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Dear ,

This issue of the WKBK&Y newsletter addresses:

1. Update Regarding Bill Impacting Estate Taxes and Family Limited Partnerships
2. A Review of the Law Regarding Extending Option Contracts
3. Transfers of Goodwill between Related Parties

1. Bill Likely to Impact Estate Taxes and Family Limited Partnerships Looks to Move Forward

Introduction

In our April 2009 newsletter we discussed proposed bill, HR 436, which would lock estate taxes at 2009 levels and disallow valuation discounts in the transfer of interests in certain entities including family limited partnerships. While many proposed bills never leave committee, it now appears that HR 436 may be presented to the House later this month.

Background

In recent years the rate at which one's estate was taxed as well as the amount that can be excluded from estate taxes has been changing on an almost yearly basis with the top marginal rate at 60% in 2001 and estate taxes slated to be entirely eliminated in 2010. With no consistency estate planners have faced an added challenge in designing estate plans since the year of one's death has substantially impacted how one's estate is taxed.

A useful device for succession planning has been to set up a family limited partnership ("FLP"). Interests in a FLP are owned by family members. When a family member's interests are transferred to another family member, taxpayers often utilize marketability and minority discounts for transfer tax purposes. Such discounts allow taxpayers to leverage annual gifting exclusions and the lifetime exclusion. The IRS has traditionally highly scrutinized FLPs; however, as WKBKY has reported numerous times over the past year, there have been a number of recent Tax Court cases ruling favorably on discounts in the FLP context.

Proposed Law

Rep. Earl Pomeroy [D-ND] sponsored HR 436: Certain Estate Tax Relief Act of 2009. Effective as of December 31, 2009, HR 436 would freeze the unified credit exclusion at \$3.5 million and the maximum estate tax rate at 45%. In addition, HR 436 would impose a 5% additional tax on the amount of one's taxable estate that exceeded \$10 million.

Furthermore, the proposed bill would change valuation rules so that valuation discounts would no longer be allowed for transfers of entities, not actively traded, if the transferee and members of the transferee's family have control of the entity. The bill would also disallow valuation discounts for nonbusiness assets held within entities not actively traded. The effect would be to eviscerate many of the succession planning purposes of family limited partnerships (FLP) and other entities with a similar intention by disallowing discounted valuations at the time of transfer. Should HR 436 become law it would apply to transfers occurring after the effective date which would allow taxpayers a limited time to try and maximize succession planning based on prior law.

At the time of our April newsletter, the bill had been referred to the House Ways and Means Committee and it was not known whether the bill would eventually make its way to the House. However, recently it appears that HR 436, indeed, may make its way out of the House Ways and Means Committee and go to the House later this month. As we stated previously, this is an excellent juncture to contact your representative in the House and let him or her know your viewpoints in regard to HR 436.

WKBKY Takeaway

HR 436 should be monitored and kept in mind when contemplating or working with estate and succession structures which may be impacted should the bill become law. In addition, this is an ideal time to utilize the political process and contact your representative to communicate your views on HR 436. WKBKY will continue to monitor this bill and provide practitioners with updates regarding the bill's status in the legislative process.

2. A Review of the Law Regarding Extending Option Contracts

Introduction

Option contracts involve a payment in exchange for the "right to buy, sell, lease, or the like within a certain period of time." *Reily v. Commissioner*, 53 TC 8 (1969). An option payment is generally not taxed until the option is exercised, lapses or is otherwise terminated. It is also not necessary that consideration for the option reduce the purchase price of the subject of the option. *Koch v. Commissioner*, 67 T.C. 71, 71 (1976).

The law is nebulous as to whether an amendment to an option contract will successfully amend the option contract or will be construed as a termination of the original option contract

and the execution of a new option contract. If the amendment is construed as a new option contract then prior option payments will become taxable. *Reily, supra*.

This article will focus on whether an amendment of an option contract to extend the expiration date of the option, executed before such expiration date, will trigger taxation of option payments in connection with the original option contract.

Discussion

Extending an option contract through an extension contemplated within the option will generally not trigger taxation. *Brown v. Commissioner*, T.C. Memo 1989-133 (1989); *Koch*, 67 T.C. 71; *Dill Co. v. Commissioner*, 33 T.C. 196 (1959).

In the case that an option contract does not allow for extensions or the option contract has already been extended to the extent allowed by the option, there is no bright-line test as to whether an extension will trigger taxation.

It appears that minor changes to an option's expiration date may not trigger taxation. Where an option was executed on April 1, 1974 with an expiration date of July 1, 1974, the Court did not find that a taxable event occurred when a June 14, 1974 collateral agreement was entered and adjusted the effective and expiration dates of the option from April 1 to April 9 and July 1 to July 9, respectively. In addition, in the same proceeding the IRS stipulated that a 90 day extension, as contemplated in the original option, was valid even though it erroneously listed Oct. 9 instead of Oct. 7 as the expiration date, effectively extending the expiration date by 2 days. *Brown*, T.C. Memo 1989-133, 6-8.

The *Reily* Court commented that the "time factor or limitation in an option is of the essence. It goes to the very nature of an option. [citation]". *Reily*, 53 TC 8, 12. However, while the preceding statement does not appear to be premised on a "time is of the essence" clause, it is important to note that the *Reily* Court dealt with an option contract which had a "time is of the essence" clause. Furthermore, the Court also based its ruling on the basis that the option extension "was granted for a different period, for a new consideration, and the manner in which it was to be exercised was entirely different." *Id.* at 13. While a combination of all factors must be considered in a finding that an amendment to an option resulted in a new option contract, it seems that the time extension component may be given more weight than other factors as, for example, there is support that a change in the purchase price may not trigger taxation. *Koch, supra*; *Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195 (1938).

In a 1992 private letter ruling, an option contract was entered and included the possibility of being extended annually for 10 years; however, at the time of the last extension the option was amended to lower the purchase price and to extend the option for an additional 11 years. The negotiations as to the appropriate purchase price caused the extension payment for year 10 to be late. The IRS concluded that the original option had lapsed and a new option contract created when the amendment was executed. In reaching its decision, the IRS mentioned that the amendment also changed the purchase price and added a cancellation clause; however, the focus on the IRS' analysis was based on the added duration of the option as can be seen in the first line

of the analysis which states that “[t]he duration as well as several other material terms...were changed by the amendment”. PLR 9129002.

In the case that an option is extended with no additional consideration being given, the Tax Court has held that such was a continuation of the original option and not a new option contract since the original consideration is continuing to act as consideration for the modified contract. *Kluesner v. Commissioner*, T.C. Memo 1989-83 (1989) In *Kluesner*, the only term modified was the extension of time for which stock options could be exercised. In reaching its decision, the Kluesner Court focused on the point that a new contract cannot be entered into without new consideration. *Id.* at 14-16.

An example where the only change to an option contract was the extension of time can also be found in *Ratner v. Coral Television Corp.*, 139 So. 2d 437 (1962). In *Ratner* an option contract expired on April 9, 1960. The option was not exercised as of April 9, 1960 although on June 6, 1960 the parties entered into an agreement which extended the original option. In finding that the original option contract expired and a new option contract was entered, the Court focused on the fact that an option, “if limited to a certain time, it must be accepted by the optionee within the terms of the option; and, if not accepted within the time specified, the right to do so is lost” and that “[w]hile it is true that... the option may be extended, it appears that such waiver or extension is based on a new contract. [citations]”. *Id.* at 438.

The *Ratner* Court appears to be basing its ruling on the premise that extending an option past its expiration date results in a new option. However, it is important to remember that the extension in *Ratner* was entered into 2 months after the option lapsed although this was not mentioned by the Court as a reason for its holding. In fact, there is support that late consideration for extending an option may effectively extend such option so long as the extension would have otherwise been valid. *Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195 (1938). The above discussed 1992 private letter ruling also touches upon this point when the IRS specifically points out that the option contract “did not specify the consequences of nonpayment of the annual installments.” PLR 9129002.

WKBKY Takeaway

The law concerning the tax implications of extending an option contract is uncertain. There is some support that a minor adjustment or extension without additional consideration may not trigger taxation; however, the best practice would be to draft option contracts that allow for extensions and, therefore, avoid the issue of whether an amendment will trigger taxation.

3. Transfers of Goodwill between Related Parties

Introduction

This article discusses the tax consequences of a sale of substantially all of a partnership’s assets to a taxpayer (in this case a corporation) sharing at least 50% common ownership. Although acquired goodwill is generally amortizable by the purchaser, to prevent the churning of losses by related parties, Code section 1239 specifies that a related party purchaser of goodwill

cannot amortize the goodwill. However, this “anti-churning rule” also prevents the gain from the sale of the goodwill from being characterized as ordinary.

WKBKY was recently asked to opine on a situation similar to the following.

Facts

Corporation currently has a contract (the “Contract”) with Partnership, whereby Partnership is granted a one-year term within which to provide advertising services on behalf of Corporation within the county. Partnership has been providing such services to the Corporation for over 35 years. The original Contract contained a 5 year term with automatic one-year extensions unless canceled by a party. Though neither side was bound to renew the Contract, Partnership and Corporation have continued to do so and have built a working relationship since the origination of the Contract.

In accordance with the foregoing, a professional appraisal of Partnership has determined that the value attributable to the Contract is slight in comparison to the value of Partnership’s goodwill (the “Goodwill”). (The Goodwill and Partnership’s interest in the Contract are collectively referred to as the “Assets”.)

Corporation and Partnership have determined that combining the two entities will enable them to maximize their profitability. Since a tax-free corporate reorganization cannot work, Corporation has offered to purchase the Assets for cash.

The two entities share more than fifty percent (50%) common ownership.

Issues

1. What is the federal income tax characterization of Partnership’s gain from the sale of the Assets?
2. May Corporation amortize or otherwise deduct its cost basis in the Contract and Goodwill?

Applicable Law

Section 1239. Code section 1239(a) provides that in the case of a sale or exchange of an asset between related persons and which is of a character which in the hands of the transferee is subject to the allowance for depreciation under section 167, the transferor’s gain must be recognized as ordinary income. For this purpose, “related persons” include a corporation and a partnership that share more than 50% common ownership. Code §§ 1239(b)(1) and (c)(1)(C), 267(b)(10).

Section 167 / 197. “Any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167.” Code § 197(f)(7). An “amortizable section 197 intangible” is any section 197 intangible that is (i)

acquired by the taxpayer on or after the effective date of section 197; and (ii) is held in connection with the conduct of a trade or business. Code § 197(c)(1). A “section 197 intangible” is defined to include “goodwill” and “franchises”. Code § 197(d)(1)(A) and (F).

A “franchise” includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods or services within a specified area. Code §§ 197(f)(4) and 1253(b)(1). Renewals of franchises are considered acquisitions thereof, but only for purposes of the costs incurred in such renewal. Code § 197(f)(4). Franchises are specifically excluded from the definition of “self-created intangibles,” which are an exception from the definition of “amortizable section 197 intangibles.” Code § 197(c)(2).

“Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.” Regs. § 1.197-2(b)(1).

Specifically excluded from the definition of a “section 197 intangible” are, unless acquired in the acquisition of assets constituting a trade or business or substantial portion thereof, (i) any right to receive tangible property or services under a contract; or (ii) any right under a contract if such right has a fixed duration of less than 15 years and is fixed as to amount and would otherwise be recoverable under a method similar to the unit of production method. Code § 197(e)(4)(B) and (D).

Section 197(f)(9) contains anti-churning rules that prevent a related party from amortizing an otherwise amortizable goodwill. Intangibles which are not goodwill or going concern value are not subject to the anti-churning rule. The anti-churning rule provides that goodwill which might otherwise be amortizable under section 197 will not qualify as amortizable if the taxpayer or a related person held or used the intangible at any time between July 25, 1991 and August 10, 1993 (the “transition period”). Regs. § 1.197-2(h)(2)(i). For this purpose, a corporation and a partnership are related parties if they share at least 20% common ownership. Regs. § 1.197-2(h)(6)(A), by reference to Code § 267(b)(10).

Characterization of Acquired Goodwill. In the absence of the provisions of Code section 197 allowing for the amortization of goodwill, it has been repeatedly held that such non-amortizable goodwill is a capital asset by both the IRS and the courts. PLR 200243002, citing Rev. Rul. 65-180; Rev. Rul. 55-79; UFE, Inc. v. Commissioner, 92 T.C. 1314, 1323 (1989); Patterson v. Commissioner, 810 F.2d 562, 569 (6th Cir. 1987); Better Beverages, Inc. v. United States, 619 F.2d 424, 425 n. 2 (5th Cir. 1980); Dixie Finance Co. v. United States, 474 F.2d 501, 506 n. 5 (5th Cir. 1973); Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1963); Michaels v. Commissioner, 12 T.C. 17 (1949).

Analysis

i. Contract

Section 1239. Partnership is a related person with respect to Corporation because Partnership shares at least fifty percent (50%) ownership Corporation. Because of the parties’

relatedness, pursuant to section 1239, gain on the sale of the Contract will ordinary income treatment because under Code section 197(f)(7), the Contract will be of a character subject to the section 167 allowance for depreciation.

Section 197. The Contract represents a “franchise” as that term is defined in Code section 197(f)(4). Accordingly, the Contract will be a section 197 intangible in Corporation’s hands. Further, because the Corporations are purchasing Partnership’s assets (including the Contract) in furtherance of their trade or business of providing funeral plots, goods and services, the Contract is an amortizable section 197 intangible.

Because franchises are excluded from the definition of “self-created intangibles,” the exception for self-created intangibles from amortizable section 197 intangibles is not applicable. Furthermore, because the purchase of the Contract is being made as part of the acquisition of assets constituting a trade or business or substantial portion thereof, the exclusions under section 197(e)(4) are also inapplicable. Finally, because franchises are not subject to the anti-churning rules, those rules will not preclude the Contract as amortizable.

Character of Gain Attributable to Contract. Because the Contract will be amortizable section 197 intangibles in the Corporations’ hands, and because the Corporations are related parties with respect to Partnership, Partnership’s gain from the sale of the Contract is ordinary pursuant to Code section 1239.

ii. Goodwill

As indicated above, Partnership is a related party for purposes of section 1239 with respect to each of the Corporations, and so, as with the Contract, gains from the sale of the Goodwill will be ordinary if they are subject to depreciation (or amortization) in the Corporations’ hands.

Section 197. The Goodwill represents intangible value in excess of the inherent value of the Contract, and it is a separate intangible asset. Under Code section 197(d)(1)(A), the Goodwill is a section 197 intangible. Moreover, because the Goodwill is being purchased in the Corporation’s course of trade or business, it would generally be amortizable by the Corporations.

However, in this case, the anti-churning rules will apply to the Goodwill because the Corporations and Partnership share more than 20% common ownership and because Partnership has held the Goodwill throughout the transition period. Accordingly, the Goodwill is not an amortizable intangible in the Corporations’ hands.

Character of Gain Attributable to Goodwill. Because the Goodwill is not a depreciable asset, there is no risk of the gain being characterized as ordinary pursuant to Code section 1239. Because the Goodwill is a self-created intangible that is not amortizable by Partnership, it is not a section 1231 asset. Finally, the case law and IRS rulings cited above confirm the characterization of non-amortizable goodwill as a capital asset.

Conclusions

1. In an asset sale, Partnership's gain from the sale of the Contract is ordinary under 1239 while its gain on the sale of the Goodwill is capital. Furthermore, the risk of Baker recharacterizing the sale of the Goodwill as something else is low because of important distinctions between Baker and the instant situation.

2. As a consequence of the anti-churning rule, the Corporation will not be able to amortize the Goodwill. Corporation can amortize the value of the Contract.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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