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A Significant Transfer Without Gift Tax

In recent case Mikel v. Commissioner, TC Memo 2015-64, the Tax Court ruled that transfers to an irrevocable discretionary trust qualified for the gift tax annual exclusion under Sec. 2503(b).

In 2007, Israel and Erna (taxpayers) created a family trust and jointly transferred to the trust property with a value of approximately $3,200,000. The trust had 60 different beneficiaries, and each beneficiary had the power (*Crummey* power) to withdraw, during the year the trust was created and any subsequent year that property was added, the amount of the gift tax annual exclusion. At the time of the gift, the annual exclusion amount was $12,000 per done. As a result, the taxpayers claimed combined annual exclusions totaling $1,440,000.

In addition to the annual withdrawal power, the instrument also provided the trustees with the discretionary authority to make distributions for, among other things, a beneficiary's health, education, maintenance or support. Any disputes regarding the proper interpretation of the distribution right had to be submitted to an arbitration panel consisting of members of the Orthodox Jewish faith, a rabbinical court referred to as a beth din. The trust document also contained an *in terrorem* clause designed to discourage beneficiaries from challenging discretionary acts of the trustee.

Based on these provisions, IRS argued that the withdrawal rights were illusory. If the trustee refused to agree to the withdrawal demand, the beneficiary would be required to challenge the decision by submitting the dispute to the rabbinical court. If this court issued an adverse ruling, the beneficiary could go to state court, but this would trigger the *in terrorem* clause, causing the beneficiary to forfeit all rights in the trust. Thus, IRS argued, as a practical matter the withdrawal right could not be enforced and therefore did not constitute a present interest eligible for the gift tax annual exclusion.

The Tax Court flatly disagreed with the IRS arguments. The court determined that the trust instrument literally required the trustee to comply with a beneficiary's exercise of a withdrawal right and that the instrument required the rabbinical court to follow state law in determining a beneficiary's rights. Further, it concluded that the *in terrorem* clause applied only to disputes over the propriety of discretionary distributions, not mandatory ones initiated by exercise of the *Crummey* withdrawal rights. Because the beneficiaries had an unconditional right to withdraw property added to the trust that was legally enforceable, each beneficiary possessed a present interest in property.

What to take away from this opinion

First, do not overlook the amount of wealth that can be transferred to other family members simply by using a withdrawal power in a trust. In *Mikel*, IRS challenged whether each of the 60 beneficiaries had the present right to the property transferred to the trust. To qualify for the present interest annual exclusion amount under Sec. 2503(b), each donee must have the unrestricted right to immediate use, possession, or enjoyment of the property. In the case of a minor, if there is no impediment under the trust or local law to appointment of a guardian and the minor donee has a right to demand distribution, the transfer is also a gift of a present interest. By qualifying for the annual exclusion, the taxpayers were able to transfer a significant amount of wealth ($1,440,000) to other family members free of gift tax. It should be noted however, that with limited exception, the generation-skipping transfer (GST) tax rules do not line-up with the gift tax rules and therefore GST tax issues should be considered separately.

Second, *in terrorem* clause could be used to dissuade future disputes regarding distributions. This clause, which more typically appears in wills, is used to discourage beneficiaries from challenging an instrument by terminating a beneficiary's interest if he or she challenges any provision in that instrument. In *Mikel*, the taxpayers were able to effectively use an *in terrorem* clause to reduce the chances of beneficiary disputes without invalidating their annual exclusions.

If you have questions about *Mikel* or annual exclusion planning in general, please contact your Andersen Tax advisor. We can help you integrate this planning to achieve your overall family wealth planning goals.

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Defining the S&P 500: A Poor Benchmark for the Modern Portfolio

As 2014 came to a close, many investors were left wondering why their portfolios underperformed the S&P 500, which reached record highs and finished up 13.7% for the year.

Because the financial media provide constant updates on this index, many investors believe that it is an appropriate measure of investment success. However, the typical investor's portfolio often bears little resemblance to the index, as the S&P 500 only represents a single asset class: U.S. large cap equities. A more suitable performance benchmark for the modern, diversified portfolio may be a weighted benchmark that proportionally represents all asset classes included in one's portfolio.

The S&P 500 is comprised of 500 U.S. large-cap stocks, chosen because they are leading companies in leading industries within the U.S. economy. Each company in the index is weighted by its market capitalization, defined as share price multiplied by the number of shares outstanding. As a result, larger, more mature firms have a greater impact on the index's performance. For example, Apple represents about 3.4% of the S&P 500 by market capitalization, in contrast to being just 0.2% if it were calculated on an equal-weighted basis. In fact, just five stocks – Apple, Berkshire Hathaway, Johnson & Johnson, Microsoft and Intel – accounted for 20% of the S&P 500's gains in 2014.

The S&P 500 is an appropriate benchmark for a portfolio consisting of all U.S. large cap stocks, as the index represents about 72% of the value of the overall U.S. equity market. However, investors often use the S&P 500 as a measure of broad market performance, despite the fact that it represents only a small segment of the global financial market. In fact, the S&P 500 represents less than 30% of the global equity market, which is only one-third of the size of the global fixed income market. Investors must therefore look elsewhere to gauge portfolio performance given exposure to asset classes such as non-U.S. equities and bonds.

When investing in multiple asset classes, a portfolio's overall benchmark should be a proportionally weighted blend comprised of the relevant indices that represent each included asset category. For example, a portfolio consisting of one-third U.S. large cap stocks, one-third U.S. bonds and one-third international stocks would be compared to a benchmark comprised of one-third S&P 500 Index, one-third Barclays U.S. Aggregate Bond Index and one-third MSCI EAFE Index. While the S&P 500 returned 13.7% in 2014, this blended benchmark returned only 3%. The blended benchmark method allows for an accurate, apples-to-apples comparison of total portfolio performance, and provides a more relevant measure of market performance for most portfolios.

Focusing on one index is often misleading, misrepresentative and can contribute to a larger and more problematic issue for most investors, namely, home bias. Despite the well-documented benefits of international diversification, many investors prefer to focus on well-known U.S. companies that they can easily see and follow. However, owning a portfolio comprised of a single asset class will likely lead to sub-optimal risk-adjusted returns. Historically speaking, 2014 was highly unusual in that the S&P 500 drastically outperformed the rest of the global financial markets. Over the past 20 years, the S&P 500 has outperformed all other major asset classes only six times, and it was the worst performing asset class five times. So far in 2015, markets are proving the value of diversification. At the time of this writing, developed international equities, as measured by the MSCI EAFE Index (up 10.9%), and emerging market equities, as measured by the MSCI Emerging Markets Index (up 4.5%), are both outperforming the S&P 500 (up 3.2%).

In the long run, disciplined investors who ignore short-term market fluctuations and maintain well-diversified portfolios tend to outperform their benchmarks. While it is important to use a weighted benchmark to judge a portfolio's performance, investors should keep in mind that the true measure of investment success is the achievement of their unique financial goals and objectives, not the outperformance of indices in the news. If you have specific questions about your portfolio, please contact your Andersen Tax advisor.

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The Risks of Underinsurance

In today's world, insurance is often a necessary evil.

Yet, recent reports by risk assessment groups indicate that over half of all businesses are underinsured, with over 80% of small businesses underinsured. This underinsurance may be the result of a calculated decision aimed at saving money—after all, insurance costs can be high. Alternatively, this could be the result of a lack of information on the part of the insured. Regardless of what motivated the decision, in the event of a loss, being underinsured could cause the closure of a business or, at the very least, a serious disruption. First, it is important to understand what it means to be underinsured. Once that is accessed, the next question is what can be done to remedy the situation.

What is underinsurance?

Underinsurance applies to both individuals and businesses that own property. Underinsurance occurs when the amount of coverage for the insured property is less than the replacement cost of such property. Although there are insurance policies that use fair market value as the basis for determining the premium, this is very uncommon and, in general, property should be insured on a replacement or reproduction cost basis. Replacement cost represents the amount needed to replace property with similar property, with functionality being the driving force. Reproduction cost represents the amount needed to replicate the property, making use of all the same materials/capacities, to the extent possible. On the other hand, fair market value measures the replacement cost and then deducts all forms of depreciation. Fair market value generally yields the lowest of the three values, with reproduction cost yielding the highest.

What's at stake?

In an actual example, a national food processing company located in the Midwest recently suffered a partial loss due to a tornado. The tornado ripped through some of their buildings, destroying inventory, finished goods, machinery and parts of the buildings. At the end, some buildings were completely destroyed, while others retained their walls, though the roof had been blown off along with the equipment inside. Although the company was insured, their policy was based on fair market value. Subsequent to the loss, all assets had to be valued as if the loss had not occurred, making sure to account for depreciation. A great debate arose among different parties regarding the amount of depreciation that should be assigned to the destroyed property. While the company had made the decision to use fair market value as the basis for their premium knowing the risks involved, they had also neglected to inform their insurer regularly of updates and changes to the facility. Ultimately, the company did not have enough coverage to adequately replace everything that had been lost.

In the case of a business, being underinsured can have a significant economic impact and can disrupt the operations of the business. While no one expects a fire or a natural disaster to happen, a single loss event can be disastrous if the payout received from the insurance company is inadequate.

How can you prevent underinsurance?

Starting with an existing policy, first, determine not just the type of policy in place, but also, what the value basis is. If the value basis is anything other than replacement or reproduction cost, it is important to understand why and to weigh the risks. Second, determine how this value basis is being determined. Is the number coming from outdated documentation? How are changes such as additions and/or removals reported to the insurer? An appraisal might be useful in order to determine a starting point for what the premium should be based on. Once a starting point is established, updates to the number can be more easily processed as changes occur on site. After five to ten years or after a significant number of changes have taken place, another appraisal might be needed.

Going forward, the following steps can help prevent underinsurance:

1. Report to the insurer the cost to rebuild the property, not the fair market value or what was paid.
2. Perform regular reviews of the business and property and note any changes.
3. Review the insurance policy at least annually to ensure the best coverage.
4. Increase the amount of coverage yearly to reflect inflation.
5. Report any additions and/or changes to the property to the insurance company.

Andersen Tax can assist you with determining the replacement or reproduction cost for your property. From calculations performed as a reasonableness check to full appraisal reports, our valuation team can help you gain *comfort that you are being adequately insured.*

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BEPS Action 13: Transfer Pricing Documentation & Country-by-Country Reporting

As outlined in our May, 2015 newsletter article, Addressing International Tax Planning in the Changing BEPS Landscape, in 2013 the OECD, together with the G20, developed a 15-point Action Plan to address abusive tax practices it refers to as Base Erosion and Profit Shifting, or BEPS.

The essence of the initiative is to develop coordinated actions that curb the ability of multinational enterprises (MNEs) to shift income arbitrarily to tax jurisdictions offering low tax rates. Among the items identified, Action 13 calls for a re-examination of transfer pricing documentation requirements in order to enhance transparency among tax administrations regarding individual taxpayers.

On June 8, the OECD released the report, *Action 13: Country-by-Country Reporting Implementation Package.*

This report follows two reports issued previously. The first, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* was issued in September, 2014. The second, *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* was issued this past February.

Highlights

- The new guidance introduces a three-tiered structure for documentation, consisting of: (i) a master file containing standardized information relevant for all MNE group members; (ii) a local file referring specifically to material transactions of the local taxpayer and (iii) a country-by-country (CbC) report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.
- The information required in the master file provides a high-level blueprint of the MNE group, while the local file provides more detailed information relating to specific intercompany transactions.
- The CbC report is new and requires aggregate tax jurisdiction-wide information relating to the global allocation of income, taxes and certain indicators of economic activity among the tax jurisdictions in which the MNE group operates. The CbC report also requires a listing of all the Constituent Entities for which financial information is reported, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main business activities carried out by that Constituent Entity.
- Specifically, the CbC report requires MNEs to report annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.
- Taken together, these three documents (CbC report, master file and local file) will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with detailed information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed and, in the event audits are called for, to commence and target audit inquiries.
- The OECD recommends that tax administrations require the first CbC Reports be filed for MNE fiscal years beginning on or after 1 January 2016. However, it is acknowledged that some jurisdictions may need time to follow their particular domestic legislative process in order to make necessary adjustments to the law.
- To aid in this latter effort, the OECD issued its implementation package on June 8, 2015. This package includes model legislation that could be used by countries to require the ultimate parent entity of an MNE group to file the CbC Report in its jurisdiction of residence including backup filing requirements. The implementation package also includes three model Competent Authority Agreements that could be used to facilitate implementation of the exchange of CbC Reports, respectively based on the 1) Multilateral Convention on Administrative Assistance in Tax Matters, 2) bilateral tax conventions, and 3) Tax Information Exchange Agreements (TIEAs).

Country-by-Country (CbC) Reporting Template

The CbC reporting requirements consist of two main templates. The first template requires MNEs to disclose financial and other data by jurisdiction (not by legal entity). On its face, the purpose of this data is to provide tax administrations with an understanding of how a given MNE's revenue, profits and people are allocated across different jurisdictions. See Table 1, below.

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE Group: Fiscal Year Concerned:											
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on Cash Basis)	Income Tax Accrued–Current Year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

The second template is more qualitative in nature and requires MNEs to disclose the scope of business activities performed in each tax jurisdiction. The template is organized into a checkbox format (see Table 2, below). Accordingly, it is likely that many MNEs will have multiple activities checked for each tax jurisdiction, thereby leading to some ambiguity in the absence of any accompanying narrative to clarify the functional profile of its operations in each jurisdiction.

Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE Group: Fiscal Year Concerned:															
Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of organization or incorporation if different from Tax Jurisdiction of Residence	Main Business Activity(ies)												
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing, or Distribution	Administrative, Management or Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares/other equity instruments	Dormant	Other[2]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

Guidance on transfer pricing documentation and country-by-country reporting © OECD 2014

Recommendations

- Because the information disclosed in the CbC reporting template will likely create some ambiguity, it is imperative for taxpayers to prepare a coherent narrative and accompanying factual profile in order to minimize the risk of facing multiple disputes.
- The narrative should provide convincing proof that the taxpayer's allocation of income is consistent with the allocation of functions, assets and risks across its value chain and further, that such allocation of functions-assets-risks is consistent with its strategic and operational approach to competing in its given market.
- To the extent that taxpayers have inconsistencies in their underlying fact profile, now is the time to address them, whether in terms of eliminating the inconsistencies, making income/expense adjustments or drafting their narrative (or all of the above).

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The Importance of Valuation Allowance Disclosure Transparency

During the past decade, many companies have experienced significant fluctuations in their earnings, while others have accumulated significant loss carry forwards.

The existence of cumulative losses creates uncertainty as to whether a company will be able to realize its deferred tax assets and, as a result, the necessity for providing documentation and disclosure surrounding valuation allowance conclusions intensifies. In particular, public companies should be clear concerning the nature, timing and other factors underlying the development of a company's allowance estimates, as well as any factors that may cause the estimates to change. This transparency is critical in reducing the risk of being second-guessed by auditors and regulators.

Financial statement disclosures surrounding income tax accounting conclusions involving significant judgment have become an area of increased focus by the SEC in recent years. In regards to valuation allowance conclusions it is important to provide the reader of financial statements with sufficient information to determine how and why the company arrived at the conclusions reached.

The following is an example of an actual company that did not record a full valuation allowance on its gross deferred tax assets and instead made the following disclosure in its financial statements:

> At the end of 20XX, the Company had net domestic deferred tax assets of approximately $XXX.X million against which a valuation allowance of $Y.Y million has been provided. Of these total assets, approximately $ZZ.Z million relates to recurring type temporary differences which reverse regularly and are replaced by newly originated items. The balance is primarily related to foreign tax credits and federal and state net operating losses that, other than for the amount for which a valuation allowance has been provided, are expected to be realized prior to expiration based upon future operating and non-operating income generated from the United States businesses, as well as foreign dividends and other foreign source income. Also, expected gains related to future sales of land would result in the realization of a portion of these assets. In addition, certain tax planning transactions are available to the Company should they be necessary.

The SEC provided the following comments, and requested responses from the company regarding their disclosures surrounding their valuation allowance conclusions:

> Given your recurring domestic losses before income tax, please discuss the nature of the U.S. deferred tax assets which have not been offset by a valuation allowance and how you determined that these would be realized. Please also address the following in regards to your U.S. deferred tax assets:
>
> - Please expand your discussion of the nature of the positive and negative evidence that you considered, how that evidence was weighted and how that evidence led you to determine it was not appropriate to record a valuation allowance on the remaining U.S. deferred tax assets;
> - Please disclose the amount of pre-tax income that you need to generate to realize the deferred tax assets;
> - Please include an explanation of the anticipated future trends included in your projections of future taxable income; and
> - Please disclose that the deferred tax liabilities you are relying on in your assessment of the realizability of your deferred tax assets will reverse in the same period and jurisdiction and are of the same character as the temporary differences giving rise to the deferred tax assets.

After responding and receiving additional SEC comments, the company agreed to modify its valuation allowance disclosure for future years. The next year, the company disclosed the following:

> At December XX, 20XX and December YY, 20YY, the Company had valuation allowances against certain deferred tax assets totaling $X million and $Y million, respectively. These valuation allowances relate to tax assets in jurisdictions where it is management's best estimate that there is not a greater than 50 percent probability that the benefit of the assets will be realized in the associated tax returns. This assessment is based upon expected future domestic results, future foreign dividends from then current year earnings and cash flows and other foreign source income, including rents and royalties, as well as anticipated gains related to future sales of land held for development. In addition, certain tax planning transactions may be entered into to facilitate realization of these benefits.

In summary, the emphasis in recent years has continued to build for a more extensive disclosure surrounding the conclusions reached on the need for a valuation allowance. Companies need to consider all positive and negative evidence in their evaluation of the need for a valuation allowance against their deferred tax assets. In addition, they need to provide a user of the financial statements with sufficient information to understand how and why the conclusions were reached. A valuation allowance disclosure provides financial statement users with the appropriate information to make more informed decisions. Given the judgmental nature of valuation allowance measurement and disclosures, it is critical for companies to continually monitor and evaluate factors impacting their valuation allowance conclusions and make the appropriate disclosures.

If you have any questions relating to this newsletter article, please contact an Andersen Tax consultant.

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