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Jackson Estate Says, “Beat It, IRS.”

By Robert W. Wood

Michael Jackson was no stranger to lawyers while he was alive. He used the services of many lawyers. His successful defense against sex abuse charges alone reportedly cost him \$20 million. He was a big spender in general, of course, and his legal bills over the course of his storied career were worthy of the King of Pop.

Mr. Jackson died unexpectedly on June 25, 2009, at the age of 50. Even after his death, he is keeping lawyers busy. As frequently occurs with top entertainers, the star's efforts during his lifetime have continued to produce a steady stream of income, and, as always, the IRS wants its cut. So, while the estate is raking in hundreds of millions of dollars, it is also paying lots of taxes. Despite the size of the checks the IRS is receiving, however, the agency wants more.

There's Income Tax

First, there are income taxes, which are distinct from estate taxes.

Just as in the case of a living individual, the income collected by an estate is subject to income tax, and

Mr. Jackson's estate continues to generate considerable income. Although Mr. Jackson himself is deceased and is therefore not required to continue filing income tax returns, his *estate* is still required to file. These are *income* tax returns but filed by the *estate* because it is still collecting income. And that income is considerable.

Reports suggest that the Jackson Estate has collected hundreds of millions of dollars since the star's death. There was a \$60 million advance for the film *This Is It* and a new recording contract worth up to \$250 million. His estate reportedly collected \$170 million in 2011 and \$145 million in 2012. There are still two Jackson-themed Cirque du Soleil tours – *Michael Jackson One* in Las Vegas and the *Michael Jackson Immortal World Tour*.

Then There's the Estate Tax

Then, there are estate taxes. You might think that after collecting all that *income* tax, the IRS would not ask for more. But the IRS and Jackson's estate are locked in a Tax Court battle over estate taxes.¹ The IRS would like more than his estate reported on its federal estate tax return.

The IRS has valued Mr. Jackson's estate at more than \$1.1 billion and alleges that the executors significantly undervalued his property. The IRS claims that the Jackson Estate owes a whopping \$505.1 million in additional taxes and another \$196.9 million in penalties.² The penalties are based on the taxes due, so if the tax charge is struck down, the penalties will go with it. Currently, the federal estate tax law allows \$5.25 million per person to be passed on tax-free to their estate after death. But the year Jackson died, the exemption amount was only \$3.5 million.

For someone who died in 2009, assets in excess of that amount are taxed at up to 45%. Given the considerable upheaval in the estate tax law over the last few years,³ the Jackson Estate will pay a 45% rate once the valuation dispute is resolved, even though the current estate tax rate is 40%. If only Jackson had died in 2010 – like billionaires George Steinbrenner, Dan Duncan and Walter Shorenstein – when there was no federal estate tax at all.

Valuation

The estate tax is calculated based on the value of the estate as of the date of death. Alternatively, the estate can elect to value the assets six months after death, something known as the alternate valuation date. Executors will often determine which value is lower and report that lower figure, because the IRS gets a share based on the value of the estate.

And that brings us to valuation, the key in most estate tax disputes. Unlike income tax cases, where the amount of cash usually can't be disputed, estate tax cases are often about valuing something. Whether it is raw land, a mountain retreat, a conservation easement or a rare piece of art, valuation disputes can be maddening.

For estate tax purposes, only net value – assets minus liabilities – is subject to tax. If the estate includes an asset worth \$100 million but there is \$50 million of debt, only \$50 million is taxed. The presence and details of debts could be key variables for the Jackson Estate, because while Mr. Jackson reportedly had many high-value assets he had many large debts too.

The specific assets must be valued as well. Mr. Jackson owned a 50% share in a valuable Sony music catalogue, and he owned his own music catalogue, real estate and art. And don't forget Neverland Ranch. Although the law may presume that every piece of real estate is unique, it is usually possible to hash out the value of a property based on comparable parcels, possible development use, legal restrictions, etc. Neverland Ranch may be in an especially unique category, however, because it is so intimately tied up with Mr. Jackson's image. That makes its value harder to fix.

Valuing Intangibles

Above all else, the tax case between the Jackson Estate and the IRS is about the value of the singer's image, likeness and intellectual properties. The value of these rights accrues to the estate, but valuation swings for assets of that variety can be huge. To give you an idea of how wild the differences in perception of valuation can

be, the IRS is said to have valued the estate's rights to Mr. Jackson's image and likeness at \$434 million. In contrast, the estate reportedly listed these rights on the federal estate tax return as worth only \$2,105.

Are some celebrities worth more dead than alive? It sounds morbid, but perhaps. Mr. Jackson's recording sales and other income did seem to spike after his death. Of course, the IRS was entitled to income tax on the income generated post-death.

But is the IRS also entitled to *estate* taxes on the value of Mr. Jackson's image and likeness? The disturbing question presented by the Jackson case is the strange connection between streams of income that are subject to the income tax and the valuation of one's image and likeness. The latter could be subject to the estate tax, which seems like double dipping.

It is, of course, true that income and estate tax often work in tandem. If the decedent was the owner of an office building, the value of the building is subject to estate tax. Yet the rental income the building generates thereafter is subject to income tax too. It is this model the IRS seeks to exploit.

Even so, many estate planners note that it is unusual for the IRS to value a decedent's image and likeness in this way. Including Jackson's image and likeness as factors in his estate's value is not something on which everyone agrees. Add to that the fact that the government has argued for this so aggressively and you have a big fight.

The value of a celebrity's image and likeness does come up in some income tax cases. For example, it can play into the sourcing of sponsorship payments, which has landed some professional athletes in tax disputes. Even if a decedent's image and likeness rights are subject to estate tax, valuation is tough. And having major estate tax dollars hinge on such rights is something new.

Timing in valuation disputes is key. Assuming that the IRS is allowed to include these rights in the estate for tax purposes, the value on the date of death is colored by what we now know occurred. Mr. Jackson's sales and income rose. But was that predictable on the date of his death?

As frequently occurs in valuation disputes, both sides may have to compromise. Indeed, just as the IRS may have been overly aggressive with its pie in the sky \$434 million valuation, the estate may have been overly aggressive in pegging the value of the rights at \$2,105. Judges in tax cases – particularly in the U.S. Tax Court where the Jackson Estate case is pending – often complain to both parties that their valuation claims need to be reasonable.

Yet it can be hard to compromise with such polarized figures. Such valuation disputes often boil down to a battle of the experts with each side arguing for an aggressive number. In this case, the estate is sure to argue that the meteoric rise in Mr. Jackson's fortunes after his death could not have been foreseen.

Rights to receive future payments must be valued for federal estate tax purposes. Their value is the projected future worth (or the aggregate of the future payment stream) discounted to present value. Reminding us of David “Bowie Bonds,” the IRS asks what a third party would pay today for the right to receive those payments in the future.⁴

Often, such calculations can be figured based on average annual earnings. However, that is difficult if not impossible when the subject’s earnings have not followed a predictable path but instead have fluctuated wildly. And Mr. Jackson did have dramatic swings in earnings and productivity.

Mr. Jackson’s past legal and public relations challenges may actually materially help his tax case. At the time of his death, Mr. Jackson was said to be spending more than he was making. In 2006, the *New York Times* reported that Mr. Jackson had churned through hundreds of millions of dollars of loans and lines of credit.⁵ His album production was low and his music wasn’t selling in the fashion of *Thriller*.

Then there were the repeated negative impacts on his image and likeness. There were the sexual abuse charges, his physical appearance controversies, gaffes with his kids, and his Martin Bashir interview. There were drug abuse rumors, and more.

In short, Mr. Jackson’s star was falling, not rising. The value of his likeness and image was on the decline. His tax lawyers can be expected to exploit that history now, presumably with facts and figures.

For example, they may argue that the *This Is It* movie released after Mr. Jackson’s death was popular because of the star’s sad death, not in spite of it. His scheduled concert tour, in rehearsal at the time of his death, can be presented as – and probably was – a huge gamble. And even if it had succeeded, there are degrees of success.

Indeed, when one looks at the history and thinks like an odds-maker, it is conceivable that the market response to Mr. Jackson would have been tepid. In a dispute of this nature, all of that translates into dollars and cents. Placing a value on the star’s projected earnings may involve more art than science, but someone must do it if the estate is to be closed and the IRS is to be on its way.

As you would expect, the Jackson Estate employed an appraiser; the IRS has too. But this will be a legal battle as well as a battle of the appraisers. The estate can be expected to contend that Mr. Jackson’s earning power and the value of his brand was low as of the date of his death. His fortunes soared after his death, as reflected in the estate’s high earnings, on which it paid income tax. But that does not mean the estate was worth all of that money on the date of his death.

Valuation is subjective. Because estate tax matters so often hinge on valuation, there are special IRS penalties. If the estate is found to have misrepresented the value of items on the federal estate tax return, penalties could run as high as 40%. That only adds to the *Thriller*-sized dollars in question.

Taxes influence who gets what, or at least how much each beneficiary receives. In this case, clearly the IRS will collect, but the question is exactly how much. The beneficiaries of the estate include charities, Mr. Jackson’s mother Katherine, and his children. Notably, his father Joseph Jackson receives nothing. The senior Mr. Jackson did go to court in 2009 to challenge his son’s will, but lost.

It is too soon to say whether the IRS or the Jackson Estate will win. Most such disputes end up being settled via compromise. But with millions of dollars at stake and the treasure trove of assets, star power and gossip that will likely be exploited by the estate, I would put my money on the estate. Beat it, IRS. ■

1. See *Estate of Michael Jackson v. Comm’r* (017152-13 U.S. Tax Court).

2. See Patrick Temple-West, *U.S. Agency Says Michael Jackson Estate Owes \$702 Million in Taxes*, Reuters (Aug. 23, 2013).

3. See American Taxpayer Relief Act of 2012, P.L. 112-240, enacted on January 2, 2013.

4. Celebrity bonds, known as Bowie Bonds, are commercial debt securities issued by a holder of fame-based intellectual property rights to receive money up front from investors on behalf of the bond issuer and their celebrity clients in exchange for assigning investors the right to collect future royalty monies to the works covered by the intellectual property rights listed in the bond. They were pioneered in 1997 by rock and roll investment banker David Pullman. en.wikipedia.org/wiki/Celebrity_bond.

5. See Timothy L. O’Brien, *What Happened to the Fortune Michael Jackson Made?*, N.Y. Times (May 14, 2006).

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