an independent contractor) in a later year. The regulations define deferral of compensation in the context of a legally binding right to a payment of compensation in a future taxable year.

About our Tax Practice Group

Our tax attorneys are proficient in helping businesses and individuals minimize their risk from a tax standpoint and maximize their business and financial goals. We have a broad depth of knowledge and expertise, allowing us to handle virtually all aspects of federal tax planning and even the most complex tax issues.

We are skillful in counseling clients as to the tax ramifications of all types of corporate transactions, including mergers and acquisitions, recapitalizations, spin-offs, reorganizations, equipment leasing, debt securitization and joint ventures. We are adept at identifying the tax issues, and assisting clients in identifying and formulating the tax strategies, necessary to further their business objectives. Our tax attorneys also counsel clients on the tax implications of real estate transactions. Working in conjunction with our attorneys in our Real Estate Practice Group, we advise clients as to the proper vehicle for owning property and how to structure the real estate transaction to best minimize the tax consequences, including utilizing limited liability companies and grantor trusts.

As a general rule, the final regulations provide that to satisfy the requirement that a plan be in writing, the document or documents constituting the plan must specify, at the time an amount is deferred, the amount to which the service provider has a right to be paid (or, in the case of an amount determinable under an objective, nondiscretionary formula, the terms of such formula), and the payment schedule or payment triggering events that will result in a payment of the amount. The final regulations adopt the provisions contained in the proposed regulations relating to initial deferral elections, subject to certain modifications.

The following are some of the notable changes included in the final Section 409A regulations:

Delay in Payment by the Service Recipient. If at the time of a specified payment date the making of the payment would jeopardize the ability of the service recipient (e.g., employer) to continue as a going concern, the payment will be treated as made upon the specified payment date if the payment is made during the first taxable year of the service provider in which the making of the payment would not have such effect.

State and Local Taxes, FICA, RRTA Tax and Foreign Taxes. The acceleration of payments is permitted under a deferred compensation plan to cover state and local taxes, FICA, RRTA taxes, and foreign taxes.

Settlements of Bona Fide Disputes Regarding the Right to a Payment. Payments may be accelerated, including acceleration of payment as a lump sum, where the right to such payments arises as part of a settlement between the service provider and the service recipient of a bona fide dispute as to the service provider's right to the deferred amount.

Cashout Rules. A service recipient may exercise discretion to cash out a service provider's entire amount deferred under a plan at any time so long as the amount deferred under the plan is less than the applicable dollar amount under Section 402(g)(1)(B) for that calendar year.

Effective Date. Section 409A is effective for amounts deferred after December 31, 2004. The final regulations are effective January 1, 2008. Taxpayers may rely on the provisions of the final regulations for taxable years beginning before January 1, 2008. For periods before January 1, 2008, the standards and transition rules set forth in Notice 2006-79 continue to apply.

Requirement to Amend Plans on or Before December 31, 2007. Where there have been deferrals of compensation under a deferred compensation plan as of January 1, 2008, but the deferred compensation has not been paid, the plan must be made compliant with Section 409A on or before December 31, 2007, with respect to such deferred compensation. These amendments are required only to bring the document into compliance effective January 1, 2008, and are not required to reflect any amendments made or actions taken under the transition rules to the extent such amendments or actions do not affect the plan's compliance with Section 409A and the final regulations for periods on or after January 1, 2008. In addition, a plan need not be amended to be made compliant with Section 409A with respect to amounts deferred under the plan that were paid on or before December 31, 2007, in compliance with the transition guidance.

Highlights of 2006 Enforcement

IRS enforcement highlights for the fiscal year ended September 30th include the following:

Total individual returns audited increased by over 6% to 1,293,681 in 2006 from 1,215,000 in 2005. This is the highest number since 1998. Some people have dismissed the audit increases because of use of correspondence, or letter exams. There was an even bigger increase in field exams--these are the traditional, sit-down audits. The number of field audits increased nearly 23% in 2006 from the previous year, and they climbed by more than half from the level in 2004.

An important part of enforcement effort has targeted high-income taxpayers. There has been a lot to emphasis to increase audits in this area. If you earn more than $100,000 or you are a millionaire, you are a lot more likely to be audited these days than just a few years ago. Audits of individuals with income of $1,000,000 and higher increased to 17,015 from 12,835, a nearly 33% increase in just one year. About 1 in every 16 of these taxpayers faced audits last year. If you are earning that kind of money and the IRS notices a problem, you are going to

hear from them. Audits of individuals with income over $100,000 surpassed 257,000, an 18% increase from 2005. This is the highest figure in more than a decade, and significantly more then double the 92,000 completed in fiscal year 2001.

There was an increase in efforts to review S corporations and partnerships; while other activity involving small business and large corporations remained relatively stable. The business numbers reflect that the IRS has placed more emphasis in the growing area of these flow-through returns involving S corporations and partnerships:

- Audits of S corporation returns increased to 13,984 from 10,417, a 34% increase. This is the highest level since 2000.
- For partnerships, audits of these flow-through returns increased to 9,777 from 8,489, a 15% increase. This category is at the highest level since 1998.
- Audits of small businesses organized as corporations remained about the same. 17,871 audits were completed in 2006, up slightly from 17,858 in 2005. Both of these figures are more than double the 7,294 audits of small businesses in 2004.

Audits of larger corporations--those with assets over $10 million--dipped by 2.2%, to 10,591 from 10,829 in 2005. While down slightly this year, audits remain up nearly 50% from 2003.

The IRS has placed renewed attention and added resources in the charitable arena to help protect the integrity and maintain faith in the charitable sector. The results show the IRS is taking important steps to combat abuse in exempt organizations. Exempt Organization area audited 7,079 returns in 2006, an increase of 43% from the previous year. That is the highest level since 2000.

In addition to increased exam activity, IRS introduced a new program in 2004 using non-traditional compliance contacts to expand enforcement presence within the tax-exempt community. These compliance contacts have been instrumental in addressing problem areas in sectors such as hospitals, executive compensation and credit counseling. In Fiscal 2006, IRS completed over 5,200 of these new compliance contacts, over and above the traditional examination program. This is a 31% increase from the previous year. Before 2004, there were none of these contacts.

Overall, some of our most common enforcement tools at the IRS also showed increases: collection activities, levies and liens continue to top their 1998 levels. Levies increased by 36% to 3,742,276. Liens rose nearly 20% to 629,813.

New Rules For Kiddie Tax

The "Kiddie Tax" applies to the net unearned income of certain children. It applies to a child if (i) the child has not reached age 18 by the end of the taxable year, and either of the child's parents is alive at such time; (ii) the child's unearned income exceeds $1,700; and (iii) the child does not file a joint tax return.

The Kiddie Tax applies regardless of whether the child may be claimed as a dependent by either or both parents. The net unearned income of a child over $1,700 is taxed at the parents' tax rates, if the parents' tax rates are higher than the rates of the child. The remainder of a child's taxable income (such as earned income, plus unearned income up to $1,700, less the child's standard deduction) is taxed at the child's rates. This results regardless of whether the Kiddie Tax applies to the child. Unearned income is income other than wages, salaries, professional fees or other amounts received as compensation for personal services. It also includes distributions from qualified disability trusts. However, a child is eligible to use the preferential tax rates for qualified dividends and capital gains; generally the 15% rate.

The Kiddie Tax is calculated by adding the net unearned income of the child to the parents' income and then applying the parents' tax rate. Net unearned income is the child's unearned income less the sum of (i) the minimum standard deduction allowable to dependents and (ii) the greater of (a) the minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.

While the allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parents' taxable income, where the child has net capital gains or qualified dividends, these items are allocated to the parents' hypothetical taxable

income according to the ratio of the net unearned income to the child's total unearned income.

A child usually files a separate return to report his or her income. Here, the items on the parents' return are not affected by the child's income and the total tax due for a child is the greater of the tax on the child's income without regard to the Kiddie Tax provisions, or the sum of (i) the tax payable by the child on the child's earned income and unearned income up to $1,700 plus (ii) the allocable parental tax on the child's unearned income.

The Small Business And Work Opportunity Act of 2007 expanded the reach of the Kiddie Tax effective for years beginning August 17, 2007, by amending Section 1(g) to provide that the tax applies to children who are 18 years old or who are full time students over 18 but under age 24. The new rules apply to children whose earned income does not exceed one-half of the total amount of their support.

Service Issues Proposed Regulations on Deduction for Claims Against Estate

A decedent's taxable estate is determined by deducting from the value of the gross estate certain deductions. That includes deductions for amounts paid for funeral and administration expenses, claims against the estate and unpaid mortgages. Specifically, Section 2053 provides that "the value of the taxable estate shall be determined by deducting from the value of the gross estate . . . claims against the estate." As explained in the applicable Treasury Regulations, "[o]nly claims enforceable against the decedent's estate may be deducted" from the gross estate. Under another Treasury Regulation, an item may be entered on the return for deduction even though its exact amount is not then known, provided it is ascertainable with reasonable certainty and will be paid. Other than that general guidance, neither the Code nor the Treasury Regulations provide any guidance on whether post-death events are relevant in determining the value of claims which may be deducted on an estate tax return. For almost 80 years, the courts have reached different conclusions on the matter through two different schools of thought. Previously, the IRS gave notice that it would continue to litigate the issue.

Now, perhaps in an attempt to end the controversy, the IRS has issued proposed regulations that provide guidance regarding the extent to which post-death events may be considered in determining the value of a taxable estate under Section 2053(a)(3).

The proposed regulations seek to resolve an inconsistency in the approaches taken by the courts relating to the extent to which post-death events are to be considered in valuing claims against a decedent's estate. In contrast to Section 2031, the proposed regulations note that Section 2053(a) does not specifically direct that a deductible claim to be valued as of the date of death.

The proposed regulations will impact estates in which there are claims outstanding at the time of the decedent's death. The proposed regulations adopt the position taken in *J. Jacobs et al., Exrs.*, CA-8, USTC 420, 34 F.2d 233 (1929), wherein the court held that the Section 2053(a)(3) deduction available to an estate will be limited to amounts actually paid in settlement of claims against the estate. The proposed regulations further explain that post-death events are to be considered when determining the amount deductible under all provisions of Section 2053, and deductions will be limited to amounts actually paid by the estate to satisfy deductible claims and expenses.

Under the proposed regulations, a final court decision as to the amount and enforceability of a claim will be accepted in determining the amount deductible if "the court passes upon the facts upon which deductibility depends." In addition, settlements will be recognized in determining the amount deductible if they are reached in bona fide negotiations between adverse parties with valid claims under applicable state law. An estate may file a protective claim for refund to maintain the estate's right to a refund if the amount of a liability is not ascertainable before the expiration of the statute of limitations for refund claims.

The proposed regulations also provide that a deduction is not available for a claim that is potential, unmatured, or contested when the federal estate tax return is filed. However, a protective claim for refund may be made before the expiration of the statute of limitations in the event that a claim is subsequently paid by the estate. The proposed regulations provide guidance for specific circumstances, including when the estate is one of multiple defendants to a claim or a claim is made by a decedent's family members or beneficiaries of a

decedent's estate. In addition, the proposed regulations incorporate amendments made to Sections 2053(d) and 2058 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16).

The proposed regulations also clarify that Treasury Regulations Section 20.2053-9 (relating to certain state death taxes) is only applicable to the estates of decedents dying on or before December 31, 2004. The foregoing rules would apply to the estate of any decedent dying on or after the date that the regulations are adopted as final regulations.

IRS Clarifies Rules On IRA Qualified Charitable Contributions

Notice 2007-7 provides guidance with respect to certain provisions of the Pension Protection Act of 2006, P.L. 109-280 ("PPA 2006") in a question and answer format. Specifically, the IRS has clarified rules regarding charitable transfers from IRAs by account owners who are past the age of 70 1/2 and the details are summarized below.

Section 1201(a) of PPA 2006 adds Section 408(d)(8) to the Code, which is applicable to distributions made in taxable years 2006 (even if made before August 17, 2006) and 2007. Under Section 408(d)(8), generally, if a distribution from an IRA is made directly by the trustee to certain organizations, the distribution is excluded from gross income. The exclusion is only available to the extent that the distribution would otherwise have been includible in gross income.

Qualified charitable distributions may be made only to an organization described in Section 170(b)(1)(A), other than supporting organizations described in Section 509(a)(3) or donor advised funds that are described in Section 4966(d)(2). Although qualified charitable distributions must satisfy Section 170 requirements to be deductible charitable contributions, qualified charitable distributions are not deductible under Section 170.

The maximum income exclusion for qualified charitable distributions is $100,000. This maximum applies to the aggregate amount of qualified charitable distributions made during any taxable year with respect to an IRA owner. Thus, if an IRA owner maintains multiple IRAs in a taxable year, the maximum that may be excluded for the owner in that year is $100,000. For married individuals filing joint returns, the limit is $100,000 per individual IRA owner.

A qualified charitable distribution is not subject to withholding under Section 3405 because an IRA owner who requests such a distribution is considered to have elected out of withholding under Section 3405(a)(2). The IRA trustee, custodian, or issuer may rely upon reasonable representations made by the IRA owner that he or she is making a qualified charitable distribution.

For purposes of Section 408(d)(8)(B)(i), if a check from an IRA is made payable to a charitable organization described in Section 408(d)(8) and delivered by the IRA owner to the charitable organization, the payment to the charitable organization will be considered a direct payment by the IRA trustee to the charitable organization. If an amount intended to be a qualified charitable distribution is paid to a charitable organization but fails to satisfy the requirements of Section 408(d)(8), the amount paid is treated as (1) a distribution from the IRA to the IRA owner that is includible in gross income under the rules of Section 408 or Section 408A, as applicable; and (2) a contribution from the IRA owner to the charitable organization that is subject to the rules under Section 170 (including percentage limits of Section 170(b)).

With respect to inherited IRAs, the exclusion from gross income for qualified charitable distributions is available for distributions from an IRA maintained for the benefit of a beneficiary if the beneficiary has attained age 70 1/2 before the distribution is made.

A distribution made directly by the trustee to a Section 170(b)(1)(A) organization will be treated as a receipt by the IRA owner under Section 4975(d)(9). The Department of Labor, which has interpretive jurisdiction with respect to Section 4975(d), has advised the Treasury and the IRS that the above distribution would not constitute a prohibited transaction. This would be true even if the individual for whose benefit the IRA is maintained had an outstanding pledge to the receiving charitable organization.

The Muppets Go To Court

Henson Estate v. Comm'r, 2007-1 USTC 60,536 (USDC SDNY No. 05 Cir. 8212 January 12, 2007) involved the Estate of James M. Henson, the creator of the Muppets.

In 1987, Jim Henson and his wife entered into a Separation Agreement. Of the 90 shares of Henson Associates Inc. which were then issued and outstanding, 35 shares were owned by Jane, and 55 shares were owned by Jim. Jane agreed to transfer her 35 shares to Jim and in return, Jim promised (in Paragraph 7(c)(4) of the Agreement) that if during Jane's lifetime Jim received value in connection with a merger or sale of Henson Associates Inc., that he would pay Jane a portion of the proceeds from the sale or merger. Jim also made an unconditional promise to pay Jane two payments of $1,000,000 each and $2,000,000 to be paid in 20 installments between the execution of the Agreement and July 1, 1996.

Paragraph 7(c)(4) of the Agreement specifically provided that if during Jane's lifetime Jim received value in connection with a merger or sale of Henson Associates Inc., ("Associates") that within 10 days thereafter, an amount equal to 35/90th of the value would be paid to Jane with the amount due to be reduced by $1,000,000, and in no event could it exceed $50,000,000.

The Agreement went on to provide that Jane's share of any proceeds would increase if Jim transferred any of his shares to a third party without receiving value. Jim also promised to create an escrow where he would deliver 35 shares of the stock in Associates as security for the performance of several of his obligations to Jane.

Jim died in 1990 and at the time of his death 25 1/2 shares remained in escrow and Associates had a total of 100 shares outstanding. Jim bequeathed his shares in Associates to his children; however, 22 2/9ths shares remained in escrow to protect Jane in the event of a default of the estate's outstanding obligations to her.

In 2000, the children sought to sell Associates, and the children, the estate and Jane entered into an agreement whereby the children agreed to pay Jane $10,000,000 plus a price guarantee and in exchange, Jane agreed to terminate the escrow and release the escrow shares.

After the children's payment to Jane, the estate filed a claim for overpayment of estate tax arguing (i) that it was entitled to deduction under Section 2053 because the children's payment to Jane was in satisfaction of Jane's valid and enforceable claim against the estate, (ii) that the Internal Revenue Service overvalued the gross estate because its shares of Associates was burdened with the obligations of the Separation Agreement, and (iii) that the children's payment to Jane entitled the estate to a marital deduction under Section 2056 because those funds were property that passed from the decedent to his surviving spouse.

The Court determined that Paragraph 7(c)(4) was unambiguous and therefore did not consider the attorney's affidavits as evidence of the parties intent. The Court also determined that the provisions of Paragraph 7(c)(4) protected Jane's right to share in the proceeds of a sale or merger of Associates by either Jim or his estate, but it did not give Jane a right to share in a subsequent sale of Associates by the Henson children. The proceeds from the children's sale of Associates did not produce any "value" as the term was defined in the Separation Agreement for "value" did not extend to assets received by Jim's beneficiaries in a sale. When the estate transferred all its interest in Associates to the children, the Paragraph 7(c)(4) contingency could no longer be satisfied.

Further, the Court went on to determine that the fact that the escrow agreement was terminated upon Jim's death did not indicate that Jane was entitled to the proceeds from any sale of Associates. The escrow was just a means to provide Jane with security against Jim's default of his payment obligations as outlined under the Separation Agreement. The escrow agreement did not grant Jane additional rights under, or alter her rights under Paragraph 7(c)(4), of the Agreement.

The Court concluded that when Jim transferred all of his interest in the Associates shares to the children, the condition precedent in Paragraph 7(c)(4) could no longer be satisfied. The estate no longer had an interest in Associates and could no longer receive value from an Associates sale or merger.

Hence, Jane did not have a valid claim against the estate for a portion of the proceeds of the children's sale of

Associates. The estate could not support a claim for a deduction under Section 2053.

The estate argued in the alternative that Jane's claim for a portion of the value received by Jim in a sale or merger encumbered Associates shares held in escrow. Thus, the value of the estate should be reduced by the amount of the children's payment made to satisfy the claim. The Court, however, determined that the escrow only provided security for the performance of Jim's payment obligations and that Jane had a right to the escrow shares only if Jim defaulted on his obligations to her. In the event of a merger or a sale, Associates shares were to be released to Jim. Jane did not retain a right in the escrow shares except for an equitable interest in case Jim did not fulfill his obligations.

As to the argument that the estate was entitled to a marital deduction for the children's payments to Jane, Section 2056 grants a deduction from the gross estate for the value of any interest in property which passes or has passed from the decedent to his or her surviving spouse. The Court determined that this requirement was not met because Jim bequeathed his interest in Associates shares to the children and the children subsequently made the payment to Jane. No property interest in the shares passed from Jim to Jane. Hence, under Section 2056 a deduction was not sustainable.

Are You A Real Estate Professional? Does The IRS Agree?

Recently, the IRS has stepped up its enforcement action against individuals who represent themselves on their tax returns to be real estate professionals.[1] The IRS has been aggressively auditing individual tax returns of real estate professionals and reclassifying many of these individuals as passive real estate investors. According to IRS studies of tax compliance, many people are inappropriately deducting losses from real estate activities. If you are taking losses from real estate activities on your federal income tax return, your chances of an IRS audit have risen dramatically over the past year.

Among those selected for audit are individuals who are in fact bona fide real estate professionals within the meaning of the law, including licensed real estate brokers and agents. Based on our experience, not all real estate professionals keep good records for the time they spend on real estate activities and, when confronted by the IRS, they often have difficulty proving that they meet the statutory requirements that can provide significant tax savings.

The advantage of being classified by the IRS as a real estate professional is obvious. A real estate professional recognized by the Internal Revenue Code can deduct the full amount of losses from his or her profession, including but not limited to, depreciation, interest expense on loans, property taxes, travel related expenses, and office expenses. If the person is not recognized as a real estate professional then he or she will be classified as a passive real estate investor and his or her deductions will be limited by Section 469.

Typically, the IRS treats all rental real estate activity as passive unless one of the exceptions apply. You are a real estate professional under Section 469(c)(7)(B) if:

1. more than half of the personal services the individual performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the *taxpayer materially participates;* **and**

2. the individual performs more than 750 hours of service during the taxable year in real property trades or businesses in which the individual materially participates.

The term material participation is defined in Section 469(h) as regular, continuous, and substantial involvement in the operations of an activity. Under Section 469(c)(7)(A), material participation must be satisfied with regard to each separate interest in rental real estate, unless the individual has made an election to treat all interests in rental real estate as a single rental activity. If you own and manage several buildings it is important that you assure that the proper election is filed by your tax professional or you will not be allowed to deduct your losses.

You must also substantiate and prove your material

[1] See Wall Street Journal dated February 28, 2007, *Real-Estate Professionals Say IRS Snares Them by Mistake.*

participation. Under Temporary Treasury Regulation Section 1.469-5T, the extent of your participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of your participation can be established by other reasonable means. Reasonable means for purposes of establishing participation may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative statements.

We have found that while time logs are not required by law, they have been proven to be particularly valuable in convincing IRS agents that our clients are eligible for treatment as tax professionals. IRS Agents are not a group with a high level of trust in taxpayers and some taxpayers have been forced to incur significant expense to appeal adverse determinations by an agent. Some are facing extended litigation to prove their status as real estate professionals. In short, even though you consider yourself to be a real estate professional, the IRS may force you to a very high standard of proof to retain the tax benefits provided to you by the Code.

If you have any questions regarding the foregoing, please contact a member of this Firm's Tax (T), Employee Benefits (EB) or Estate Planning (EP) Groups.

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This newsletter provides information on current legal issues. However, that information should not be construed as legal advice or an opinion as to particular situations or applications.

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