

# Michael Jackson Tax Case is a Thriller

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Between sex abuse charges<sup>1</sup> and contract disputes over promotions and concerts,<sup>2</sup> Michael Jackson was no stranger to lawyers while he was alive. Now, even after his death, he is still keeping lawyers busy, producing a healthy stream of income and paying considerable taxes. Despite the size of the checks the IRS is receiving, however, the agency wants more.

Mr. Jackson died unexpectedly on June 25, 2009, at age 50.<sup>3</sup> As frequently occurs with top entertainers, the star's efforts during his lifetime have continued to produce a steady flow of income even after his death. As always, the IRS wants its cut. First, there are income taxes, which are distinct from estate taxes.

## Income and Estate Taxes

Mr. Jackson's estate continues to rake in 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.<sup>4</sup> 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*,"<sup>5</sup> and a new recording contract worth up to \$250 million.<sup>6</sup> His estate reportedly collected \$170 million in 2011<sup>7</sup> and \$145 million in 2012.<sup>8</sup> There are still two Jackson-themed Cirque du Soleil tours—*Michael Jackson One* in Las Vegas and the *Michael Jackson Immortal World Tour*.

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

are *estate* taxes. You might think that after collecting all that *income* tax, the IRS would not ask for more. But when the owner of an estate dies, the IRS taxes the deceased's right to transfer property to his or her heirs.<sup>9</sup>

The IRS and Jackson's estate are now locked in a Tax Court battle over estate taxes.<sup>10</sup> As with income taxes, an estate tax dispute starts with a tax return. And unlike income tax returns, where even high income returns stand a statistically small chance of being audited, estate tax returns are almost sure to be audited, especially if the numbers are remotely large.<sup>11</sup>

## Audit and Litigation

The Jackson estate is large, so an audit was inevitable. Not surprisingly, the IRS claims to be owed more than Jackson's estate reported on its federal estate tax return. The agency asserts that the Jackson estate owes a whopping \$505.1 million in additional taxes and another \$196.9 million in penalties.<sup>12</sup>

The penalties are based on the taxes due, so if the tax charge is struck down, the penalties go with it. Currently, the federal estate tax law allows \$5,340,000 per person to be passed tax-free to one's heirs.<sup>13</sup> But in 2009, the year Jackson died, the exemption amount was \$3,500,000.<sup>14</sup> The year of death controls which tax law applies.<sup>15</sup>

For someone who died in 2009, assets in excess of that amount are taxed at up to 45%.<sup>16</sup> Given the considerable upheaval in the estate tax law over the last few years,<sup>17</sup> the Jackson estate will pay a 45% rate once the valuation dispute is resolved, even though the current estate tax rate is 40%. Timing matters in other ways, too. If Jackson had died in 2010—like billionaires George Steinbrenner, Dan Duncan, and

Walter Shorenstein—there would be no federal estate tax whatsoever.<sup>18</sup>

### Valuing the Estate

The estate tax depends on the value of the estate as of the date of death.<sup>19</sup> Alternatively, the estate can elect to value the assets six months after death, something known as the alternate valuation date.<sup>20</sup> Executors often determine which value is lower and report that lower figure. But apart from the choice of which of these two dates produces the lower tax, 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 cannot be disputed, estate tax cases usually are 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.<sup>21</sup> If the estate includes an asset worth \$100,000,000 but there is \$50,000,000 of debt, only \$50,000,000 is taxed. The presence and details of debts could be key variables for the estate. Mr. Jackson reportedly had many high value assets but had many large debts too.

Beyond this fundamental rule about debts, specific assets must be valued, and that is a special problem here. Jackson owned a 50% share in a valuable Sony music catalogue, his own music catalogue, real estate, and art.<sup>22</sup> And don't forget Neverland Ranch, a sprawling amusement park-like estate located in Santa Barbara, where Jackson resided.<sup>23</sup> Axiomatically, the law presumes that every piece of real estate is unique.

Nevertheless, it is usually possible to hash out the value of real estate based on comparable parcels, possible development use, legal restrictions, and so on. 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.

### The Dispute

Above all else, though, 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 just defining the nature and legal status of such rights is not free from doubt. They may

not readily fall within the established intellectual property categories of copyright, patent, or trademark.

Even worse, valuation swings for assets of that variety can be substantial. For example, the IRS is said to have valued the estate's rights to Mr. Jackson's image and likeness at \$434,000,000. In contrast, the estate reportedly listed these rights on the federal estate tax return as worth only \$2,105.00.<sup>24</sup>

On February 7, 2014, court documents leaked to the LA Times revealed an additional valuation gap between the estate and the IRS.<sup>25</sup> Reportedly, Jackson's estate valued Jackson's total net worth at a little over \$7,000,000. The IRS, on the other hand, ballooned the value to \$1.125 *billion*. Apparently, the IRS is also claiming that the estate figure was so vastly undervalued that it will assess a gross valuation misstatement penalty. That is a special penalty that raises the existing valuation penalties from 20% to 40%.<sup>26</sup>

As frequently occurs in valuation disputes, both sides may have to compromise. Indeed, the IRS may have been overly aggressive with its pie in the sky \$1.125 billion for Jackson's net worth and \$434,000,000 for his likeness and image. Similarly, the estate may have been unreasonable in pegging the star's net worth as only \$7,000,000 and the value of the rights at \$2,105.00. 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 polarized figures. In estate tax cases, there are also multiple interested parties, including the beneficiaries of the estate.<sup>27</sup> They often have a big say in any deal that is struck. Such valuation disputes often boil down to a battle of the experts, each side arguing for an aggressive number.

In this case, the estate is certain 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.<sup>28</sup> Their value is the projected future worth (or the aggregate of the future payment stream) discounted to present value.<sup>29</sup>

Readers may remember David Bowie and Bowie Bonds<sup>30</sup>—asset-backed securities issued by the musician that used current and future revenue from recordings made before 1990 as collateral. Bowie may have been the first, but other musicians since have followed his lead.

Such financial moves may actually help the IRS's case here, for the IRS also asks what a third party would pay today for the right to receive those payments in the future.

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. Curiously, Mr. Jackson did have dramatic swings in his earnings and productivity, and that seems certain to help the estate's case that much of his post-death success could not have been predicted as of his date of death.

### Personal and Business Conduct

Mr. Jackson's past legal and public relations challenges may materially help his tax case too. At the time of his death, Mr. Jackson was said to be spending more money 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.<sup>31</sup> His album production was low and his recordings were not selling in the fashion of *'Beat It'* and *'Thriller.'*

There were also repeated negative impacts to his image and likeness, including sexual abuse charges, his physical appearance controversies, gaffes with his kids, and his inflammatory Martin Bashir interview.<sup>32</sup> There were also persistent drug abuse rumors, and more.

In short, Mr. Jackson's star was fading, 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, figures, charts, graphs, and economic experts.

As one 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 viewed 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 Mr. Jackson's history and tries to think 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 it must be done if the estate is to be closed and the IRS is to be appeased.

As you would expect, the Jackson estate employed an appraiser to value the Jackson assets, and the IRS has one too. As such, 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 were 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 later success does not mean the estate was worth that same amount of money on the date of his death.

Of course, 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 at stake.

### Concluding Thoughts

It is too soon to say whether the IRS or the Jackson estate will win. Most such disputes end up being compromised. But with the dollars at stake and the treasure trove of assets, star power, and gossip that will likely be exploited by the estate, it is this author's opinion that the estate stands in favor. And this author bets that the Jackson estate's advisers want to say "Beat it, IRS."

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- 1 *Michael Jackson Formally Charged in Molestation Case*, CNN, Dec. 19, 2003, <http://edition.cnn.com/2003/LAW/12/18/jackson.case/>.
  - 2 Roger Friedman, *Jackson May Lose Out in Promoter Dispute*, FOXNEWS.COM, Oct. 11, 2005, <http://www.foxnews.com/story/2005/10/11/jackson-may-lose-out-in-promoter-dispute/>.
  - 3 Brooks Barnes, *A Star Idolized and Haunted, Michael Jackson Dies at 50*, N.Y. TIMES, June 25, 2009, available at [http://www.nytimes.com/2009/06/26/arts/music/26jackson.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2009/06/26/arts/music/26jackson.html?pagewanted=all&_r=0).
  - 4 See I.R.C. § 641 (2011).
  - 5 Bryan Alexander, *Michael Jackson Concert Film Due in October*, TIME, Aug. 11, 2009, available at <http://content.time.com/time/arts/article/0,8599,1915682,00.html>.
  - 6 Ethan Smith, *Sony Places Big Bet on a Fallen 'King,'* W. ST. J., Mar. 16, 2012, available at <http://online.wsj.com/news/articles/SB10001424052748704588404575124023860735864>.
  - 7 Dorothy Pomerantz, *The Top-Earning Dead Celebrities*, FORBES, Oct. 25, 2011, available at [http://www.forbes.com/special-report/2011/dead-celebs-11\\_land.html](http://www.forbes.com/special-report/2011/dead-celebs-11_land.html).
  - 8 Dorothy Pomerantz, *Top-Earning Dead Celebrities 2012*, FORBES, Oct. 24, 2012, available at <http://www.forbes.com/pictures/mfl45mell/michael-jackson/>.

- 9 See I.R.C. § 2001 (2011).
- 10 See *Estate of Michael Jackson v. Comm’r*, No. 017152-13 (T.C. filed July 26, 2013).
- 11 See 2012 INTERNAL REVENUE SERVICE DATA BOOK, IRS, 2012, 22 (2012), available at <http://www.irs.gov/pub/irs-soi/12databk.pdf>. Of 12,582 estate tax returns filed in tax year 2011, 29.9% were audited. In contrast, individual tax returns had a 1% audit rate in 2011. Estate tax returns with assets of \$5,000,000-\$10,000,000 saw a 58.6% audit rate, while assets of \$10,000,000 or more had an effective 116% audit rate in 2011.
- 12 See Patrick Temple-West, *U.S. Agency says Michael Jackson Estate Owes \$702 Million in Taxes*, REUTERS, Aug. 23, 2013, available at <http://www.reuters.com/article/2013/08/23/entertainment-us-usa-tax-jackson-idUSBRE97M0YN20130823>.
- 13 I.R.C. § 2010(c)(3); Rev. Proc. 2013-35.
- 14 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 521, 115 Stat. 71 (2001).
- 15 I.R.C. § 2001(b)(2).
- 16 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 511, 115 Stat. 70 (2001).
- 17 See American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 (2013). The act was pivotal in averting the so-called “fiscal cliff” crisis that occurred in late 2012. Had Congress not passed the bill, the 2013 estate tax rate and applicable exclusion amount would have reverted to their respective levels before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax rate in 2013 would have soared to 55%, while the applicable exclusion would have plummeted to \$1,000,000. The American Taxpayer Relief Act of 2012 extended the 2001 reforms and ensured more reasonable rates and exemptions.
- 18 I.R.S. Notice 2011-66 (I.R.B.) (Aug. 5, 2011).
- 19 I.R.C. § 2031(a) (2011).
- 20 I.R.C. § 2032 (2011).
- 21 I.R.C. § 2053 (2011).
- 22 Zack O’Malley Greenburg, *Michael Jackson’s \$400 Million Afterlife*, FORBES, June 29, 2011, available at <http://www.forbes.com/sites/zackomalleygreenburg/2011/06/29/michael-jacksons-400-million-afterlife/>.
- 23 Carrie Melago, *Michael Jackson’s Neverland, His Own ‘Oz’ and Place To Reclaim Lost Childhood*, N.Y. DAILY NEWS, June 26, 2009, available at <http://www.nydailynews.com/entertainment/michael-jackson-neverland-oz-place-reclaim-lost-childhood-article-1.375639>. Michael Jackson once stated that coming to his Neverland Ranch was “like stepping into Oz.” The ranch featured two fully functioning train stations, a Ferris wheel, a roller coaster, and a super slide, among many other attractions.
- 24 Steve James and Randee Dawn, *What’s Michael Jackson’s image worth? A \$434 million question for the IRS*, NBC NEWS, Aug. 27, 2013, <http://www.nbcnews.com/entertainment/whats-michael-jacksons-image-worth-434-million-question-irs-8C11010436>.
- 25 Jeff Gottlieb, *Michael Jackson estate embroiled in tax fight with IRS*, L.A. TIMES, Feb. 7, 2014, <http://articles.latimes.com/2014/feb/07/local/la-me-jackson-taxes-20140208>.
- 26 Under § 6662(g)(1), an estate that undervalues its property as 65% or less of the property’s actual amount is subject to the substantial estate tax valuation understatement penalty. The Jackson estate’s valuation of Jackson’s net worth is 0.6% of what the IRS is claiming is the correct amount. The substantial estate tax valuation understatement penalty is defined by § 6662(h)(1) to be 40%, as opposed to the standard § 6662(a) 20% underpayment of tax penalty.
- 27 The beneficiaries of the estate include charities, Mr. Jackson’s mother, Katherine, and his children. Notably, his father, Joseph Jackson, receives nothing. See Jackson, Michael, *Last Will of Michael Joseph Jackson*, July 2, 2002, [http://hosted.ap.org/specials/interactives/\\_documents/jackson\\_will.pdf](http://hosted.ap.org/specials/interactives/_documents/jackson_will.pdf) (last visted May 5, 2014). The senior Mr. Jackson did go to court in 2009 to challenge his son’s will, but lost. See Judge: *Joe Jackson can’t challenge will executors*, USA TODAY, Nov. 10 2009, available at [http://usatoday.com/life/people/2009-11-10-jackson-father-will\\_N.htm](http://usatoday.com/life/people/2009-11-10-jackson-father-will_N.htm).
- 28 I.R.C. § 2039 (2011).
- 29 *Id.*
- 30 *Bowie Sells Himself On Wall Street*, MTV, Feb. 12, 1997, <http://www.mtv.com/news/articles/1426433/bowie-sells-himself-on-wall-street.jhtml>.
- 31 See Timothy L. O’Brien, *What Happened to the Fortune Michael Jackson Made?*, N.Y. TIMES, May 14, 2006, available at [http://www.nytimes.com/2006/05/14/business/yourmoney/14michael.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2006/05/14/business/yourmoney/14michael.html?pagewanted=all&_r=0).
- 32 See Tania Branigan, *I was Betrayed by Bashir; Rages Jackson*, THE GUARDIAN, Feb. 6, 2003, available at <http://www.theguardian.com/news/2003/feb/07/uknews>. In the 2003 interview with Martin Bashir, Michael Jackson openly states that he allowed children to sleep in the same bed as him.