



The IRS and the Estate of Michael Jackson *What Went Wrong*

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

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The IRS & The Estate of Michael Jackson: What Went Wrong

In the ongoing dispute of the Estate of Michael Jackson, in a previously unreported court filing the IRS has increased their original claim for tax and penalty from \$702m to \$731m. The IRS now values the Estate (and Lifetime Taxable Gifts) at \$1.178B compared to the Estate Form 706 Valuation of \$7m, a valuation difference of \$1.171B.

Jackson the "King of Pop" died in 2009 and this estate tax battle with the IRS has been ongoing for years with no end in sight and no trial date yet set.

IRS tax auditors previously valued Jackson's original master recordings at \$45.5 m (for a 50% ownership interest); the IRS asserts that he actually owned 100% of them so the value is now \$91m (not the \$11.9m as reported on the estate tax return).

The IRS tax dispute centers around the following valuation issues:

- 1) The Estate valued Jackson's name and likeness at \$2,105; the IRS valued it at \$434.26m, a difference of over \$434m;
- 2) The Estate valued Jackson's interest in the Trust that owns the Beatles/Jackson's songs at \$0, the IRS valued them at \$469m, a difference of \$469m;
- 3) The Estate valued Jackson's master recordings at \$11.9m while the IRS valued them currently at \$91m, a difference of nearly \$80m;

So, how is this all possible? Someone appears to have "bad math." The IRS claim is for tax: \$525.6m and penalty: \$205m, total: \$730.6m. In addition interest accrues and legal/professional fees run. So in the end is this a billion dollar tax and fee dispute? Certainly appears to be the case with no apparent end in sight.

If the Estate tax return is based on the law and the facts support it they may win. However, it is incredible that Michael Jackson the world's most famous entertainer whose estate earns \$160m per year (nearly 3 times Elvis at \$55m per year, nearly 10 times Bob Marley at \$18m per year, and nearly 14 times John Lennon at \$12 m per year) had a name and likeness worth \$2,105 (not to mention a \$0 valuation for the Beatles/Jackson songs). In the words of Bob Dylan: "Something is Happening Here and You Don't know What it is."

Tax Planning/Celebrity Image Rights

Celebrity Image Name and Likeness ("Celebrity Image Rights") value is an "unmined field in the law". To date, there are no cases that address whether the value of a person's image rights are subject to estate tax, and if so, how to value them. Several US Tax Court decisions have addressed the value of a celebrity's image and likeness for income tax purposes (see professional golfer Retief Goosen dispute over sponsorship payments).

The proliferation of world-wide audiences (a global market) for American music and film has resulted in multi-million dollar income streams for Estates of Dead Celebrities (see Forbes List of Top Earning Dead Celebrities (2012) in which Michael Jackson at \$160m in annual income was far and away the top earner with Elvis at \$55m a distant second.

Since the US estate/gift tax is 40% tax planning for celebrity image, name, and likeness ("Celebrity Image Rights") has become of paramount importance since the untimely death of Elvis in the 1970s.

In the LA Times 2/7/14 article, Michael Jackson Estate Embroiled in Tax Fight with IRS, Professor Edward McCaffery, USC Gould School of Law was quoted: "Before Croce dies (1973 plane crash) everyone is tired of his songs. But after the tragic death there's a spike up."

Under the "Jim Croce" effect the celebrity's death may cause their Celebrity Image Rights to "skyrocket" in value due to the "spike up on death."

So what to do? The key tax planning strategy discussed in this article recommends the following income, estate and gift tax planning strategy, for celebrity image rights:

1) Assuming there will be a 40% US Estate Tax due as of the date of death as to the value of the Celebrity Image Rights, it is important that the value be independently established by a written appraisal by a reputable third party appraiser to avoid the battle of "dueling" incompatible appraisals which is the crux of the problem for the IRS/Estate of Michael Jackson Estate Tax audit/pending US Tax Court Case. The appraisal should be while the celebrity is alive.

2) For tax planning purposes, the Celebrity Image Rights if valued under \$5.45m (2016) may be used to fund (via transfer) an irrevocable trust which triggers the filing of Form 709/US Gift Tax Return. As long as the value of the Celebrity Image Rights is under \$5.45m no gift tax is triggered by the tax filing. The key to this estate/gift tax planning is that the appreciation on

the value of the Celebrity Image Rights (above and beyond the appraised value, while the celebrity is alive) escapes US estate tax of 40% (i.e. All appreciation above the appraised value, which had no gift tax, would have no estate tax either). Since the Celebrity Image Rights are an illiquid IP asset, if taxed at 40% it would require cash to pay the tax which is not supplied by the rights themselves but most come from other sources (savings, asset sales et al). For example, if the date of death value of the Celebrity Image Rights is \$10m then a 40% US Estate Tax would be due i.e. \$4m. How does that tax get paid (that is the key tax problem facing the Estate of Michael Jackson)?

3) In addition to escaping the 40 % US estate tax imposed on the illiquid Celebrity Image Rights, the transfer of the rights to an irrevocable trust exempts these assets from third party creditor attachment, providing asset protection for the celebrity while alive and their heirs upon death (absent a fraudulent conveyance).

For Celebrity Image Rights valued at over \$5.45m (2016) additional tax planning techniques may include: structuring the asset transfer as a sale (not a contribution) to an Intentionally Defective Grantor Trust (which is an irrevocable trust whose assets are excluded from US estate and gift tax; up to \$5.45m for the assets contributed, \$10.9m Husband and Wife/2016), which sale is not subject to capital gains tax so the transfer of the assets to the trust for the sale is a non-taxable event. Additionally, if the Rights are sold to the Trust for a note (with payments due) no tax is due for the receipt of interest payments from the Trust (to the Trust Grantor) for the sale of the Rights to the Trust, paid under the Note.

If the Note was a self-cancelling Note, which terminated at the Celebrity's death, the value of the Note would not be included in the Celebrity's Estate and the Note would not be subject to the 40% US Estate tax.

4) Additional tax savings may come from investment tax planning for income (royalties received by the Trust from the licensing or sale of the Celebrity Image Rights). For investment tax planning, the stream of royalties earned by the licensing/sale of the Celebrity Image Rights may escape US income taxation if the entity which owns the Image Rights (e.g. a California Limited Liability Company) is transferred as one of five or more investments, held in the cash value component of an off-shore private placement life insurance policy (subject to IRC sec. 817 diversification rules).

If the CA LLC which owns the Celebrity Image and Likeness is a part of the cash value component of the off-shore private placement variable life insurance policy, there is no income tax due on receipt of the royalties (by

the cash value component of the policy) there is no tax reporting for receipt of the royalties, and the royalties may annually compound tax-free creating a greater net-after tax return.

If the private placement variable life insurance policy is owned by an irrevocable trust then the death benefit paid under the policy is received by the heirs income, estate and gift tax free upon death.

While alive, the royalty stream from the Celebrity Image Rights is not subject to tax by the Celebrity. If the life insurance policy is structured as a non modified endowment contract ("Non-Mec") the celebrity while alive may access the cash value (which includes premiums paid and earnings both from the royalty stream from the Image Rights, and the investment earnings on the principal held in the cash value).

The celebrity, who needs cash while alive, can receive it tax-free from the life insurance policy which is a non-mec (i.e. a life insurance policy that is funded over 5 years). Funds accumulate tax-free in the policy "cash value" (which is effectively a bank account, under the policy, which holds the premiums paid and earnings/royalties received which are not subject to either income tax reporting or payment of income taxes due). Tax-free withdrawals from the cash value (under the non-mec rules) include: withdrawal of basis (i.e. premiums paid) on a tax-free basis; "borrow as a loan" the earnings (on the premiums paid) which includes royalties/investment earnings, both of which are tax-free transactions so the celebrity has tax-free access to the cash held under the policy cash value.

For the loan "borrowed from the cash value", it accumulates over time with interest and then at the insured's death it is repaid i.e. the death benefit received repays the loan. For example, if the loan was \$5m and the death benefit was \$10m the loan is repaid and there is an additional \$5m net death benefit for the heirs (which under the tax planning proposed is income, estate and gift tax free). So the life insurance policy becomes a wealth creation strategy.

Life insurance premiums pay for the policy at a fraction of the cost of the death benefit, i.e. the "leveraged premiums" fund the death benefit. For example, if the death benefit was \$10m and the premiums were \$2.5m the leverage is 4:1 (i.e. for every \$1 paid in premiums, \$4 are received in death benefit). The net wealth creation then becomes an additional \$7.5m (i.e. \$10m death benefit less \$2.5m premiums paid) paid tax-free to the celebrity's heirs.

For Asset Protection, if the Life Insurance Policy is a Puerto Rico Life Insurance Policy it is exempt from creditor attachment (under the laws of Puerto Rico) which means both the Celebrity Image Rights and the income stream from those rights may not be attached by creditors of the celebrity or heirs.

Conclusion

So how many commercial uses are there for the Celebrity Image Rights (i.e. how many ways can these rights be monetized?) If the Star Wars Film franchise is any indication there are many different rights all with different revenue streams. The great American scientist, George Washington Carver found 142 uses for a peanut. My bet is over time a Celebrity Image Rights will be competitive. Remember this industry really started in the 1970s with Elvis and ascended thanks to the King of Pop, the legendary Michael Jackson.

The appraisal is more of an art than a science; keep in mind it comes down to the appraisers best guess. So, there appears to be room to move and a difference among both appraisers and the IRS to establish the value of the celebrity image rights.

Final caution, have a written appraisal by a qualified appraiser and be prepared to explain your valuations if the IRS comes knocking. Since estates valued over \$10m have an almost 100% audit rate for estate taxes expect that IRS will come knocking.

