2018 FEDERAL TAX UPDATE

Recent Developments in Federal Income, Estate and Gift Taxes Affecting Individuals and Small Businesses

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses using the timeframe of August, 2017, through November, 2018. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

Most of the content for Part I of these materials (an overview of the so-called Tax Cuts and Jobs Act) is adapted from Samuel A. Donaldson, *Understanding the Tax Cuts and Jobs Act* (January 3, 2018), available at SSRN: https://ssrn.com/abstract=3096078.

I. THE "TAX CUTS AND JOBS ACT" OF 2017 AND POST-ENACTMENT GUIDANCE

A. INTRODUCTION AND THE PATH TO ENACTMENT

Signed by President Trump on December 22, 2017, Public Law 115-97, formally titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" but commonly known as the "Tax Cuts and Jobs Act," represents the most dramatic change to the Internal Revenue Code since passage of the Tax Reform Act of 1986.

Whereas the Tax Reform Act of 1986 was the product of years of bipartisan negotiation, the Tax Cuts and Jobs Act was the product of a deeply partisan and largely closed-door process. Early in 2017, Senate leadership indicated it would not seek to produce "permanent" legislation with bipartisan support. To prevent a Democratic filibuster, Senate procedural rules generally required that tax legislation be revenue-neutral over a ten-year timeframe. That led observers to believe any tax reform would "sunset" after ten years, as was the case with the Economic Growth and Tax Relief Reconciliation Act of 2001. But achieving long-standing tax reform goals proved to be a costly endeavor, even with the potential of a sunset. When it became clear that the hoped-for package of tax cuts would generate a considerable deficit over the next ten years, leadership in both houses scrambled to get the votes required to pass budget resolutions

that permit a cumulative ten-year deficit did not exceed $1.5 trillion. Passage of those resolutions late in October, 2017, soon led to the introduction of legislation.

The House Ways and Means Committee publicly unveiled its bill (H.R. 1, The Tax Cuts and Jobs Act) on November 2, 2017. Prior to that date, there were only three documents offering any suggestion of what the bill would contain. The first was the Republican blueprint for tax reform, published on June 24, 2016, with the title "A Better Way: Our Vision for a Confident America." Though not quite a "contract with America," the 35-page blueprint outlined how Republicans would seek to reform the Internal Revenue Code in the names of fairness and simplicity. It proposed three income tax brackets for individuals (12 percent, 25 percent, and 33 percent), complete repeal of the alternative minimum tax, "postcard filing," elimination of all itemized deductions except for mortgage interest and charitable contributions, and repeal of the estate and generation-skipping transfer taxes.

The second document was a one-page bullet-point memorandum from the White House issued on April 26, 2017. Given its "length" it is not surprising that the memo was short on detail. It generally agreed with the Republican blueprint but also spoke of a "15% business tax rate," a "one-time tax on trillions of dollars held overseas," and the need to "eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers."

The third document was the Unified Framework for Fixing Our Broken Tax Code, a nine-page memorandum issued on September 27, 2017, by a conglomerate of White House and Congressional leaders. It contained details on three fundamental themes of tax reform (tax relief and simplification for families, competitiveness and growth for job creators, and global competitiveness), but little in the way of specifics as to how those details would be implemented. Like the blueprint and the White House memo, the Framework called for substantially larger standard deduction, a reduction in the number of tax brackets (with a top rate of either 35 percent or 39.6 percent), a larger child tax credit, and the elimination of all itemized deductions except for mortgage interest and charitable contributions. But other themes were explained much more cryptically. Consider this language from the Framework under the heading of "Other Provisions Affecting Individuals," reproduced in its entirety:

> Numerous other exemptions, deductions and credits for individuals riddle the tax code. The framework envisions the repeal of many of these provisions to make the system simpler and fairer for all families and individuals, and allow for lower tax rates.

With only this much background to go on, tax professionals were anxious to see how the House bill exactly implemented these ideas. As it turned out, the House bill was consistent with the broad themes of the Republican blueprint, the White House memo, and the Unified Framework, but it also contained a number of surprises, especially regarding itemized deductions and the treatment of certain exclusions. A "chairman's mark" from the Senate Finance Committee indicated that while Senate leadership was largely on board with the House

bill, it would take a much different approach on key issues. The House bill passed on November 16, 2017, by a vote of 227 - 205, shifting the spotlight to the Senate.

The Senate bill retained the general themes of the House bill with one important exception: it also included repeal of the individual mandate imposed by the Patient Protection and Affordable Care Act. House leadership questioned whether linking tax reform with continued efforts to strip away “Obamacare” would delay a vote or, even worse, jeopardize the entire endeavor. But the Senate passed by its bill on December 2, 2017, with a 51-49 vote, despite vehement objection from Democrats that the final version of the bill was made available only hours before the vote.

As expected, the House and Senate bills were different, so a Conference Committee bill was required. Generally speaking the House bill was more ambitious in its scope, but the very narrow majority margin in the Senate essentially ensured that the resulting Conference Committee bill would hew more closely to the Senate version.

The 503-page Conference Committee bill was accompanied by a 560-page Joint Explanatory Statement of the Committee of Conference, herein cited as the “Conference Report.” The final legislation, passed on December 20, 2017, contained just a few small differences from the Conference Committee bill. Preliminary estimates from the Joint Committee on Taxation indicate that the ten-year cumulative deficit incurred to implement the Act’s changes will be approximately $1.5 trillion, just within the margin approved by Congress in its budget packages.

B. INDIVIDUAL INCOME TAX REFORM

1. Individual Ordinary Income Tax Brackets

Originally, Republican leadership sought to reduce both the number of individual income tax brackets and the tax rates. Under prior law, seven tax brackets ranging from 10% to 39.6% applied to an individual taxpayer’s ordinary income. The Blueprint for Tax Reform pushed for three brackets of 12%, 25%, and 33%. But by the time of the Unified Framework, that position changed to brackets of 12%, 25%, and 35%, with the possible retention of the 39.6% bracket.

Ultimately, the Act preserved the seven-bracket regime, though it reduced the rates in the top six brackets and widened the sizes of the top four brackets. The Joint Committee on Taxation estimates the ten-year cost of reducing the individual income tax brackets to be $1.21 trillion. Estimated Budget Effects of the Conference Agreement for H.R. 1, The “Tax Cuts and Jobs Act” (December 17, 2017) (hereafter, “Estimated Budget”) at 1. The Act also cut the number of tax brackets applicable to trusts and estates from five to four, but it retained the super-thin lower brackets. The following chart offers a visual comparison of pre- and post-Act tax brackets for 2018:

Federal Income Tax Brackets for Individuals, Estates, and Trusts – ORDINARY INCOME

PRE-TAX CUTS AND JOBS ACT*				POST-TAX CUTS AND JOBS ACT (THROUGH 2025)			
2018 Taxable Income Exceeding				2018 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Rate	Single	Married	Trusts and Estates	Rate
$0	$0		10%	$0	$0	$0	10%
$9,525	$19,050	$0	15%	$9,525	$19,050		12%
$38,700	$77,400	$2,600	25%	$38,700	$77,400		22%
$93,700	$156,150	$6,100	28%	$82,500	$165,000	$2,550	24%
$195,450	$237,950	$9,300	33%	$157,500	$315,000		32%
$424,950	$424,950		35%	$200,000	$400,000	$9,150	35%
$426,700	$480,050	$12,700	39.6%	$500,000	$600,000	$12,500	37%

* From Revenue Procedure 2017-58, issued October 19, 2017.

On November 15, 2018, Treasury issued the inflation-adjusted federal income tax brackets for 2019 in *Revenue Procedure 2018-57*. Here are the ordinary income tax brackets for 2019:

2019 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Rate
$0	$0	$0	10%
$9,700	$19,400		12%
$39,475	$78,950		22%
$84,200	$168,400	$2,600	24%
$160,725	$321,450		32%
$204,100	$408,200	$9,300	35%
$510,300	$612,350	$12,750	37%

2. Individual Adjusted Net Capital Gain and Dividend Income Tax Brackets

Neither the House bill nor the Senate bill intended any changes to the federal taxation of adjusted net capital gain or qualified dividend income. Thus, the three brackets for capital gain and dividend income (0%, 15%, and 20%) remain. Curiously, however, the Act made very slight modifications to the bracket ceilings, as shown in the next chart.

The chart also shows that the Act made no changes to §1411, the 3.8-percent surcharge on net investment income applicable to individuals with adjusted gross incomes above a stated (and still fixed) threshold and to estates and trusts in the highest tax bracket.

Federal Income Tax Brackets for Individuals, Estates, & Trusts – CAPITAL GAINS & DIVIDENDS

Pre-Tax Cuts and Jobs Act*				Post-Tax Cuts and Jobs Act (through 2025)			
2018 Taxable Income Exceeding				2018 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Cap Gain Rate	Single	Married	Trusts and Estates	Cap Gain Rate
$0	$0	$0	0%	$0	$0	$0	0%
$38,700	$77,400	$2,600	15%	$38,600	$77,200	$2,600	15%
AGI > $200,000	AGI > $250,000		18.8%	AGI > $200,000	AGI > $250,000		18.8%
$426,700	$480,050	$12,700	23.8%	$425,800	$479,000	$12,700	23.8%

* From Revenue Procedure 2017-58, issued October 19, 2017.

Revenue Procedure 2018-57 sets forth the following tax brackets for 2019:

2019 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Cap Gain Rate
$0	$0	$0	0%
$39,375	$78,750	$2,650	15%
AGI > $200,000	AGI > $250,000		18.8%
$434,550	$488,850	$12,950	23.8%

3. Zero-Bracket Provisions: Standard Deduction, Personal Exemption, and Child Tax Credit

Prior law achieved a so-called "zero-bracket" through the trinity of the standard deduction, the deduction for personal and dependency exemptions, and the child tax credit. In an effort to simplify this regime, the Act repeals the deduction for personal and dependency exemptions and embiggens both the standard deduction and the child tax credit. All of the modifications set forth here expire at the end of 2025.

Standard Deduction. The Act substantially increases the amount of the standard deduction, as shown in the following table:

2018 Standard Deduction Pre-Tax Cuts and Jobs Act	**Filing Status**	2018 Standard Deduction Post-Tax Cuts and Jobs Act
$13,000	**Married Filing Jointly**	$24,000
$9,550	**Head of Household**	$18,000
$6,500	**Unmarried**	$12,000
$6,500	**Married Filing Separately**	$12,000

The Act makes no changes to the inflation-adjusted additional standard deduction amount available to blind taxpayers and those age 65 and over. Thus, for 2018, the additional standard deduction amount for "the aged or the blind" is $1,300, or $1,600 if the taxpayer is also unmarried and not a surviving spouse. The estimated foregone revenue over a ten-year period attributable to the increased standard deduction is $720.4 billion. Estimated Budget at 1.

Under *Revenue Procedure 2018-57*, issued November 15, 2018, the standard deduction amounts for 2019 are as follows:

Filing Status	2019 Standard Deduction
Married Filing Jointly	$24,400
Head of Household	$18,350
Unmarried	$12,200
Married Filing Separately	$12,200

For 2019, the additional standard deduction amount for "the aged or the blind" is still $1,300, but $1,650 if the taxpayer is also unmarried and not a surviving spouse.

Personal and Dependency Exemptions. Under prior law, a taxpayer could claim a personal exemption deduction of $2,000, though this amount was adjusted for inflation (the 2018 inflation-adjusted exemption was set to be $4,150). Married coupled filing jointly could claim two exemptions. In addition, a taxpayer could claim an exemption deduction for each of the taxpayer's dependents, generally defined as either "qualifying children" or "qualifying relatives." Thus, for example, a married couple with two qualifying children could claim four personal exemptions on their joint return, a total deduction that would have been $16,600 in 2018. But if the couple's adjusted gross income exceeded an inflation-adjusted threshold amount (what was to be $320,000 in 2018), the amount of the deduction would be gradually reduced (reaching zero if the couple's 2018 adjusted gross income was $442,000 or more).

The Act effectively repeals the deduction for personal and dependency exemptions for the years 2018 through 2025 by reducing the exemption amount in those years to zero. The Act expressly retains the regular personal exemption for so-called "qualified disability trusts," and the nominal personal exemptions currently in play for estates ($600) and trusts ($100 or $300, depending on whether the trust is required to distribute its income) also survive. The Joint Committee on Taxation projects that repealing the personal exemptions will generate over $1.21 trillion in revenue between 2018 and 2026. Estimated Budget at 1.

Child Tax Credit. The Act generally doubles the amount of the child tax credit and even adds a temporary (smaller) credit for dependents that are not qualifying children of the taxpayer. It also makes the credit more available to upper-middle-class taxpayers by increasing the thresholds before the phaseout begins. It also increases the refundable portion of the credit. The following table summarizes these changes:

Child Credit Feature	Pre-Tax Cuts and Jobs Act	Post-Tax Cuts and Jobs Act
Credit Amount	$1,000 per child	$2,000 per child $500 per other dependent
Phaseout Begins When AGI Exceeds… Unmarried & Head of House Joint Filers	 $75,000 $110,000	 $200,000 $400,000
Phaseout Complete When AGI Hits… Unmarried & Head of House Joint Filers	 $95,000 $130,000	 $240,000 $440,000
Refundable Portion	15% of earned income in excess of $3,000	15% of earned income in excess of $2,500, not to exceed $1,400 per child (as adjusted for inflation)

The estimated revenue loss from modifying the amount of the child tax credit is $573.4 billion over ten years. Estimated Budget at 1. The Act also provides that in order to claim the credit for a qualifying child, the taxpayer must include the child's social security number on the return. That provision is estimated to generate $29.8 billion in revenue over ten years. Estimated Budget at 1.

4. Tax Treatment of Education Expenses

a. Section 529 Plan Withdrawals for Elementary and Secondary Schooling: Distributions from "qualified tuition programs" (more popularly, "§529 plans") are not included in gross income if used to pay for "qualified higher education expenses." The Act now defines "qualified higher education expenses" to include tuition expenses at "an elementary or secondary public, private, or religious school." Importantly, the maximum amount that may be distributed tax-free for elementary and secondary school tuition or for homeschooling expenses is $10,000 per child (not $10,000 per account); distributions in excess of that amount will be taxable under the normal rules of §529. The projected revenue cost of this measure is $500 million over ten years. Estimated Budget at 3.

b. Exclusion for Discharge of Student Loan Debt at Death: New §108(f)(5) generally excludes from gross income the cancellation of a student loan on account of the student's death or total disability if such cancellation occurs after 2017 and before 2026. The new provision is expected to cost about $100 million in foregone revenue over ten years. Estimated Budget at 3.

c. New Rollovers Between §529 Plans and ABLE Accounts: The Act permits amounts from qualified tuition plans to be rolled over to an ABLE account without penalty, so long as the ABLE account is owned either by the qualified tuition plan's designated beneficiary or his or her spouse, descendant, sibling, ancestor, stepparent, niece, nephew, aunt,

uncle, first cousin, or in-law. Any amounts rolled over from a qualified tuition plan count toward the overall limit on amounts that can be contributed annually to an ABLE account. Any rolled-over amount in excess of the contribution limit will be treated as ordinary income to the distributee. Such penalty-free rollovers will be in effect through 2025. The estimated revenue loss from this new rule is expected to be less than $50 million. Estimated Budget at 3. For more on the contribution limit and ABLE accounts generally, see the material below under "Other Individual Income Tax Items of Note."

d. New Excise Tax on Certain Private Colleges and Universities: Although this particular reform does not directly affect individuals, it affects college education and is thus included here. Starting in 2018, private colleges and universities may pay an excise tax equal to 1.4 percent of the school's net investment income, but the excise tax only applies to tax-exempt private schools with: (1) at least 500 tuition-paying full-time equivalent students (more than half of whom are located in the United States); and (2) aggregate endowments of at least $500,000 per student. The expected revenue gain from this new tax is $1.8 billion over ten years. Estimated Budget at 5. The Act asks the Treasury to issue regulations describing which assets are used directly in carrying out the school's exempt purpose and thus are exempt from the tax. Regulations are also to explain the computation of net investment income, though the statute says generally that rules relating to the net investment income of a private foundation will apply for this purpose.

5. Other Exclusions and Deductions Applicable to Individuals

a. Overall Limit on Itemized Deductions Suspended: Section 68 generally reduces the amount of otherwise allowable itemized deductions once a taxpayer's adjusted gross income exceeds a certain inflation-adjusted threshold. (That threshold, for example, was set to be $320,000 for married couples and $266,700 for unmarried individuals in 2018.) For taxpayers with very high adjusted gross incomes, up to 80 percent of itemized deductions could be lost under this rule. Through new §68(f), the Act suspends the application of this phaseout for the years 2018 through 2025.

b. Home Mortgage Interest Deduction Modified: Under prior law, a taxpayer could deduct "qualified residence interest," generally defined as the interest paid on either "acquisition indebtedness" or "home equity indebtedness." Acquisition indebtedness is debt incurred to buy, build, or improve either the taxpayer's principal residence or one other residence selected by the taxpayer (a taxpayer thus cannot have acquisition debt on three or more homes), provided the subject home secures the debt. Home equity indebtedness is any other debt secured by the residence, regardless of how the loan proceeds are used by the taxpayer. Prior law limited the amount of acquisition indebtedness to $1 million (half that amount for a married individual filing separately) and the amount of home equity debt to $100,000. Thus, for example, if an unmarried taxpayer borrowed $1.5 million to purchase the taxpayer's only home and gave the lender a mortgage on the home, the taxpayer could deduct 11/15 of the interest paid to the lender ($1 million of the $1.5 million loan is acquisition debt and another $100,000 of the loan qualified as home equity debt).

For 2018 through 2025, the Act limits the amount of acquisition debt to $750,000 ($375,000 for a married individual filing separately) and suspends entirely any deduction for home equity debt. In the above example, then, the taxpayer can only deduct half of the interest paid to the lender ($750,000 of the $1.5 million loan is acquisition debt and none of it qualifies as home equity debt).

Importantly, the new limit on acquisition debt only applies to **debt incurred after December 15, 2017**; preexisting acquisition debt is subject to the original $1 million cap. The Act also applies the $1 million acquisition debt cap to taxpayers who made a binding contract before December 15, 2017, to close on the purchase of a principal residence before 2018 and who actually purchase such residence by the end of March, 2018. There is no similar exception for home equity debt—the deduction for interest on home equity debt is suspended regardless of when such debt was incurred.

c. Deduction for State and Local Taxes Unrelated to a Business Modified: Prior law allowed a taxpayer to deduct state and local property tax as well as either state and local income or sales taxes (as well as foreign real property taxes) without limitation. For example, if a taxpayer in 2017 paid local real property tax of $5,000 in connection with the taxpayer's personal residence, state income tax of $10,000, and state sales tax of $13,000 on personal costs, the taxpayer can deduct a total of $18,000 (the $5,000 in real property tax and the sales tax of $13,000, since that amount is larger than the $10,000 of state income tax).

For 2018 through 2025, the Act limits the total deduction a taxpayer can claim for state and local taxes unrelated to the taxpayer's trade or business or other profit-seeking activity to $10,000, and the deduction for foreign real property taxes on property unrelated to a business or investment activity is repealed entirely. In the example above, then, if the same taxes were paid in 2018 the total deduction would be limited to $10,000. If, on the other hand, the real property taxes were paid in connection with investment property, the total deduction would be $15,000 ($10,000 in state income or sales tax plus the $5,000 in real property taxes since the real property taxes are incurred in connection with a profit-seeking activity).

The $10,000 limit on personal state and local taxes is reduced to $5,000 in the case of a married individual filing a separate return. It seems odd that the limit is the same for joint filers and unmarried individuals (whether filing as head of household or not), but the separate figure for married individuals filing separately clearly signals this is the case.

In July, 2018, four states (New York, Connecticut, Maryland and New Jersey) filed a lawsuit in a New York federal district court against the United States, claiming the $10,000 limit unconstitutionally intrudes on state sovereignty. The suit claims the limit "will depress home prices, spending, job growth and economic growth, and impede their ability to pay for essential services such as schools, hospitals, police, and road and bridge construction and maintenance."

The lawsuit comes on the heels of other attempts to circumvent the cap through procedures like allowing taxpayers to treat state and local tax payments as charitable contributions. In *Notice 2018-54* (issued on May 23, 2018), Treasury announced forthcoming proposed regulations "addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations. The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments."

Some practitioners have suggested placing personal residences into a limited liability company and then transfer the LLC interests into one or more trusts taxed as separate entities. Each such trust can then claim up to $10,000 in state and local real property taxes. Those contemplating this strategy should consider the possible application of the new proposed Regulation §1.643(f)-1 (discussed in the context of §199A below). The proposed regulation provides that where two or more trusts have substantially the same grantor(s) and substantially the same primary beneficiary or beneficiaries, the trusts will be treated as a single trust for federal income tax proposes if a principal purpose of the establishing multiple trusts is the avoidance of federal income tax. There are other potential hurdles to consider, including the federal income tax consequences from a sale of the residences, the need to stuff income-producing assets into the LLC to offset the claimed deductions, and the need for consent from banks on the transfer of mortgaged property.

d. Deduction for Charitable Contributions Modified: The Act increases the deduction limit for cash contributions to charitable organizations. Under prior law, a taxpayer could not deduct more than 50 percent of the taxpayer's "contribution base" (in most cases, an amount equal to the taxpayer's adjusted gross income) for cash contributions. Thus, for example, if a taxpayer donated $100,000 cash to a qualified charitable organization in a year in which the taxpayer's contribution base was $150,000, the taxpayer could deduct only $75,000 of the contribution in the year of donation. The remaining $25,000 would carry over to the next year as though the cash contribution was made in that year.

Under the Act, §170(b)(1)(G) now provides that for **cash donations** made from January 1, 2018, through December 31, 2025, the applicable limit is **60 percent of the donor's contribution base**. In the prior example, then, the taxpayer could deduct $90,000 of the $100,000 cash contribution under the new rule, with only $10,000 carrying over to the next year. Further, cash contributions are deemed to happen before all other contributions, maximizing the chance of their deduction.

The Act also **repeals the deduction for 80 percent of payments to an institution of higher education in exchange for the right to purchase seats at athletic events**. Accordingly, such

payments are deductible only to the extent the amount paid exceeds the value of the consideration received (the season tickets).

Finally, the Act **repeals §170(f)(8)(D)**, which permitted an exception to the requirement that a taxpayer receive a contemporaneous written acknowledgement from the charity in order to claim a charitable contribution deduction in some cases. The exception contemplated that the Service would promulgate a form by which a charity could provide a substitute for the written acknowledgement, but the Service never did so. (Well, it issued proposed regulations in October of 2015 that it promptly withdrew in January of 2016.) In a couple of Tax Court cases from 2017, taxpayers learned that until Treasury produced such a form, the exception was dormant. Apparently, Congress held little hope that a form would ever be forthcoming, so it simply killed the exception.

The Joint Committee on Taxation estimates the cumulative revenue gain from repealing the overall limit on itemized deductions, limiting the home mortgage interest deduction, limiting the deduction of state and local taxes, and reforming the charitable contribution deduction will be over $668.4 billion between 2018 and 2026. Estimated Budget at 2.

e. Deduction for Medical Expenses Modified: Prior to 2013, individuals could deduct unreimbursed medical expenses to the extent they exceeded 7.5 percent of adjusted gross income. Part of the Patient Protection and Affordable Care Act increased the deduction threshold from 7.5 percent of adjusted gross income to 10 percent of adjusted gross income, but the 7.5-percent threshold still applied to taxpayers age 65 and over through 2016. For alternative minimum tax purposes, however, all taxpayers were subject to the 10 percent threshold as of 2013.

While the House bill originally called for the complete repeal of the deduction for medical expenses, the Senate version both saved the deduction and made it more attractive. Under the Act, the threshold for deducting medical expenses is 7.5 percent of adjusted gross income for all taxpayers, regardless of age. But this new rule (actually, a return to the old rule) applies for **2017 and 2018 only**. Still, the Joint Committee on Taxation expects that Congress will lose $5.2 billion in revenue over this two-year period. Estimated Budget at 2. The Act also provides that the medical expense deduction threshold for alternative minimum tax purposes during these years is also 7.5 percent.

f. Deduction for (and Inclusion of) Alimony Payments Repealed: Prior law provided that the recipient of certain "alimony" payments had to include those payments in gross income. Likewise, individuals making those payments could deduct them in determining adjusted gross income. The Act permanently repeals the deduction for alimony payments and likewise repeals the rules related to inclusion of such payments in gross income, effective for any divorce or separation instrument **executed after 2018** or for any divorce or separation instrument **modified after 2018 where the modification expressly provides that the new law is to apply**. In effect, then, we return to the pre-statute common law, which provided that payments between ex-spouses were neither income to the recipient nor deductible by the

payor. In most cases, not surprisingly, the payor of alimony is in a higher tax bracket than the payee. Repealing both the deduction and the inclusion requirement is thus not revenue-neutral; the new regime is expected to generate $6.9 billion in additional revenue over the next ten years. Estimated Budget at 3.

Prior law (§682) also provided that where a payor ex-spouse established a trust to make alimony payments to a recipient ex-spouse, the recipient ex-spouse (and not the payor ex-spouse) would be taxed on the trust's income. The Act repeals this provision effective for trusts established under divorce and separation instruments executed after 2018. In *Notice 2018-37* (issued April 13, 2018), Treasury announced it will issue regulations providing that §682 will continue to apply to trust income payable to a recipient ex-spouse who was divorced or legally separated under a divorce or separation instrument executed on or before December 31, 2018, unless the instrument is modified after that date and the modification expressly provides that the new law is to apply.

g. Deduction for Personal Casualty and Theft Losses Limited: Prior law permitted individuals to deduct losses unrelated to a business or investment activity when such losses arose from fire, storm, shipwreck, or other casualty, or from theft, but only to the extent any such loss exceeded $100 and only to the extent the net personal casualty loss for the year exceeded 10 percent of an individual's adjusted gross income. Under the Act, such losses are deductible in 2018 through 2025 only if they are attributable to Presidentially-declared disasters under §401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

h. Deduction for Moving Expenses Suspended: Subject to certain requirements related to the distance moved and the amount of work time spent at the new location, §217 generally permits a deduction for moving expenses (costs of moving household goods plus traveling expenses except meals) paid or incurred during the taxable year in connection with starting work as an employee or as a self-employed individual at a new principal place of work. New §217(k) suspends the deduction from 2018 through 2025, except in the case of members of the United States Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. The measure is expected to add $7.6 billion in revenue during the suspension period. Estimated Budget at 2.

i. Suspension of Miscellaneous Itemized Deductions: Prior law allowed an individual to deduct "miscellaneous itemized deductions" to the extent that they, in the aggregate, exceeded 2 percent of the individual's adjusted gross income. Section 67 defines a "miscellaneous itemized deduction" as any itemized deduction other than one listed in §67(b). Common examples of miscellaneous itemized deductions include safe deposit box rentals for storing investment assets, net hobby expenses, fees paid for appraisals in connection with casualty loss and charitable contribution deductions, fees paid to accountants and attorneys for tax advice and tax return preparation, and the unreimbursed business expenses of an employee. New §67(g) suspends any deduction for miscellaneous itemized deductions for 2018 through 2025. The Act makes no change to the above-the-line deduction of up to $250 for unreimbursed expenses paid by an elementary or secondary school educator.

The suspension of miscellaneous itemized deductions presents a special wrinkle for trusts and estates. Under §67(e)(1), deductible costs in connection with the administration of a trust or an estate "which would not have been incurred if the property were not held in such trust or estate" (what we might call "unique administration costs") are *treated as* above-the-line deductions and thus spared from the §67(a) limitation otherwise applicable to miscellaneous itemized deductions. Apparently, some practitioners fear that the suspension of miscellaneous itemized deductions likewise makes unique administration costs nondeductible. But in *Notice 2018-61* (issued July 13, 2018) the Service declared that this fear is misguided. Since §67(e)(1) treats unique administration costs as above-the-line deductions allowable in determining adjusted gross income, they are not miscellaneous itemized deductions and thus not subject to the suspension. The Notice also clarified that administration expenses that commonly or customarily would be incurred by an individual (including the appropriate portion of a bundled fee) are still miscellaneous itemized deductions and thus nondeductible by an estate or non-grantor trust during the suspension period.

j. Exclusion for Qualified Bicycle Commuting Reimbursements Suspended: Section 132(f)(1)(D) allows an employee to exclude from gross income any "qualified bicycle commuting reimbursement," defined generally in §132(f)(5)(F)(i) as a reimbursement paid to an employee to cover reasonable expenses "for the purchase of a bicycle and bicycle improvements, repair, and storage, if such bicycle is regularly used for travel between the employee's residence and place of employment." The exclusion is limited to $20 per "qualified bicycle commuting month," defined generally as a month in which the employee uses the bike for a substantial portion of the commute to and from work and during which the employee receives no other qualified transportation fringe. The Act, through new §132(f)(8), suspends the exclusion for qualified bicycle commuting reimbursements from 2018 through 2025. To the surprise of none, the measure is not expected to generate more than $50 million in revenue during the period of the suspension. Estimated Budget at 2.

6. Other Individual Income Tax Items of Note

a. Kiddie Tax Simplification: Section 1(g) imposes the so-called "kiddie tax" on the net unearned income of certain minors. Generally, the tax applies where a child is age 18 or under on the last day of the taxable year (or age 23 or under and a full-time student on such date), the child has at least one living parent at such time, the child has more than $1,050 of unearned income for the year (that was the 2018 threshold), and the child does not file a joint return. If the child is 18 or older, however, the tax does not apply unless the child's earned income is less than one-half of the amount of the child's support. Unearned income is defined generally as all income other than compensation for services and distributions from qualified disability trusts. Where the tax applies, the child's net unearned income (unearned income in excess of the $1,050 threshold for 2018), is taxed at the parents' marginal rate if such rate is higher than the rate that would be applicable to the child. Earned income is unaffected by the kiddie tax.

The Tax Cuts and Jos Act simplifies this regime through 2025. Instead of taxing net unearned income at the parent's marginal rate, net unearned income is taxed using the same brackets and rates as in effect for trusts and estates. As before, *earned* income of a minor child is still taxed using the ordinary rates and brackets for unmarried persons. The thinking behind this change is that the child's tax is now "unaffected by the tax situation of the child's parent or the unearned income of any siblings." (Conference Report, page 9).

According to *Revenue Procedure 2018-57*, issued on November 15, 2018, the threshold for computing a child's net unearned income will be $1,100 in 2019.

b. Paid Preparers Must Investigate Claims of Head of Household Status: The Tax Cuts and Jobs Act modifies §6695(g) to direct promulgation of regulations imposing due diligence requirements on paid tax return preparers in determining a taxpayer's eligibility to file as a head of household. Failure to meet these requirements results in a $500 penalty per failure.

c. Increased Contribution Limits to ABLE Accounts: Late in 2014, Congress created §529A, which authorized states to create so-called "qualified ABLE programs" under which one could make contributions to a tax-exempt account for the benefit of a disabled individual. A disabled person (defined as one who would qualify as blind or disabled under Social Security Administration rules) may have a single account to which total annual contributions may not exceed the federal gift tax annual exclusion amount ($14,000 at the time, but now $15,000). Income from the account is exempt from federal income tax, and distributions made to the beneficiary for "qualified disability expenses" are likewise tax-free. Qualified disability expenses are defined broadly to include education, housing, transportation, employment training, assistive technology, health, wellness, financial management, and legal expenses (some of which are not already covered by Medicaid and OASDI benefits). Any other distributions, however, are subject to a 10-percent penalty and count as resources for purposes of the beneficiary's Medicaid exemption. There is no income tax deduction for contributions to the account, and any such contributions from third parties are treated as completed gifts of present interests to the beneficiary. Assets inside of an ABLE account do not count as "resources" of the beneficiary for purposes of qualifying for federal assistance. If, however, the account balance ever exceeds $100,000, the beneficiary will be denied eligibility for SSI benefits. Furthermore, any assets inside of the account upon the beneficiary's death are subject to Medicaid payback rules.

The Act provides that through 2025, once $15,000 has been contributed to an ABLE account, the account's designated beneficiary generally may contribute an additional amount up to such beneficiary's compensation for the year or, if less, the federal poverty line for a one-person household. Moreover, any such additional contribution is eligible for the so-called "saver's credit" under §25B.

C. BUSINESS TAX REFORM

1. Reduction in C Corporation Tax Rates

Under prior law, §11(b) set forth four federal income tax brackets applicable to a C corporation's taxable income:

Taxable Income	Marginal Tax Rate
Up to $50,000	15%
$50,001 - $75,000	25%
$75,001 - $10,000,000	34%
$10,000,001 and up	35%

If a corporation's taxable income exceeds $100,000, the lower two brackets are phased out such that the corporation ultimately pays a flat tax of 34 percent on its first $75,000 of taxable income. In addition, so-called "personal service corporations" paid a flat 35-percent tax on taxable income.

The Act provides for a **flat rate of 21 percent** on all corporate taxable income, with no special rate for personal service corporations, effective for taxable years beginning in 2018 and later. This provision therefore does not "sunset;" it is as permanent as possible. The estimated revenue loss from the new 21-percent flat rate is nearly $1.35 trillion over ten years. Estimated Budget at 3.

The Act also repeals §1201, which provided that if the maximum corporate tax rate exceeds 35 percent, the maximum rate applicable to a corporation's net capital gain will be 35 percent. A 21-percent flat rate rendered this rule obsolete.

2. Reduction in Dividends-Received Deduction for C Corporations

Prior law allowed corporations to claim a deduction for dividends received from other domestic corporations subject to federal income tax. The Act reduces the size of this deduction to reflect the lower 21-percent flat tax, as the following table shows:

If the receiving corporation…	The Dividends-Received Deduction under PRIOR LAW was…	The Dividends-Received Deduction under the NEW LAW is now…
Owns less than 20% of the stock of the paying corporation (by vote and value)	70% of the dividend received	50% of the dividend received (so such dividends would be taxed at a top rate of 10.5%)
Owns 20% or more of the stock of the paying corporation (by vote and value)	80% of the dividend received	65% of the dividend received (so such dividends would be taxed at a top rate of 7.35%)

Is a member of the same affiliated group as the paying corporation	100% of the dividend received	100% of the dividend received

3. Qualified Business Income Deduction for Partners, S Corporation Shareholders, and Sole Proprietors

Arguably the most significant component of the 2017 Act is the introduction of new §199A, a provision permitting taxpayers to deduct a percentage of their "qualified business incomes" for the taxable year. Having just given C corporations a substantial break through the flat 21-percent tax rate, Congress (particularly the Senate Finance Committee) wanted to offer some benefit to pass-through entities and sole proprietors.

Already in the Code was §199, a provision that allowed a manufacturer to deduct 9 percent of "qualified production activities income" (or 9 percent of taxable income, if less), but the deduction could not exceed 50 percent of the "W-2 wages" paid to employees. Section 199 thus favored domestic manufacturers that employed workers. By repealing §199 and replacing it with new §199A, Congress looked to make the deduction available to more taxpayers. Importantly, so as to highlight the benefit to middle-class taxpayers, the new deduction contains some limits applicable only to taxpayers in the top three tax brackets.

a. Executive Summary of the New §199A Deduction

(1) Who Qualifies – To qualify for the new deduction, you must be a partner in a business entity taxed as a partnership, a shareholder of an S corporation, or a sole proprietor engaged in a trade or business. C corporations and their shareholders do not qualify for this deduction, nor do employees.

(2) Taxable Income Zones – Your eligibility for the deduction as well as the amount of your deduction depends on your taxable income (without regard to this new deduction).

ZONE 1 → Your 2018 taxable income does not exceed $157,500 ($315,000 if you're married and filing a joint return with your spouse) (the figures for 2019 are $160,700 and $321,400, respectively)

ZONE 2 → Your 2018 taxable income exceeds $157,500 ($315,000 for joint filers) but does not exceed $207,500 ($415,000 for joint filers) (for 2019, the latter figures are $210,700 and $421,400, respectively)

ZONE 3 → Your 2018 taxable income exceeds $207,500 ($415,000 for joint filers) (the figures for 2019 are $210,700 and $421,400, respectively)

(3) Specified Service Businesses – If your business: (1) involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting,

athletics, financial services, or brokerage services; (2) has as its principal asset the reputation or skill of one or more of its employees or owners; or (3) involves the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities, then your deduction may be limited, as shown below:

ZONE 1 → No restriction

ZONE 2 → Your deduction is subject to a phase out

ZONE 3 → You get no deduction at all

(4) Must be Engaged in Conduct of United States Trade or Business – Your partnership, S corporation, or sole proprietorship must be engaged in the conduct of a trade or business within the United States. The deduction is not available with respect to investment or personal activities, even if conducted as partnerships or S corporations.

(5) Deduction Amount – The amount of the deduction depends on your taxable income zone:

ZONE 1 → 20% of "qualified business income"

ZONE 2 → 20% of "qualified business income," reduced if your "wage-basis limit" is less

ZONE 3 → 20% of "qualified business income," or, if less, your "wage-basis limit"

(6) Qualified Business Income – Generally, "qualified business income" is the net amount of your items of income, gain, loss, and deduction from an eligible trade or business, *except that* items of capital gain and loss (whether short-term or long-term) are excluded. The term also does not include certain dividends from REITs, cooperatives, and publicly-traded partnerships, as those items are subject to special rules. If the net amount from all of your eligible businesses produce a net loss, that net loss carries over to the next taxable year as a loss from a separate qualified trade or business. Compensation paid to you from the business (and guaranteed payments paid to you by a your partnership) are not qualified business income.

(7) The "Wage-Basis Limit" – This amount is *greater* of: (a) 50% of the W-2 wages paid by the business to all employees (including you); and (b) 25% of the W-2 wages paid to all employees (including you) *plus* 2.5% of the unadjusted basis immediately after acquisition of all depreciable property used in the business that is still on hand at the end of the year.

(8) Application to Trusts and Estates – Estates and trusts with interests in partnerships and S corporations are eligible for the deduction. The Act instructs Treasury to issue regulations explaining how the deduction is to be apportioned between fiduciaries and beneficiaries.

(9) Sunrise, Sunset – The new deduction applies in taxable years that begin after 2017 and before 2026. In most cases, this means the deduction expires at the end of 2025. The estimated hit to the federal coffers over the lifespan of this deduction is over $414 billion. Estimated Budget at 1.

(10) Taken in Addition to Standard Deduction – Although the §199A deduction is not "above the line," a taxpayer may claim the deduction in addition to the standard deduction. The §199A deduction is thus like the former deduction for personal and dependency exemptions in that a taxpayer need not itemize in order to claim the deduction.

(11) Reduction in Penalty Thresholds Where §199A Deduction Claimed – Section 6662 imposes a penalty equal to 20 percent of any underpayment of federal tax attributable to (among other things) a substantial understatement of income tax. Normally an understatement on an income tax return is "substantial" if it exceeds 10 percent of the amount of tax required to be shown on the return (or, if greater, $5,000). Now, however, if a taxpayer claims the §199A deduction, an understatement is substantial if it exceeds 5 percent of the amount of tax required to be shown on the return (or $5,000, if greater). The new statute suggests that the reduced threshold applies even where the understatement is not attributable to the §199A deduction; merely claiming the deduction serves to reduce the threshold, without regard to what triggers the understatement.

b. Under the Hood Look at the Statute

Generally under §199A(a), a noncorporate taxpayer may claim a deduction from 2018 through 2025 equal to the taxpayer's "combined qualified business income," but the total deduction cannot exceed 20 percent of the taxpayer's ordinary and dividend income. To compute the deduction amount, therefore, one must determine: (1) the taxpayer's "qualified business income" from any particular activity; (2) how to compute the "combined qualified business income" from all such activities; and (3) the taxpayer's ordinary and dividend income.

Qualified Business Income. Section 199A(c)(1) generally defines "qualified business income" as the net amount of "qualified items of income, gain, deduction, and loss" (think ordinary items effectively connected with the conduct of a United States trade or business that are included or allowed in computing taxable income) with respect to any "qualified trade or business" of the taxpayer.

The statute generally defines a "qualified trade or business" as any trade or business *except for*: (1) one involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services; (2) one where the business's principal asset is the reputation or skill of one or more of its employees or owners; (3) one involving the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities; and (4) the trade or business of performing services as an employee. But if the taxpayer's taxable income in 2018 is less than $157,500 ($315,000 for married couples filing jointly), the first three

disqualifications do not apply. (Those taxable income thresholds are to be adjusted annually for inflation—the figures for 2019 are $160,700 for unmarried taxpayers and heads of households and $321,400 for joint filers.) If the taxpayer's 2018 taxable income is more than $157,500 but less than $207,500 (or, in the case of married joint filers, more than $315,000 but less than $415,000), however, only a percentage of the qualified items of income, gain, deduction, or loss counts as qualified business income.

Combined Qualified Business Income and the Wage- and Capital-Based Limitation. One would expect "combined qualified business income" simply to be the net sum of the qualified business incomes from all of the taxpayer's trade or business activities, but it's not quite that simple. Instead, §199A(b)(1)(A) effectively defines the term to mean the sum of the *deductible amounts* from each trade or business activity. Section 199A(b)(2) generally provides that the deductible amount is 20 percent of the taxpayer's qualified business income from the trade or business. But for taxpayers with taxable incomes above a set threshold, the deductible amount cannot exceed 50 percent of the "W-2 wages" from the business or, if greater, 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of all "qualified property." This limit phases in once a taxpayer's taxable income for 2018 exceeds $157,500 ($315,000 for joint filers), and applies fully once taxable income for 2018 exceeds $207,500 ($415,000 for joint filers).

Under §199A(b)(4), a taxpayer's "W-2 wages" from a trade or business generally means the amount of wages and deferred compensation paid by the taxpayer that are attributable to qualified business income. In the case of partnerships and S corporations, §199A(f)(1)(A) explains that each partner or shareholder is treated as having W-2 wages in an amount equal to such partner or shareholder's allocable share of the W-2 wages paid by the entity. For S corporations that will be an easy determination. Treasury will have to issue guidance on the application of this rule in the case of entities taxed as partnerships.

Under §199A(b)(6), "qualified property" basically means depreciable tangible property on hand at the close of the taxable year and used in the production of qualified business income, provided the property is still within its "depreciable period" (generally defined as the first ten years in which the taxpayer has placed the property in service or the asset's regular recovery period, whichever is longer).

The Conference Report explains the wage- and capital-based limitation with this example: "[A] taxpayer (who is subject to the limit) does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50 percent of W-2 wages, or $0, or (b) the sum of 25 percent of W-2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: $100,000 x .025 = $2,500. The amount of the limitation on the taxpayer's deduction is $2,500." (Conference Report, page 38.)

Limitation Based on Taxable Income. Even after the application of the foregoing rules, the total deduction under §199A generally cannot exceed 20 percent of the excess (if any) of the taxpayer's taxable income over the sum of any net capital gain plus any "qualified cooperative dividends." By carving out net capital gain, the rule effectively means the total §199A deduction cannot exceed the taxpayer's ordinary and dividend income.

Not an Above-the-Line Deduction. The Act clarifies that the §199A deduction is not allowed in computing adjusted gross income. It is, instead, a "below-the-line" deduction that a taxpayer may claim *in addition to* the standard deduction or as part of the taxpayer's itemized deductions, as was the case with the former deduction for personal and dependency exemptions under §151.

Trusts and Estates. Section 199A(a) only excludes corporate taxpayers from the deduction. By negative implication, therefore, trusts and estates may claim the §199A deduction. In fact, §199A(f)(1)(B) provides that in determining the apportionment of W-2 wages and the apportionment of unadjusted basis in qualified property between fiduciaries and beneficiaries, rules similar to those in the old §199 deduction will apply.

Conference Report Examples. Here are two examples cribbed from the Conference Report's explanation of the Senate version of §199A. (Conference Report at 36-37.) The examples have been altered to reflect the provisions of the final Act.

Example 1

H and W file a joint return on which they report taxable income of $335,000 (determined without regard to this provision). H is a partner in a qualified trade or business that is not a specified service business (''qualified business A''). W has a sole proprietorship qualified trade or business that is a specified service business (''qualified business B''). H and W also received $10,000 in qualified REIT dividends during the tax year.

H's allocable share of qualified business income from qualified business A is $300,000, such that 20 percent of the qualified business income with respect to the business is $60,000. H's allocable share of wages paid by qualified business A is $100,000, such that 50 percent of the W–2 wages with respect to the business is $50,000. As H and W's taxable income is above the $315,000 threshold amount for a joint return but not above $415,000, the wage limit for qualified business A is phased in. Accordingly, instead of limiting the deduction amount to the $50,000 share of W-2 wages, the $60,000 deduction amount is reduced by 20 percent of the difference between $60,000 and $50,000, or $2,000. H's deductible amount for qualified business A is therefore $58,000.

W's qualified business income and W–2 wages from qualified business B, which is a specified service business, are $325,000 and $150,000, respectively. H and W's taxable income is above the $315,000 threshold amount for a joint return. Thus, the exclusion of qualified business income and W–2 wages from the specified service business are phased in. W has an

applicable percentage of 80 percent. (Their taxable income is $20,000 more than the threshold amount, and $20,000 is 20 percent of $100,000, so they must take 20 percent off the otherwise allowable amounts.) In determining includible qualified business income, W takes into account 80 percent of $325,000, or $260,000. In determining includible W–2 wages, W takes into account 80 percent of $150,000, or $120,000. W calculates the deductible amount for qualified business B by taking the lesser of 20 percent of $260,000 ($52,000) or 50 percent of includible W–2 wages of $120,000 ($60,000). W's deductible amount for qualified business B is $52,000.

H and W's combined qualified business income amount of $120,000 is comprised of the deductible amount for qualified business A of $58,000, the deductible amount for qualified business B of $52,000, and 20 percent of the $10,000 qualified REIT dividends ($2,000). H and W's deduction is limited to 20 percent of their taxable income for the year ($335,000), or $67,000. Accordingly, H and W's deduction for the taxable year is $67,000.

Example 2

H and W file a joint return on which they report taxable income of $200,000 (determined without regard to this provision). H has a sole proprietorship qualified trade or business that is not a specified service business (''qualified business A''). W is a partner in a qualified trade or business that is not a specified service business (''qualified business B''). H and W have a carryover qualified business loss of $50,000.

H's qualified business income from qualified business A is $150,000, such that 20 percent of the qualified business income with respect to the business is $30,000. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified business A. H's deductible amount for qualified business A is $30,000.

W's allocable share of qualified business loss is $40,000, such that 20 percent of the qualified business loss with respect to the business is $8,000. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified business B. W's deductible amount for qualified business B is a reduction to the deduction of $8,000.

H and W's combined qualified business income amount of $12,000 is comprised of the deductible amount for qualified business A of $30,000, the reduction to the deduction for qualified business B of $8,000, and the reduction to the deduction of $10,000 attributable to the carryover qualified business loss (20 percent of the $50,000 carryover loss—treated as its own qualified business activity under §199A(c)(2)—is $10,000). H and W's deduction is limited to 20 percent of their taxable income for the year ($200,000), or $40,000. Accordingly, H and W's deduction for the taxable year is $12,000.

c. Proposed Regulations

On August 8, 2018, Treasury issued proposed regulations offering guidance on a number of issues related to §199A. The preamble to the proposed regulations estimates that about 10 million taxpayers will claim the deduction and that the "annual burden hours" per taxpayer will vary from 30 minutes to 20 hours, with an average of 2.5 hours. The proposed regulations clarify some of the statutory terms and exercise the express grants of authority given to Treasury in §199A. These materials summarize several of the notable provisions from the proposed regulations.

Definition of Trade or Business. The proposed regulations generally adopt the definition of "trade or business" from §162 and related case law and administrative guidance for purposes of §199A. The proposed regulations go one step further, however, providing the rental or licensing of property to a related trade or business is treated as a trade or business if both the rental/licensing business and the related trade or business are commonly controlled. This facilitates the aggregation of the businesses for purposes of computing the deduction amount, as explained below.

No Effects on Outside Basis or Stock Basis. The proposed regulations clarify that the §199A deduction has no effect on the determination of a partner's basis in a partnership interest or an S corporation shareholder's stock basis.

Wages Paid by Another Party. As expected, the proposed regulations provide that in computing W-2 wages, wages paid by another party to the taxpayer's employees can be treated as wages paid by the taxpayer, but such wages may not be taken into account by the paying party.

Unadjusted Basis Immediately After Acquisition. The proposed regulations state that the unadjusted basis in depreciable property is generally the property's §1012 cost basis as of the date the property is placed in service, with the following exceptions: (1) for property contributed to a partnership in a §721 transaction, the unadjusted basis will be the partnership's basis in the property under §723; (2) for property contributed to an S corporation in a §351 transaction, the unadjusted basis will be the corporation's basis in the property under §362; and (3) for inherited property, the unadjusted basis will be the fair market value of the property at the time of the decedent's death as provided in §1014. The proposed regulations further state that any basis adjustments under §734(b) or §743(b) do not affect the unadjusted basis of depreciable property.

Property Transferred with a Principal Purpose of Increasing the §199A Deduction. Treasury fears some taxpayers will acquire depreciable property at the end of a taxable year merely to increase the total "unadjusted basis immediately after acquisition" in order to inflate the §199A deduction amount, only to turn around and dispose of the property shortly after the close of the taxable year. Accordingly, the proposed regulations exclude any depreciable property acquired within 60 days of the end of the taxable year and disposed of within 120 days

without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer can show that the principal purpose of the acquisition and disposition was unrelated to increasing the §199A deduction.

Improvements Treated as Separate Property. One might reasonably think that the cost of permanent improvements would not factor into the computation of a property's "unadjusted basis." But the proposed regulations adopt a friendly position: any addition or permanent improvement to depreciable property is treated as separate depreciable property with its own recovery period. "For example," says the preamble, "if a taxpayer acquired and placed in service a machine on March 26, 2018, and then incurs additional capital expenditures to improve the machine in May, 2020, and places such improvements in service on May 27, 2020, the taxpayer has two qualified properties: the machine acquired and placed in service on March 26, 2018, and the improvements to the machine incurred in May 2020 and placed in service on May 27, 2020." This is especially favorable where the applicable recovery period of the original property has expired, for although the property's unadjusted basis no longer counts for purposes of computing the wage-basis limit, the cost of improvements may still have an active recovery period.

Allocation of Unadjusted Basis Among Partners and S Corporation Shareholders. Where the depreciable property is held by a partnership or S corporation, the proposed regulations provide that a partner/shareholder's share of the entity's unadjusted basis is that partner/shareholder's share of the entity's tax depreciation for the taxable year. If a partnership does not have tax depreciation for the year but the property still counts toward the wage-basis limit (like when property has been held for less than 10 years but longer than its recovery period), then each partner's share of the unadjusted basis is based on how the gain from a sale of the property for fair market value would be allocated among the partners. (In the case of an S corporation without tax depreciation for the year, each shareholder simply takes into account a pro rata share of the entity's unadjusted basis in the depreciable property.)

Ordinary Income from Sale of Partnership Interest is Qualified Business Income. Under §751, the sale of a partnership interest can give rise to ordinary income where the entity has unrealized receivables and other assets that yield ordinary income. While capital gain clearly does not count as qualified business income, practitioners wondered whether ordinary income from §751 would count as qualified business income. The proposed regulations answer this question in the affirmative. Specifically, any gain attributable to assets of a partnership giving rise to ordinary income under §751 is considered attributable to the partnership's business and therefore counts as qualified business income assuming the regular statutory requirements for qualified business income are met.

Aggregation of Multiple Trades and Businesses. The preamble to the proposed regulations recognizes that a taxpayer can be engaged in multiple businesses (and, of course, an individual can own interests in more than one pass-through entity that conducts a trade or business). In order to simplify computation of the deduction, the proposed regulations allow

(but do not require) a taxpayer to aggregate separate trades or businesses if the following four requirements are met:

(1) Each trade or business is itself a trade or business.
(2) The same person or group of persons directly or indirectly owns a majority interest in each of the businesses for the majority of the taxable year.
(3) None of the businesses is a specified service business.
(4) The businesses meet at least two of the following factors: (a) the business provide the same products and services (the preamble lists "a restaurant and a food truck" as an example) or they provide products and services that are customarily provided together (the example in the preamble is "a gas station and a car wash"); (b) the businesses share facilities or "significant centralized business elements" (personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (c) the businesses are operated in coordination with (or reliance on) other businesses in the group (the preamble cites "supply chain intermediaries" as an example).

Specified Service Businesses – De Minimis Rule. The statute defines as a specified service business as one that "involves the performance of services" in any of certain fields. Practitioners worried that a business engaging in such services to any extent faced characterization as a specified service business even if the income from the services were a small fraction of the business's overall revenues. The proposed regulations introduce a *de minimis* rule under which a business will not be considered a specified service business merely because it provides a small amount of services in a specified service activity. The exact rule depends on the business's gross receipts. A business will not be treated as a specified service business if the business has gross receipts of $25 million or less for the taxable year and less than 10 percent of such gross receipts are attributable to the performance of services in a specified service activity. Where a business has more than $25 million in gross receipts for the year, the threshold drops to 5 percent.

Specified Service Businesses – What Counts and Doesn't Count. The proposed regulations flesh out the exact services that are "in the fields of" the various itemized professions. The following table summarizes these rules.

Services in the Field of	***Includes***	***Does Not Include***
Health	Medical services by physicians, pharmacists, nurses, dentists, vets, physical therapists, psychologists, and other professionals that provide medical services directly to patients	Operation of health clubs or health spas, payment processing, or research / testing / manufacture / sale of drugs or medical devises

Services in the Field of	***Includes***	***Does Not Include***
Law	Services by lawyers, paralegals, arbitrators, mediators, and similar professionals	Printers, delivery services, stenography services
Accounting	Services by accountants, enrolled agents, return preparers, financial auditors, bookkeeping services, and similar professionals	Payment processing and billing analysis
Actuarial Science	Services by actuaries and similar professionals	Services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events
Performing Arts	Services by individuals who participate in the creation of performing arts, including actors, singers, musicians, entertainers, directors, and similar professionals	Services in the maintenance and operation of equipment or facilities for use in the performing arts and broadcasters of performing arts
Consulting	Provision of professional advise and counsel to clients to assist the client in achieving goals and solving problems; lobbyists	Services other than advice and counsel, based on all facts and circumstances; ancillary consulting services related to setup, operation, and repair of goods that are not separately purchased or billed
Athletics	Services by athletes, coaches, and team managers in sports	Services in the maintenance and operation of equipment or facilities for use in athletics and broadcasters of athletic events
Financial Services	Managing wealth, advising clients on finances, developing retirement and/or wealth transition plans, advisory services in valuation, mergers, acquisitions, restructurings	Taking deposits and making loans
Brokerage Services	Arranging transactions between a buyer and seller with respect to securities	Services by real estate brokers or insurance brokers

Specified Service Businesses – "Reputation or Skill" Businesses. In addition to the specifically listed service activities above, the statute also defines as a specified service business to include any other business the principal asset of which is the reputation or skill of one or more of its employees or owners. Practitioners wondered what other professions could be

snared by this broad language. Personal trainers? Tattoo artists? Hair stylists? The preamble to the proposed regulations observes that Congress did not intend for this catch-all provision to apply broadly. So the proposed regulations limit the meaning of the "reputation or skill" clause to include *only* the following three businesses: (1) receiving income from **endorsing products or services**; (2) licensing or receiving income for **use of an individual's likeness**, name, signature, voice, trademark, or other symbols associated with the individual's identity; and (3) receiving **appearance fees**.

Specified Service Businesses – Anti-Cracking Rule. Some wealthy owners of specified service businesses have contemplated spinning off non-service parts of the business into a separate entity so that the income from those parts could still qualify for the deduction. For example, a lawyer who owns a law practice and the office building in which the practice operates might place the building into a separate entity in order to qualify the rental income for the §199A deduction. To foreclose this strategy, the proposed regulations provide that a specified service business includes any business with 50 percent or more common ownership that provides 80 percent or more of its property or services to a specified service business. That rule torpedoes the lawyer's strategy in the above example. But what if the lawyer leases half of the building to a deli owned by unrelated individuals? In this case, the proposed regulations state that the portion of the property or services provided to the specified service business will itself be treated as a specified service business. So while the lawyer could claim a deduction in connection with the rental income from the deli, the rents received from the law practice would still be income from a specified service business.

Employees Who Become Independent Contractors. Since employees do not qualify a deduction, some employees might wish to become independent contractors. Of course, there are plenty of tax and non-tax implications to making this switch, so employees should tread carefully here. But as far as §199A is considered, the employer and former employee should note that the proposed regulations presume that an ex-employee is still an employee for purposes of the §199A deduction if the ex-employee is providing substantially the same services. The presumption may only be rebutted upon a showing that the ex-employee is performing services in a capacity other than as an employee under all applicable federal tax rules.

Trusts and Estates. Logically enough, the proposed regulations state that in the case of a grantor trust, the deemed owner of the trust treats the qualified business income of the trust as if it had been received directly by the deemed owner. For nongrantor trusts and estates, each beneficiary's share of the trust's qualified business income, W-2 wages, and unadjusted basis of depreciable property generally tracks the beneficiary's share of distributable net income ("DNI") deemed distributed to the beneficiary (even if depreciation deductions from the property are allocated differently than DNI). To the extent the entity's DNI is not deemed distributed, that same share of the entity's qualified business income, W-2 wages, and unadjusted basis is deemed to be retained by the entity.

No Using Multiple Trusts to Generate Bigger Deduction. Trusts and estates have the same $157,500 threshold applicable to individuals, though for purposes of determining whether the entity has taxable in excess of this threshold, taxable income is to be computed before the application of any distribution deduction. Some clients might be tempted to convert a single trust into multiple trusts so as to take advantage of multiple thresholds, but the proposed regulations expressly provide that "trusts formed or funded with a significant purpose of receiving a deduction under §199A will not be respected for purposes of §199A." Furthermore, Treasury has proposed new Regulation §1.643(f)-1 which provides that where two or more trusts have substantially the same grantor(s) and substantially the same primary beneficiary or beneficiaries, the trusts will be treated as a single trust for federal income tax proposes if a principal purpose of the establishing multiple trusts is the avoidance of federal income tax.

4. Cost Recovery

a. Expansion of §179 Expensing: Under prior law, a taxpayer (other than an estate or trust) generally could elect to expense the first $500,000 of so-called "§179 property" placed in service during the taxable year, but that amount was reduced by the amount by which all such property placed in service during the year exceeded $2 million. Both of those numbers, however, were adjusted for post-2015 inflation, and we were therefore set to have a cap of $520,000 for 2018 that would not be reduced until a taxpayer placed in service more than $2,070,000 in §179 property for the year. *Revenue Procedure 2017-58.* "Section 179" property, generally, is depreciable tangible personal property (or certain computer software) acquired by purchase for use in the active conduct of a trade or business.

The Act **increases the annual cap from $500,000 to $1 million** and **increases the phaseout threshold from $2 million to $2.5 million**. Both numbers will adjust for post-2018 inflation. (*Revenue Procedure 2018*-57, issued November 15, 2018, announced that the cap for 2019 is $1,020,000, and the phaseout threshold is $2,550,000.)

In addition, the Act **expands the scope of §179 property to include "qualified real property,"** generally defined as any of the following improvements made to nonresidential real property made after the property was first placed in service: roofs, HVAC systems, fire alarms, and security systems.

The changes made to §179 are not scheduled to expire, and the estimated revenue loss over the next ten years is nearly $26 billion. Estimated Budget at 3.

b. Increased Expensing Bonus Under §168(k): Prior law allowed a bonus depreciation deduction equal to 50 percent of the adjusted basis of "qualified property" (generally, new property with a recovery period of not more than 20 years and certain improvements made to other property) in the year the property was placed in service. For this purpose, the property's adjusted basis is determined after the elective application of §179 but before the application of the regular depreciation rules described in §168(a).

The Act generally increases the bonus depreciation deduction for qualified property as shown in the following table:

Year(s)	Applicable Percentage of Adjusted Basis
2018 – 2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027 and later	0%

The Act also generally allows a taxpayer to claim the §168(k) bonus with respect to used property, so long as the property is new to the taxpayer. This measure is expected to cost an aggregate $86.3 billion over the next ten years. Estimated Budget at 3.

c. Depreciation Limits on Luxury Cars and Certain Personal-Use Property Modified: The Act increases the limits imposed by §280F(a) on the depreciation of certain passenger cars, as the following table shows:

Maximum Depreciation Deduction for Luxury Car (assuming no §168(k) bonus)	2017 Amounts Pre-Tax Cuts and Jobs Act	2018 Amounts Post-Tax Cuts and Jobs Act
First year vehicle is placed in service	$3,160	$10,000
Second year vehicle is placed in service	$5,100	$16,000
Third year vehicle is placed in service	$3,050	$9,600
Fourth year vehicle is placed in service and later	$1,875	$5,760

The new §280F amounts will be adjusted for inflation, and they are not subject to sunset.

In addition, the Act permanently removes "computer or peripheral equipment" from designation as "listed property." As a result, for example, a computer will no longer be subject to straight-line cost recovery if the business use of the asset is less than half of its total use, the rule denying a deduction where the business use is by an employee will not apply, and the ongoing substantiation requirements related to the computer's cost and business use likewise will not apply.

d. Applicable Recovery Period for Real Property Improvements Consolidated: Prior law had separate rules and depreciation limits for "qualified improvement property," "qualified leasehold improvements," "qualified restaurant property," and "qualified retail improvement property." The Act eliminates the last three categories so those assets generally become "qualified improvement property." The Act generally provides that qualified

improvement property may be depreciated over a 10-year recovery period (15 years where the alternative depreciation system applies) using the straight-line method and half-year convention. As a result, restaurant buildings (which generally do not meet the definition of qualified improvement property but are instead nonresidential real property) will be depreciable over 25 years using the straight-line method and the mid-month convention.

e. Alternative Depreciation System for Electing Farming Businesses: Farmers who elect out of the new limitation on the deduction for interest (see below) will automatically elect to depreciate any property with a recovery period of 10 years or more using the "alternative depreciation system," which generally requires use of the straight-line method over the asset's class life.

5. Other Business Income Tax Items of Note

a. New Limitation on Excess Business Losses of Individuals, Partnerships, and S Corporations: Under new §461(l), a noncorporate taxpayer's "excess business loss" for the taxable year is disallowed and treated as a net operating loss carryover to the next taxable year. "Excess business loss" is defined as the amount by which the taxpayer's aggregate deductions attributable to all trades or businesses exceeds the sum of the taxpayer's aggregate gross income attributable to all such trades or businesses plus $250,000 (or $500,000 in the case of joint filers). Both of these dollar amounts will be adjusted for inflation, but this new limit under §461(l) expires at the end of 2025. Section 461(l)(4) provides that in the case of a partnership or S corporation, the limitation applies at the partner or shareholder level.

Revenue Procedure 2018-57, issued on November 15, 2018, states that the inflation-adjusted thresholds for 2019 will be $255,000 and, for joint filers, $510,000.

b. Carried Interests: The benevolent overlord of students everywhere, Wikipedia, explains a carried interest as "a share of the profits of an investment paid to the investment manager in excess of the amount that the manager contributes to the partnership, specifically in alternative investments (private equity and hedge funds). It is a performance fee, rewarding the manager for enhancing performance." As such, of course, it is compensation for services. But because the carried interest is held in the form of a profits interest of an entity taxed as a partnership, the managers receive their fees in the form of a share of the partnership's long-term capital gains. So while mutual fund managers and other investment advisors receive fee payments taxable as ordinary income, their counterparts in private equity and venture capital firms enjoy a preferential rate on payments allocable to their partnership profits interests.

The Act purports to address this anomaly through new §1061, which generally treats a partner's share of long-term capital gain from partnership investments held three years or less as short-term capital gain where the partner acquired the partnership interest through the performance of substantial services. The rule only applies to partnerships engaged in raising or

returning capital and investing in, disposing of, or developing securities, commodities, investment or rental real estate, and cash or cash equivalents.

“That’s pretty much a joke,” writes Washington Post columnist Allan Sloan, “given that venture capital and buyout funds — whose managers are the biggest beneficiaries of the ‘carried interest’ loophole — typically hold investments for well over three years before selling them. This legislation has the appearance of reform, but not the substance.” Sloan, *Carried Interest Reform is a Sham*, Washington Post, December 1, 2017.

The Conference Report states that the three-year holding period applies even in the case of a §83(b) election:

> [T]he fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer’s net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

Conference Report at 269. The estimated revenue gain from the new rule is $1.1 billion over ten years. Estimated Budget at 6.

c. Limiting Like-Kind Exchanges to Real Property: Under prior law, the exchange of personal property held for business or investment use for property of like kind qualified for nonrecognition under §1031. The Act now limits the scope of §1031 to exchanges of real property, simply by changing every reference to “property” in §1031 to “real property,” as well as deleting §1031(e) related to livestock and §1031(i) related to certain stock.

The new limit applies to exchanges completed in 2018 or later. Section 1031 still applies to a like-kind exchange of personal property if either (1) the property given up was disposed of by the taxpayer before 2018; or (2) the property received by the taxpayer was acquired before 2018. The estimated revenue gain from narrowing the scope of §1031 is $31 billion over ten years. Estimated Budget at 3.

d. Modification of Deduction for Entertainment Expenses: Prior law disallowed a deduction for entertainment costs unless the taxpayer established that the entertainment was “directly related to” or “substantially associated with” the taxpayer’s business or profit-seeking activity. Even then, the taxpayer could only deduct 50 percent of the cost of the entertainment. The Act amends §274 to disallow a deduction for all entertainment

expenses period, no matter whether the entertainment relates to or is associated with the taxpayer's business. The change applies to amounts paid or incurred for entertainment in 2018 or later, and is expected to generate $23.5 billion in revenue over the next ten years. Estimated Budget at 4.

e. Deduction for Certain Fines and Penalties Explained: Section 162(f) used to be succinct: "No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." The Act now expands the text of §162(f) considerably, with five new paragraphs, all generally effective as of December 22, 2017. The gist of the new rule is to deny a deduction for amounts paid or incurred to (or at the direction of) a government or certain listed nongovernmental regulatory entities in relation to the violation of a law or the investigation or inquiry into the potential violation of a law.

The Act contains exceptions for payments that are restitution, remediation of property, or amounts paid to come into compliance with any law that violated or involved in the investigation or inquiry. It also adds reporting requirements whereby government agencies have to report settlement agreements and orders entered into where the amount required to be paid is at least $600.

Under the transitional guidance appearing in *Notice 2018-23* (issued March 29, 2018), reporting is not required until the date specified in proposed regulations that the Service intends to issue (not earlier than January 1, 2019), and such date will not be earlier than the publication date of the proposed regulations. The guidance also provides that reporting will not be required for any amounts required to be paid or incurred under a binding court order or settlement agreement entered into before such specified date.

f. Deduction for Local Lobbying Expenses Repealed: Section 162(e) generally disallows deductions for lobbying expenses and expenses connected with political campaigns, but prior law contained an exception for expenses connected with appearing before or communicating with "any local council or similar governing body." The exception treated tribal governments as local councils for purposes of this exception. The Act repeals this exception effective as of December 22, 2017. The estimated revenue gain from this measure is just $800 million over the next ten years. Estimated Budget at 6.

g. No Deduction for Settlements Subject to Nondisclosure Agreements in Connection with Sexual Harassment or Sexual Abuse: Introduced in the Senate Bill, new §162(q) provides as follows:

> *(q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE.—No deduction shall be allowed under this chapter for—*
>
> *(1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or*
>
> *(2) attorney's fees related to such a settlement or payment.*

While the statute is clear that settlement payments related to sexual harassment or sexual abuse might be deductible if there is no nondisclosure agreement, it is not clear whether attorney fees paid in cases where there is no nondisclosure agreement could be deductible. On the one hand, §162(q)(2) does not contain the "if such settlement or payment is subject to a nondisclosure agreement" clause, suggesting that the denial of a deduction for attorney fees is not conditioned on the presence of a nondisclosure agreement. But on the other hand, §162(q)(2) refers to "such" a settlement or payment, which is either a reference to "a settlement or payment related to sexual harassment or sexual abuse" or a reference to "a settlement or payment … subject to a nondisclosure agreement." In any case, the new provision applies to amount paid or incurred after December 22, 2017. The estimated revenue gain from the new rule is less than $50 million over the next ten years. Estimated Budget at 6.

h. Exclusion of and Deduction for Employee Achievement Awards Modified: Section 74(b) allows an employee to exclude from gross income (and §274(j)(1) sometimes allows an employer to deduct) the value of an "employee achievement award." Section 274(j)(3) defines an employee achievement award as an item of tangible personal property awarded from an employer to an employee in a meaningful ceremony recognizing the employee's length of service or safety achievement, provided the circumstances and condition of the award do not create a significant likelihood that the award is just disguised compensation. The Act clarifies that "tangible personal property," for this purpose, does not include cash, cash equivalents, gift cards, gift coupons, most gift certificates, vacations, meals, lodging, event tickets, stock, bonds, securities, or similar items. The new definition applies to awards made in 2018 or later. The Joint Committee estimates a revenue pickup of less than $50 million over the next ten years from this new rule. Estimated Budget at 4.

i. Accrual Method Modified: Traditionally, an accrual-method taxpayer has income when all events have occurred that fix the right to payment and the amount can be determined with reasonable accuracy. This is known as the "all-events test" for income. The Act adds a new §451(b), effective starting in 2018, which generally provides that the all events test is met with regard to an item of income no later than when the income is taken into revenue on the taxpayer's financial statement. This is expected to add over $8 billion in federal revenues in the next ten years. Estimated Budget at 4.

The Act also adds a new §451(c), also starting in 2018, allowing an accrual method taxpayer to elect to defer the inclusion of certain advance payments to the end of the year following the year of receipt if such income is likewise deferred for financial accounting purposes. The new rule does not apply to advance receipts of rents, insurance premiums, and other specified items. In effect, this rule is the codification of guidance previously published by the Service (Revenue Procedure 2004-34). In fact, in *Notice 2018-35* (issued April 12, 2018) provides that taxpayers may continue to rely on Revenue Procedure 2004-34 for the treatment of advance payments until expected formal guidance on new §451(c) is promulgated. As it considers this new guidance, the Service has requested suggestions for future guidance, in particular whether taxpayers without an applicable financial statement may continue to use Revenue Procedure

2004-34 and whether Revenue Procedure 2004-34 should be expanded in its scope to include other forms of advance payments.

j. More Self-Created Property Excluded from Definition of Capital Asset: Section 1221(a)(3) provides that copyrights, compositions, letters, memoranda and similar property held by the creator or by someone whose basis is determined with reference to the creator's basis are not capital assets. The Act adds patents, inventions, models, designs (whether or not patented), secret formulae and processes to this list, applicable to dispositions made in 2018 or later. The Joint Committee estimates this may add about $500 million in revenues over the next ten years. Estimated Budget at 4.

The House bill likewise called for the repeal of §1235, which provides that a transfer of substantially all rights in a patent or undivided portion thereof by the creator (or an unrelated party who acquired the patent by paying consideration in money or money's worth to the creator before the invention was reduced to practice) automatically qualifies for long-term capital gain treatment. Since self-created patents would not be capital assets under the new law, the House bill figured a provision conferring automatic long-term capital gain treatment would be a contradiction. But the Act makes no change to §1235. So we have one provision (§1221(a)(3)) saying a patent is not a capital asset in the hands of the inventor, but another provision (§1235) says the inventor can still qualify for automatic long-term capital gain treatment on the sale of the entire patent or an undivided portion thereof. If that stands, it would seem the only taxpayers affected by §1221(a)(3) are those who receive patents by gift from the inventor—donees cannot claim the benefit of §1235 because they do not give the inventor consideration in money or money's worth. They are thus stuck with ordinary income treatment.

k. Small Business Accounting Method Reform: Prior law generally limited the cash method of accounting to individuals and businesses that use the cash method for financial accounting purposes. Prior law provided that C corporations, partnerships with a C corporation partner, and certain tax-exempt entities could not use the cash method, with exceptions for certain farming businesses, qualified personal service corporations, and entities with average annual gross receipts of no more than $5 million for all prior years. A taxpayer also could not use the cash method where the purchase, production or sale of merchandise is an income-producing factor.

The Act now expands the availability of the cash method to include all taxpayers (other than tax shelters) with average annual gross receipts of up to $25 million for the three prior taxable years, even where a taxpayer produces income from the purchase, production, or sale of inventory. The $25-million figure will be adjusted for post-2018 inflation. *Revenue Procedure 2018-57*, issued November 15, 2018, states that the figure for 2019 is $26 million.

In addition, taxpayers meeting the $25 million ($26 million in 2019) gross receipts test above are no longer required to use the inventory method of accounting for inventories. Instead, taxpayers can account for inventory either by treating inventory for tax purposes either the

same way as the taxpayer accounts for it for financial accounting purposes or by treating inventory as non-incidental materials and supplies (deductible when first used or consumed in the taxpayer's business).

But wait, there's more! Taxpayers meeting the $25 million ($26 million in 2019) gross receipts test are also exempted from the uniform capitalization rules of §263A. This expansion of favorable tax accounting rules applies to taxable years beginning in 2018 and later. The estimated revenue hit from all of these measures is $30.5 billion over ten years. Estimated Budget at 3.

l. S Corporation Conversions to C Corporations: Given the new 21-percent flat tax applicable to C corporations, some S corporation shareholders might consider terminating the S election, thus converting the entity to a C corporation. Shareholders should know that one consequence of making the conversion might be a change in accounting method. The former S corporation may have used the cash method if it maintained no inventory, but the new C corporation may be forced to use the accrual method. (Note the discussion immediately above, however, in connection with the expanded availability of the cash method under the Act.)

If a change of accounting method is required, §481(a)(2) requires that in the year of change "there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted…." To mitigate the impact of the "§481 adjustment" in this scenario, the Act creates new §481(d) specifically targeted to conversions from S corporation to C corporation status. Under the new rule, the §481 adjustment" is prorated over the first six taxable years starting with the year of conversion, but only in cases where: (1) the entity was an S corporation on December 21, 2017; (2) the entity revoked its S corporation status on or after December 22, 2017, and on or before December 21, 2019; and (3) all of the persons who were shareholders of the corporation on December 22, 2017 are the only persons who were shareholders of the corporation on the date of the revocation of the S election. The estimated revenue loss from this new rule is $6.1 billion over ten years. Estimated Budget at 3.

m. New Limit on Deduction of Business Interest: Starting in 2018, the deduction for "business interest" in the case of a taxpayer with average annual gross receipts of $25 million or more over the past three years is limited to an amount equal to the sum of: (1) the taxpayer's "business interest income;" plus (2) 30 percent of the taxpayer's "adjusted taxable income;" plus (3) where applicable, the taxpayer's "floor plan financing interest." Any business interest not allowed as a deduction under this rule carries over the next taxable year. In the case of partnerships, the limit is applied at the entity level, and each partner will have a share of the entity's adjusted taxable income. The Joint Committee estimates this restriction will add over $253 billion to federal revenues over the next ten years.

Business Interest. New §163(j)(5) defines business interest as any interest paid or accrued on debt properly allocable to a trade or business. The term does not include

“investment interest,” which has its own cap under §163(d). Section 163(j)(7) excludes certain businesses from the definition of a “trade or business” solely for purposes of the business interest deduction limitation, meaning the limit on interest expense will not apply to these specified groups. They include the business of being an employee, certain utilities, as well as any “electing real property trade or business” (defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business) and any “electing farming business.” In the case of farmers, though, note the consequence of making the election as regards depreciation of equipment used by an electing farmer as discussed above.

Business Interest Income. New §163(j)(6) defines business interest income as the amount of interest includible in the taxpayer’s gross income for the year that is properly allocable to a trade or business of the taxpayer. Here too, investment interest income expressly does not count as business interest income.

Note that in *Notice 2018-28* (issued on April 2, 2018), the Service announced that it will issue proposed regulations under §163(j) providing (among other things) that solely for purposes of §163(j), all interest paid or accrued by a C corporation on its indebtedness will be “business interest” and all interest on indebtedness held by the C corporation that is includible in gross income of the C corporation will be “business interest income.” This rule, however, will not apply to S corporations. The proposed regulations are also expected to address the extent to which §163(j) affects the computation of a C corporations’ earnings and profits.

Adjusted Taxable Income. New §163(j)(8) defines adjusted taxable income as the taxpayer’s taxable income computed without regard to six items: (1) items not properly allocable to a trade or business; (2) business interest; (3) business interest income; (4) any net operating loss deduction; (5) any deduction for qualified business income under new §199A; and (6) for 2018 through 2021 only, deductions for depreciation, amortization, or depletion. The statute authorizes Treasury to announce other adjustments going forward.

Floor Plan Financing Interest. New §163(j)(9) generally defines floor plan financing interest as interest paid on debt used to finance the acquisition of motor vehicles (defined to include both boats and farm equipment) held for sale or lease and which is secured by such vehicles.

n. Modification of Net Operating Loss Deduction: Prior law allowed a taxpayer to deduct the net operating loss carryovers to the taxable year plus any net operating loss carrybacks to such year. The Act **caps this deduction to 80 percent of taxable income** (computed without regard to the net operating loss deduction).

The Act also **repeals the two-year carryback** of net operating losses except in the case of certain losses incurred by farmers. Similarly, the net operating losses of a property and casualty insurance company may be carried back two years and carried forward 20 years.

Finally, the Act allows for **indefinite carryforwards** of net operating losses, as opposed to the 20-year limit that was in place under prior law (with the exception for property and casualty insurance companies described above). Combined, these modifications are expected to drive up federal revenues by more than $201 billion over ten years. Estimated Budget at 3.

o. Repeal of Deduction for Income Attributable to Domestic Production Activities: The Act repeals §199, effective for taxable years beginning in 2018 or later. Section 199 had authorized a deduction equal to nine percent of either a taxpayer's "qualified production activities income" or, if less, taxable income. Generally, "qualified production activities income" was excess of the taxpayer's "domestic production gross receipts" over the sum of the cost of goods sold allocable to those receipts and other expenses, losses, and deductions allocable to those receipts. The statute generally defined "domestic production gross receipts" as gross receipts derived from the sale, exchange, disposition, lease, rental, or license of tangible personal property, computer software, motion pictures, films, videotapes, and sound recordings that was made, grown or extracted in whole or in significant part within the United States, as well as real property construction performed in the United States by one in the ordinary course of a construction business. The total deduction, however, could not exceed 50 percent of the W-2 wages paid by the taxpayer that were properly allocable to domestic production gross receipts. Repeal of the deduction is expected to add $98 billion to federal revenues over the next ten years. Estimated Budget at 4.

p. Excessive Employee Remuneration Limitation Modified: Section 162(m) generally limits the deduction for compensation paid to a "covered employee" of a publicly held corporation to no more than $1 million per year. A "covered employee" is either a CEO on the last day of the taxable year or an employee whose compensation must be reported to shareholders under federal securities laws because the employee is one of the four most highly compensated officers other than the CEO.

The Act makes a few modifications to this rule starting in 2018, three of which are worth mention here. First, the Act includes the company's CFO as a covered employee no matter whether the CFO is one of the four highest paid officers. Second, the CEO and CFO are covered employees if they held their roles at any point during the taxable year (not just the last day of the taxable year, as under prior law). Finally, the Act eliminates preexisting exceptions for commissions and performance-based compensation from application of the $1 million limit. Accordingly, commissions and performance-based compensation now count toward the $1 million limit. Combined, these new limits are expected to raise some $9.2 billion in revenues over the next ten years. Estimated Budget at 4.

D. WEALTH TRANSFER TAX REFORM

1. Increase in Basic Exclusion Amount

The American Taxpayer Relief Act of 2012 made permanent the $5,000,000 basic exclusion amount for federal estate, gift, and generation-skipping transfer taxes that was introduced in

the Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010. The basic exclusion amount adjusted for inflation after 2011.

For decedents dying in	The basic exclusion amount is
2011	$5,000,000
2012	$5,120,000
2013	$5,250,000
2014	$5,340,000
2015	$5,430,000
2016	$5,450,000
2017	$5,490,000

Pursuant to Revenue Procedure 2017-58, the basic exclusion amount for 2018 was set to be $5,600,000. But the Act doubles the basic exclusion amount under §2010(c)(3) from $5 million to $10 million, with adjustments for inflation after 2011 using a new, "chained-CPI" method. Thus, **the basic exclusion amount for 2018 is $11,180,000** (nearly twice the $5.6 million figure originally estimated for 2018). *Revenue Procedure 2018-57*, issued November 15, 2018, states that **the basic exclusion amount for 2019 is $11,400,000**.

The Act provides that the basic exclusion amount will revert to $5 million (adjusted for post-2011 inflation) after 2025. The estimated revenue loss from doubling of the basic exclusion amount is $83 billion over ten years.

The House Bill called for a temporary repeal of the estate and generation-skipping transfer taxes, along with a reduction in the tax rate applicable to taxable gifts. But the Senate Bill focused only on doubling the basic exclusion amount, an approach adopted in the Conference Bill. Thus, the federal wealth transfer taxes survive, but once again suffer a significant reduction in scope.

2. Retention of Stepped-Up Basis

Neither the House Bill nor the Senate Bill proposed any changes to the application of §1014, which provides a fair-market-value-at-date-of-death basis for property acquired from a decedent. Some commentators were of the belief that if the estate tax was repealed, Congress would be forced to repeal or at least substantially curtail the scope of §1014, perhaps treating property acquired from a decedent the same as property acquired through an inter-vivos gift (with, generally, a carryover basis under §1015). But since the Conference Bill took temporary estate tax repeal off the table, no one was surprised at the retention of "stepped-up" basis under §1014.

3. Post-Act Estate Planning Strategies

Estate planning for unmarried individuals likely changes very little. Some previously "wealthy" single persons (those with, say, estate of $8 million) no longer need to sweat the federal wealth

transfer taxes as part of their estate planning, though they will want to consider how to plan for the potential re-introduction of those taxes in 2026 when the basic exclusion amount is set to drop back to $5 million (adjusted for post-2011 inflation). Because the doubling of the basic exclusion amount is only temporary under the Act, one should be hesitant to tear down an existing estate plan that took wealth transfer taxes into account.

Planning for married couples, however, could change significantly. The current structure of the federal income, estate, and gift tax system makes it so no one template can be used for all married couples. Instead, modern tax planning requires married couples to be sorted into one of three "buckets," each with its own template.

BUCKET ONE	BUCKET TWO	BUCKET THREE
Combined net worth less than one basic exclusion amount (no more than $11.4 million in 2019)	Combined net worth more than one basic exclusion amount but not more than two basic exclusion amounts (more than $11.4 million but not more than $22.8 million in 2019)	Combined net worth more than two basic exclusion amounts (more than $22.8 million in 2019)

This section of the materials offers a possible template for each bucket. Before doing so, two points must be stressed from the outset. First, the application of state estate, gift, and inheritance tax laws may affect the relative size of each bucket and even, perhaps, the total number of buckets in play. Suppose, for example, that a married couple with a $7 million combined net worth resides in a state that imposes its own wealth transfer tax with an exclusion amount of only $2 million. The strategies discussed below for Bucket One assume no transfer tax at all will be imposed. If the amount of state estate tax is a concern, the planner in this example might limit the Bucket One template to couples with combined net wealth of $2 million or less and use some of the strategies from Bucket Two in an attempt to plan for the state estate tax. But even that approach requires caution, as state estate tax systems may not permit all of the options described in Bucket Two, most notably QTIP and portability elections. So where state transfer taxes are an issue, the planner will need to give careful consideration as to how these templates may be applied successfully to couples that face liability for such taxes.

Second, just as no two snowflakes are alike, no two estate plans are ever identical. What follows are general templates that a planner can use as a starting point in designing the precise estate plan that will work best for any particular married couple. These templates do not consider the special issues that arise, for example, in planning for a beneficiary with special needs, planning for couples that hear the word "dynasty" and get all atwitter, or planning for couples that intend to leave the bulk of their wealth to one or more charitable organizations. Likely no one will use the exact templates set forth herein, but hopefully they provide a helpful framework for building plans that will actually be implemented.

a. Planning for Bucket One Couples. There is a three-part template for married couples with a combined net worth not in excess of the basic exclusion amount.

BUCKET ONE TEMPLATE
* Trust or outright gift upon death of first spouse?
* Ensure stepped-up basis for all assets on death of surviving spouse
* Consider protective portability election

Transfer Upon First Spouse's Death: Trust or Outright Gift? The couple needs to decide how the assets of the first of them to die should pass. For most couples, there are two choices: by outright gift to the surviving spouse or to a trust of which the surviving spouse is a beneficiary. In answering this question, taxes are irrelevant. Clients choosing to use a trust will be doing so for non-tax reasons. Those reasons could include: (1) the desire of the first spouse to die to control the disposition of his or her assets after death; (2) a concern that the surviving spouse may not have the capacity or desire to manage the assets; and (3) a concern that assets in the name of the surviving spouse might be vulnerable to creditors.

Of course there are also good reasons for clients to prefer an outright gift, like the desire to avoid the costs of trust formation and administration or the desire to avoid the complexity of trusts (you can't get much simpler than an outright gift). Happily, Bucket One couples are free to choose the method that works best for them; taxes do not control any of the decisions here.

Ensure All Assets Get Stepped-Up Basis on Survivor's Death. Since transfer tax planning is not an issue for Bucket One couples, it is crucial that planners get the income tax planning piece right. And that means ensuring everything gets a fresh-start, fair market value basis for income tax purposes upon the surviving spouse's death.

Where couples choose to let assets pass to the surviving spouse by **outright gift**, the step-up in basis on the surviving spouse's death is assured since the spouse owns everything. At this point, however, it is worth mention that the fresh-start, fair market value basis on property passing from a decedent can cause a "step-down" in basis as well (as where the property's value at the time of the surviving spouse's death is less than the surviving spouse's adjusted basis in the property). While estate planners are well-trained in making sure such losses are recognized prior to death so they are not lost, clients will sometimes find a way to die before fully purging loss assets from their portfolios. "Step-downs" will thus happen from time to time. But most beneficiaries will benefit from the application of the fair-market-value-at-date-of-death rule.

Obtaining a stepped-up basis for everything on the surviving spouse's death is more complicated where the couple decides to have assets pass from the first spouse to die via a **trust**. If structured as a typical irrevocable trust, the assets of the trust will not receive a stepped-up basis on the death of the surviving spouse because those assets are not included in the surviving spouse's gross estate for estate tax purposes. For Bucket One couples using trusts, therefore, the key is to create a trust that causes inclusion of the trust assets in the survivor's gross estate. Gross estate inclusion is not an adverse result for Bucket One couples, recall,

because federal wealth transfer taxes are not an issue: even if everything is included in the surviving spouse's gross estate, the total size of the estate is less than the surviving spouse's basic exclusion amount.

There are at least two ways to structure a trust so that it results in gross estate inclusion, thus assuring that the assets get a stepped-up basis on the surviving spouse's death. First, the trust instrument can give the surviving spouse a testamentary power to appoint all or any portion of the trust estate to the surviving spouse's estate. This is a **general power of appointment**, and property subject to a general power of appointment is generally includible in the gross estate of the power-holder. In order for this approach to get the maximum advantage, the surviving spouse should be entitled to all of the income from the trust (payable at least annually) for the surviving spouse's life. This makes the property passing to the trust eligible for the estate tax marital deduction, thus maximizing the amount that can pass to the surviving spouse through a portability election, as described below. But since estate taxes are not a factor for Bucket One clients, it is not critical that the surviving spouse receive the income. Nor is it crucial that the power be so broad; it is sufficient, for example, that the spouse has a testamentary power to appoint the trust property only to the creditors of the surviving spouse's estate.

Second, the trust can be structured to qualify for the qualified terminable interest property ("**QTIP**") exception to the terminable interest rule. If a trust meets the requirements for a QTIP election and the executor of the estate of the first spouse to die properly makes the QTIP election, the assets remaining in trust upon the death of the surviving spouse will be included in the surviving spouse's gross estate, thus assuring here too that the assets qualify for a stepped-up basis. Some practitioners had been concerned that the Service might disregard QTIP elections made by the estate of a Bucket One deceased spouse on the grounds that the QTIP election was not necessary to avoid imposition of federal estate tax. In Revenue Procedure 2016-49, however, the Service made clear that it would not disregard a valid QTIP election unless requested to do so by the executor.

Consider the Protective Portability Election. By definition, estate taxes are not an issue for Bucket One couples. Even if the clients completely bungle the handling of the first spouse's estate, the surviving spouse alone has a basic exclusion amount ample enough to shelter all of the property from federal wealth transfer taxes. Thus one may rightfully wonder why the Bucket One template would consider the need for a portability election.

Planners might consider a portability election upon the death of the first spouse simply because the surviving spouse may come into other, unexpected wealth (prizes, jackpots, punitive damage awards, treasure trove) or may see unexpected surges in the value of assets. In any of those cases, having the deceased spouse's unused exclusion amount in addition to surviving spouse's own basic exclusion amount could prove helpful. Since the only cost to making the portability election is filing a timely estate tax return that would be subject to the relaxed reporting requirements described above, this would likely be cheap insurance.

b. Planning for Bucket Two Couples. Planning for these couples is perhaps the most challenging. Clearly *some* transfer tax planning is in order; if the planner does nothing and wastes the first spouse's applicable exclusion amount, the surviving spouse will not have sufficient exclusion to cover the couple's combined net worth, even if those assets do not appreciate in value after the death of the first spouse.

The question, though, is what kind of planning makes the most sense. Before 2011, we always used our friend, the credit shelter trust. Even where the credit shelter trust made no sense outside the world of taxes, it was often the only recourse to make sure each spouse's exclusion was utilized fully. Now, however, we also have the portability election at hand. And for clients in Bucket Two, the portability election is usually all we need to make sure federal wealth transfer taxes remain a nullity. So the planner has to consider which is better: using the good, old-fashioned credit shelter trust or the new-fangled portability election.

When Credit Shelter Trust is Better. In many cases, the credit shelter trust will be the better option. The two principal advantages of credit shelter trusts are these:

(1) Asset Appreciation Expected. Unlike the basic exclusion amount, the "deceased spousal unused exclusion amount" from a portability election does not adjust for inflation. Thus, for example, suppose the executor of the first deceased spouse elects to have a $11 million DSUE Amount pass to the surviving spouse. When the surviving spouse dies 25 years later, the basic exclusion amount will be substantially higher, but the DSUE Amount will still be $11 million.

On the other hand, assets placed in a credit shelter trust will not be subject to estate tax on the death of the surviving spouse no matter how much they may appreciate in value. If the assets owned by the surviving spouse are expected to appreciate substantially before the surviving spouse's death, then, the credit shelter trust will usually be the preferred option.

(2) Client Wants to Use the Generation-Skipping Transfer Tax Exemption. While the portability election applies for both federal estate tax and federal gift tax purposes, it does not apply for purposes of the generation-skipping transfer tax. On the other hand, executors can elect to apply the GSTT exemption to assets placed in a credit shelter trust, permanently shielding the trust assets from the generation-skipping transfer tax. If the couple wants to make significant provision for grandchildren and other beneficiaries further down the line of descent, the credit shelter trust will be more attractive.

When Portability is Better. But there are situations where portability may have the edge over credit shelter trusts. Here are three that come to mind:

(1) Some Assets Don't Fit Well in Credit Shelter Trusts. Retirement accounts and residences make for poor assets in a credit shelter trust. For income tax purposes we can generally achieve better results by naming the surviving spouse as beneficiary instead of a trust. For purposes of excluding gain from the sale of a residence, moreover, title in the surviving

spouse's name is better since trusts cannot occupy a residence, one of the conditions required for excluding gain.

(2) Some Surviving Spouses Don't Survive Long Enough. If the surviving spouse does not live for a meaningful period of time following the first spouse's death, there is little chance that assets inside of a credit shelter trust will have had an opportunity to appreciate in value to any significant extent. So after undergoing the expense, delay, and complexity involved in funding and administering the credit shelter trust, it would do no better than the simple, cost-effective portability election.

(3) Stepped-Up Basis May be More Important. Remember that assets owned either outright by the surviving spouse or by a QTIP trust will get a stepped-up basis for income tax purposes on the death of the surviving spouse. Assets inside of the typical credit shelter trust, however, do not get a step-up in basis. One must therefore check the balance sheets, for if the lurking capital gain in the estate is substantial yet the combined net worth puts the couple just over one basic exclusion amount, the step-up in basis matters much more than the estate tax savings—to the point that a credit shelter trust may be unwise.

BUCKET TWO TEMPLATE
* Trust or outright gift upon death of first spouse?
* If <u>outright gift</u> preferred, use disclaimer planning
* If <u>trust</u> is preferred, use *Clayton* QTIP

So the decision between a credit shelter trust and a portability election, ultimately, comes down to the answers to these five questions: (1) when will the first spouse die?; (2) what assets will the couple have at the time of the first spouse's death?; (3) how much longer will the surviving spouse live after the death of the first spouse?; (4) what will the basic exclusion amount be when the first spouse dies?; and (5) what will the transfer tax rates be upon the death of the first spouse? If we know this information, we can make the right choice. But few planners will be in a position to answer these questions with any confidence. Accordingly, the important theme for all planning in Bucket Two is **flexibility**. We want a plan that can let the couple choose the right path (credit shelter trust or portability election) when they have better answers to those five questions (i.e., after the death of the first spouse) instead of a plan that forces them to commit to one path now when there is so much uncertainty. This template does that.

Transfer Upon First Spouse's Death: Trust or Outright Gift? It all starts with the same question posed to Bucket One couples: if taxes were not an issue, what should happen to the assets when the first spouse dies? Since we can create an effective plan regardless of which option the couple chooses (outright gift or trust), tax consequences have no relevance at this stage. See the Bucket One template for discussion of when couples might prefer outright gifts over trusts and vice versa.

Outright Gifts – Disclaimer Planning. If the couple elects to have the assets of the first spouse pass to the survivor by outright gift, then the testamentary document (will or living trust) should contain a provision whereby any gift properly **disclaimed** by the surviving spouse shall pass to a credit shelter trust. This way, we keep both portability and the credit shelter trust on the table, and we need not choose between them until after the death of the first spouse to die.

If, for example, we know after the death of the first spouse that portability is the better option (because the survivor is not expected to live long, or because of the nature of the assets, or because of whatever other reason), the surviving spouse simply accepts the gift. The executor can then file an estate tax return that claims a full marital deduction. This reduces the taxable estate to zero (since all passes to the surviving spouse outright), and then the unused applicable exclusion amount passes to the surviving spouse. But if we decide that a credit shelter trust is the better option, the spouse can disclaim the gift (or disclaim an amount equal to the amount of the first spouse's remaining applicable exclusion amount) and by operation of the instrument the gift will pass to the credit shelter trust.

This structure postpones making the ultimate decision until after the death of the first spouse. Like any plan making use of qualified disclaimers, the planner should discuss with the couple the practical constraints involved. For instance, the surviving spouse must not accept the benefit of any of the deceased spouse's property in order for any disclaimer to be valid. That means funds will need to be available for the surviving spouse so that the survivor is not tempted to accept the benefit of the deceased spouse's property before the final decision whether to make a disclaimer has been made.

Trusts – Clayton *QTIP.* If the couple instead opts to have the assets of the first spouse pass to the survivor through a trust, a good vehicle is the so-called *Clayton* QTIP trust. A *Clayton* QTIP is just like a regular QTIP trust in that all income is to be paid at least annually to the surviving spouse and trust distributions during the spouse's lifetime can be made only to the surviving spouse. And like a regular QTIP trust, the executor has to elect to treat assets intended to qualify for the marital deduction as "qualified terminable interest property." But the *Clayton* QTIP trust contains an additional provision: to the extent the executor does not elect to qualify an asset passing to the trust as qualified terminable interest property, such property shall automatically pass to a credit shelter trust.

An example illustrates the flexibility of this approach. Suppose the deceased spouse's will leaves everything to a *Clayton* QTIP. If the deceased spouse's executor decides that portability is the preferred planning option for whatever reason, the executor will make the QTIP election on a timely filed estate tax return for all of the assets in the trust. The gift will qualify for the unlimited marital deduction, meaning the deceased spouse's taxable estate will be reduced to zero and the full deceased spousal unused exclusion amount can port over to the surviving spouse. If the executor instead decides that the credit shelter trust is best, the executor can select assets with a value equal to the deceased spouse's remaining applicable exclusion

amount and then make the QTIP election for *all other assets*. The unelected assets will pass automatically to the credit shelter trust.

As with the disclaimer approach, the *Clayton* QTIP allows the couple to defer making the decision between portability and the credit shelter trust until after the first spouse dies. It thus provides the needed flexibility.

c. Planning for Bucket Three Couples. Unlike good stories, we have saved the most boring for last. Not much has changed when it comes to advising, say, the $50 million estate. The techniques used prior to both the Act and the American Taxpayer Relief Act remain attractive now. Choosing between portability and a credit shelter trust alone will not be enough.

The planner still needs to consider strategies that can reduce the amount of wealth subject to tax while still retaining the desired level of control over and cash flow from the assets in the estate. These strategies include: spousal lifetime access trusts (SLATs); irrevocable life insurance trusts (ILITs); grantor retained annuity trusts (GRATs); charitable lead trusts (CLATs and CLUTs); charitable remainder trusts (CRATs, CRUTs, NIMCRUTs); donor-advised funds, private foundations, and pooled income funds; family limited partnerships (FLPs) and limited liability companies; installment sales to "defective" grantor trusts; and dynasty trusts. Of course, even some Bucket Two couples may find one or more of the these strategies useful in their own planning as well. But it's now primarily Bucket Three couples that are concerned with gross estate minimization.

E. ALTERNATIVE MINIMUM TAX REFORM

1. Corporate AMT Repealed

Prior law imposed an alternative minimum tax (AMT) on some corporations. The key to calculating a corporation's AMT liability was to determine its "alternative minimum taxable income" (AMTI). The starting point, no surprise, was the corporation's regular taxable income. Certain adjustments to that figure were made under §§56 and 58. For example, a corporation had to recompute certain depreciation deductions by using the straight-line method rather than the usual accelerated cost recovery system allowed for regular tax purposes. §56(a)(1)(A)(i). The taxable income figure was then further adjusted by the so-called "preference items" in §57. For example, a corporation had to increase taxable income by the amount of tax-exempt interest received on private activity bonds. §57(a)(5)(A). (For regular tax purposes, such interest is excluded from gross income under §103.)

The final major adjustment to taxable income was the "adjusted current earnings" (ACE) adjustment provided in §§56(c)(1) and (g). The purpose of this adjustment was to reflect the corporation's true earnings for the taxable year. Once all adjustments have been made, a "tentative minimum tax" was computed by computing 20 percent of the corporation's AMTI as exceeds the exemption amount ($40,000). But the $40,000 exemption amount was reduced by

25 percent of the amount by which AMTI exceeded $150,000. §55(d)(3). AMT liability thus applied to the extent tentative minimum tax liability exceeded the corporation's regular tax liability.

The corporate AMT was only a concern to very large corporations. Certain "small" C corporations were wholly exempt from the AMT. A C corporation with average annual gross receipts of $7.5 million or less for all three-year periods beginning after 1993 and ending before the taxable year was considered a "small" corporation and, as such, was deemed to have a tentative minimum tax liability of zero. IRC §55(e). For the corporation's first three-year period (or portion of a period), the limit was $5 million instead of $7.5 million.

The Act repeals the corporate AMT effective for taxable years beginning in 2018 or later. This repeal is permanent; it is not scheduled to sunset. The estimated revenue loss from repeal is $40.3 billion over ten years. Estimated Budget at 3.

2. Individual AMT Retained with Higher Exemptions

Individuals, estates, and trusts are likewise subject to the AMT. The minimum tax imposed is the amount by which tentative minimum tax exceeds the regular income tax liability for the year. There is a "tentative minimum tax" when AMTI (computed in roughly the same manner for individuals as for corporations) exceeds the exemption amount. Taxpayers with high AMTIs face a phaseout of the exemption amount.

The House Bill called for complete repeal of the individual AMT to accompany repeal of the corporate AMT, but the Senate would not have it. Instead, the final Act temporarily increases both the exemption amount and the exemptions amount phaseout threshold, as illustrated in the following table (effective for 2018 through 2025):

	PRE-TAX CUTS AND JOBS ACT*			**POST-TAX CUTS AND JOBS ACT**		
Taxpayer	Joint Filers	Unmarried	Estates and Trusts	Joint Filers	Unmarried	Estates and Trusts
AMT Exemption Amount	$86,200	$55,400	$24,600	$109,400	$70,300	$24,600
Phaseout of exemption amount begins when AMTI exceeds	$164,100	$123,100	$82,050	$208,400	$156,300	$82,050

* Figures from Revenue Procedure 2017-58.

The new dollar amounts are set to be adjusted for inflation, but will expire at the end of 2025. These adjustments are expected to cost about $637 billion in foregone revenue over this period. Estimated Budget at 2. Under *Revenue Procedure 2018-57*, issued on November 15,

2018, the 2019 exemption amount for joint filers is $111,700; for unmarried taxpayers the exemption amount is $71,700. For estates and trusts, the 2019 exemption amount is $25,000.

F. PROPOSED REFORMS THAT DID NOT SURVIVE THE FINAL BILL

Both the House and Senate bills contained provisions that were left on the cutting room floor by the Conference Committee. A number of these last-minute cuts had been discussed in the popular press, so some clients might be under the mistaken impression that the final Act contains some of these provisions. Accordingly, these materials conclude with a brief mention of various reform proposals from the House and Senate bills that were not included in the final Act, as confirmation that these proposals are not in fact part of the new law.

1. Individual Tax Reforms Not Enacted

a. Exclusion of Gain on Sale of Personal Residence: The House bill made three changes to the §121 exclusion applicable to gain from the sale of a personal residence. First, it replaced the requirement that the taxpayer own and occupy the home for two of the five years prior to the sale with the requirement that the taxpayer own and occupy the home for five of the right years prior to the sale. Second, it would have limited the application of §121 to every five years instead of every two years. Finally, it would have imposed a phaseout of the exclusion once the taxpayer's adjusted gross income exceeded $250,000 ($500,000 for joint filers).

The Senate bill was on board with the first two changes, but it did not include an income-based phaseout. It also provided for a sunset of the changes come 2026. But for reasons not apparent, the Conference bill enacted none of the proposed changes to §121.

b. American Opportunity Tax Credit and Lifetime Learning Credit. Current law provides for both the American Opportunity Tax Credit and the Lifetime Learning Credit. The American Opportunity Tax Credit gives individuals a credit of up to $2,500 for qualified tuition and related expenses paid first the "first four years" of post-secondary education in a degree or certificate program, though the credit generally is phased out ratably for taxpayers with adjusted gross incomes between $80,000 and $90,000 (double those amount for joint filers). Up to 40 percent of the credit is refundable The Lifetime Learning Credit is nonrefundable credit of 20 percent of qualified tuition and related expenses, but subject to a cap of $2,000. The credit extends beyond the first four years of undergraduate education, but is phased out ratably for taxpayers with adjusted gross incomes between $56,000 and $66,000 (double those amount for joint filers).

The House bill would have repealed the Lifetime Learning Credit and modified the American Opportunity Tax Credit by also allowing a half-credit in the *fifth* year of undergraduate education. The Senate bill did not address the education credits at all, and the Conference bill did not include the House bill provision.

c. **Student Loan Interest**: The House bill would have repealed the §221 deduction for interest paid on student loans. The Senate bill contained no similar provision, and it was dropped from the Conference bill.

d. **Qualified Tuition and Related Expenses**: The House bill would have repealed §222 deduction for qualified tuition and related expenses, but the Senate and Conference bills rejected this.

e. **Exclusion for Qualified Tuition Reductions**: The House bill called for repeal of §117(d), which generally excludes from gross income the value of tuition reductions furnished to employees, their spouses, and their dependents. Colleges and universities vocally opposed the measure, as it would have made most graduate assistant positions taxable. The Senate bill did not contain this provision, and the provision was dropped from the Conference bill.

f. **Exclusion of Interest on United States Savings Bonds Used for Higher Education**: The House bill repealed §135, the exclusion of interest earned on a Series EE savings bond issued after 1989 to the extent the interest does not exceed the taxpayer's qualified higher education expenses. The Senate bill ignored the proposed repeal, as did the Conference bill.

g. **Exclusion for Educational Assistance Programs**: The House bill also called for repeal of §127, which excluded up to $5,250 of annual educational assistance provided to an employee by an employer relevant to undergraduate and graduate education. But neither the Senate bill nor the Conference bill included this provision.

h. **Deduction and Contributions to Archer Medical Savings Accounts**: The House bill made contributions to Archer MSAs nondeductible as of 2018, and likewise provided that such payments would be includible in gross income and count as wages if paid by an employer. But the Senate bill did not include this provision and it was likewise dropped from the Conference bill.

i. **Exclusion for Employer-Provided Housing**: Section 119 allows an employee to exclude from gross income the value of lodging furnished by an employer for the convenience of the employer, provided the employee is required to accept the lodging on the employer's business premises as a condition of employment. The House bill limited this exclusion to a maximum $50,000 exclusion, subject to a phaseout based on the employee's compensation. It also disallowed the exclusion entirely to employees who own five percent or more of the employer. The Senate bill did not pick up this provision; neither did the Conference bill.

2. Business Tax Reforms Not Enacted

a. Expenses in Contingent Fee Cases: *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), held that an attorney could deduct litigation costs in contingent fee cases even though the attorney may later recoup those expenses under the contingent fee arrangement. The House bill would have overruled *Boccardo* through a specific rule disallowing a deduction for litigation costs paid under a contingent fee arrangement until the contingency ends. The Senate bill contained no similar provision, and the Conference bill let it die.

b. 25 Percent Rate on Qualified Business Income: Instead of the 20-percent deduction for qualified business income coined in the Senate bill, the House bill would have instead applied a maximum rate of 25 percent to qualified business income. In addition, the House version treated passive activities differently than active businesses: all of the ordinary income from a passive activity would qualify for the rate preference, but only the "capital percentage" of business income (presumptively 30 percent of the ordinary income) would qualify in the case of active businesses.

3. Wealth Transfer Tax Reforms Not Enacted

As explained above, the House bill called for eventual repeal of the federal estate and generation-skipping transfer taxes, accompanied with a reduced tax rate of 35 percent for purposes of the federal gift tax. But the Senate settled simply for doubling the basic exclusion amount and leaving the tax rate alone.

II. THE BIPARTISAN BUDGET ACT OF 2018

On February 9, 2018, Congress passed the Bipartisan Budget Act of 2018. The President signed the bill the same day. In addition to providing continued funding of the federal government through March 23, the Act retroactively extended through 2017 over 30 Code provisions that had technically expired. The legislation also introduced a few new rules. Here are some of the more important items of note.

A. SIMPLIFIED FILING FOR OLDER INDIVIDUALS

The Act requires the Service to prepare a simplified income tax return form to be designated as "Form 1040-SR" for use by taxpayers age 65 or older at the end of the taxable year. The form is to be as similar as possible to the Form 1040-EZ, but its use will not to be restricted based on the amount of taxable income shown on the return or the fact that the income to be reported for the tax year includes social security benefits, distributions from qualified retirement plans, annuities, distributions from other deferred payment arrangements, interest and dividends, or capital gains and losses.

Taxpayers using the 1040-SR will not be allowed to itemize deductions, but the larger standard deduction in play under the Tax Cuts and Jobs Act lessens the impact of this restriction. The form is to be available for taxable years beginning after February 9, 2018.

B. NEW ABOVE-THE-LINE DEDUCTION FOR WHISTLEBLOWERS

The Act adds new § 62(a)(21), offering an above-the-line deduction for attorney fees and court costs paid by or on behalf of a taxpayer in connection with any award under §7623(b) (awards to whistleblowers who furnish information about tax evaders to the Service). The above-the-line deduction also applies to post-2017 attorney fees and court costs paid by taxpayers in connection with awards under §21F of the Securities Exchange Act of 1934, a State law relating to false or fraudulent claims that meets the requirements described in §1909(b) of the Social Security Act, and §23 of the Commodity Exchange Act. The total deduction amount cannot exceed the amount of the award includible in the taxpayer's gross income for the taxable year.

C. EXTENDERS

Among the provisions extended through 2017 were the exclusion for discharge of debt on a principal residence under §108(a)(1)(E), the treatment of mortgage insurance premiums as qualified residence interest under §163(h)(3), the deduction for qualified tuition and related expenses under §222(e), and the three-year recovery period for race horses two years old or younger under §168(e)(3)(A).

III. OTHER DEVELOPMENTS OF NOTE

A. PROPOSED ANTI-CLAWBACK REGULATIONS

As explained above, the basic exclusion amount is set to revert from $10 million (adjusted for post-2011 inflation) to $5 million (adjusted for post-2011 inflation) in 2026. If a client makes a taxable gift of, say, $10 million in 2019, and if Congress takes no other action, will that mean that the client must pay gift tax in 2026 on the amount in excess of the reduced basic exclusion amount? Alternatively, will the client’s estate have to pay estate tax on that excess amount if the client dies in 2026? The answer to both of these questions has always been “no.” More precisely, the answers *should be* “no,” but some planners worried that the statute was not entirely clear on this point.

The relevant statute, §2001(g)(1) states that:

> For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent’s death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute—
>
> (A) the tax imposed by chapter 12 with respect to such gifts, and
>
> (B) the credit allowed against such tax under section 2505, including in computing—

(i) the applicable credit amount under section 2505(a)(1), and
(ii) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).

Note that the statute tells us to use the *rates* of tax in effect at death rather than the *rates* in effect at the time of the gift. It does not say to use the *exemption amounts* in effect at death. That's what led some planners to conclude that there could be "clawback," the scary-sounding term for gift or estate tax attributable to a prior taxable gift. The Tax Cuts and Jobs Act addressed this concern by enacting §2001(g)(2):

(2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—
(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
(B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

Though perhaps cryptic in its language, the directive to Treasury was clear: issue regulations making clear that a large gift made today will not face gift or estate tax when the basic exclusion amount reverts to a smaller amount.

On November 23, 2018, Treasury published proposed regulations implementing the Congressional mandate. Here is the text of the proposed regulations:

§20.2010-1 Unified credit again estate tax; in general.
* * *
(c) *Special rule in the case of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death*—
(1) *Rule.* Changes in the basic exclusion amount that occur between the date of a donor's gift and the date of the donor's death may cause the basic exclusion amount allowable on the date of a gift to exceed that allowable on the date of death. If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts. The

amount allowable as a credit in computing gift tax payable for any year may not exceed the tentative tax on the gifts made during that year, and the amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate. Sections 2505(c) and 2010(d).

(2) *Example.* Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.

Looking for an easy way to state this rule? Ron Aucutt offers one: "Viewed another way, if what would otherwise be the basic exclusion amount for estate tax purposes is less than the total of the basic exclusion amount applied to post-1976 taxable gifts, it is increased for estate tax purposes under this new regulation to equal that total." Treasury's news release, issued the same day as the proposed regulations, offers another: "the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the [basic exclusion amount] applicable to gifts made during life or the [basic exclusion amount] applicable on the date of death."

B. CHARITABLE CONTRIBUTIONS

1. Final Regulations on Substantiation and Reporting Requirements for Charitable Contributions (T.D. 9836, July 27, 2018).

Treasury has finalized regulations proposed in 2008 related to the substantiation and reporting requirements for the income tax deduction for charitable contributions that were amended by legislation in 2004 and 2006. For the most part, the final regulations adopt the provisions of the proposed regulations with only minor changes. There are, however, two significant changes.

The first important change relates to the substantiation rules under §§170(f)(8) and 170(f)(17). Section 170(f)(8) does not require a donee's contemporaneous written acknowledgment to include the date of the contribution. And §170(f)(17) does not require a statement of whether any goods or services were provided in exchange for the contribution. In response to comments, the final regulations make clear that a single written acknowledgment that satisfies all substantiation requirements under both sections 170(f)(8) and 170(f)(17) is adequate substantiation for contributions of cash, check, or other monetary gifts.

The second set of changes relate to the definition of qualified appraisal and qualified appraiser. Although the final regulations on these definitions are very close in substance to the proposed regulations, the preamble to the final regulation states that in order to provide appraisers reasonable time to meet the new education and experience requirements, this part of the final regulations apply only to contributions made on or after January 1, 2019.

2. Original Sticker Price is Not Fair Market Value (*Grainger v. Commissioner*, T.C. Memo. 2018-117, July 30, 2018).

"Petitioner is a retired grandmother who is fond of shopping." So begins the Tax Court's opinion regarding a claimed charitable contribution deduction for donations of used clothing. It gets better: "Seeking to combine her love of shopping with a desire for a tax cut, she developed in 2010 what she described at trial as her 'personal tax shelter.' Having learned that a taxpayer may generally claim a charitable contribution deduction in an amount equal to the fair market value (FMV) of donated property, she assumed that the FMV of a retail item is the dollar amount shown on the price tag when the retailer first offers the item for sale. Petitioner thus saw an opportunity: If she could find items that had been heavily discounted from the amounts shown on their original price tags, she could achieve a net tax benefit simply by buying and immediately donating those items." Using loyalty points together with deep discounts from end-of-season sales, for instance, the taxpayer "might purchase for $10 an item that had an original retail price of $99." She would then donate the item and claim a $99 deduction, which would save more than $10 in federal income tax.

The plan started modestly, with a noncash charitable contribution deduction of about $18,000 on her 2010 return. But the deductions grew to over $32,000 in 2011, $34,000 in 2012, $40,000 in 2013, and almost $47,000 in 2014. The Service investigated her 2012 return and reduced the deduction to $2,520, the taxpayer's actual cash outlay for the donated items. Because the claimed deduction for the clothing totaled more than $5,000, the Tax Court observed, the taxpayer had to substantiate the deduction with a qualified appraisal and attach an "appraisal summary" on a Form 8283. But the taxpayer had only Goodwill receipts, on which a Goodwill employee had marked the date and location of the donation, that the donated items were clothing, and a signature. Such does not make a qualified appraisal.

The court went on to observe, however, that even if the taxpayer had secured an appraisal, "we would still sustain respondent's disallowance because she failed to employ a legitimate methodology to determine the FMV of the donated clothing." The court reasoned that no reasonable buyer with knowledge of the relevant facts would pay a price higher than the discounted price charged by the retailer. Accordingly, it sustained the deficiency.

3. No More Donor Disclosure Requirement for Many Tax-Exempt Organizations (*Revenue Procedure 2018-38*, July 17, 2018).

The Service has announced that tax-exempt organizations other than §501(c)(3) organizations are no longer required to report the names and addresses of their contributors on the Schedule B of their Forms 990 or 990-EZ. Organizations relieved of these obligations must still keep this information in their books and records, however. The Service explained that it does not need personally identifiable information of donors to be reported on the Schedule B in order to carry out its enforcement responsibilities, and the "the requirement to report such information increases compliance costs for some private parties … and poses a risk of inadvertent disclosure of information that is not open to public inspection." The relaxed reporting requirements will apply to information returns for tax years ending on or after 2018.

4. Engaging in Spring Cleaning, the Service Consolidates Guidance on Reliance Issues Related to Donations (*Revenue Procedure 2018-32*, May 16, 2018).

Over the years, the Service has issued a lot of guidance to explain the extent to which grantors and contributors may rely on the Service's identification of an organization's tax-exempt and foundation status. Through these various publications the Service has also outlined several safe harbors with regard to the effect of grants and contributions on an organization's foundation status. In an effort to simplify compliance, the Service has brought all of this guidance into one new, streamlined revenue procedure.

The new revenue procedure explains that if an organization listed in or covered by the searchable "Tax Exempt Organization Search (Pub. 78 Data)" or "Exempt Organization Business Master File Extract" databases ceases to qualify as a charity and the Services revokes a determination letter or ruling concluding that the organization is one to which contributions are deductible under §170, grantors and contributors to that organization still may generally rely on the determination letter or ruling information provided in the databases until the date of a public announcement stating that the organization ceases to qualify as a charity. According to the new revenue procedure, the public announcement may be made "via the Internal Revenue Bulletin, on the portion of the IRS website that relates to exempt organizations, or by such other means designated to put the public on notice of the change in the organization's status."

The new revenue procedure clarifies, however, that the Service may still disallow a deduction for any contribution made after an organization ceases to qualify as a charity and prior to the public announcement or posting of the revocation if the grantor or contributor: "(1) had knowledge of the revocation of the determination letter or ruling prior to the public announcement or posting; (2) was aware that such revocation was imminent; or (3) was in part responsible for, or was aware of, the activities or deficiencies on the part of the organization that gave rise to the loss of qualification."

In this regard, the new revenue procedure contains an important safe harbor: grantors and contributors will not be considered to be responsible for or aware of an act that results in loss of qualification due to change in financial support if the aggregate grants or contributions from the grantor or contributor are 25% or less of the organization's aggregate support for the four prior taxable years. This safe harbor is *not* available to grantors or contributors who are in a position of authority within the organization (like a foundation manager, for example). The safe harbor is also not available if the grantor or contributor had actual knowledge of the loss of qualification on or after the date of the public announcement that the organization ceases to qualify.

5. No Donation Where Taxpayer Receives Quid Pro Quo (*Triumph Mixed Use Investments III LLC v. Commissioner*, T.C. Memo. 2018-65, May 15, 2018).

The taxpayer claimed to have donated some $11 million in land (747 acres, in fact) to the city of Lehi, Utah. The donation agreement even stated that the transfer was for no consideration and was completely voluntary on the part of the taxpayer. And yet the Tax Court agreed with the Service that the taxpayer could not claim a charitable contribution deduction since the evidence showed the taxpayer made the donation to secure approval from the city for a development plan.

The court observed that the taxpayer's development plan faced public opposition and that the city council specifically required the taxpayer to dedicate open space as a condition to approving the plan. The timing of the alleged contribution and the approval of the plan indicated that the "donation" was simply part of a negotiation in which the city received open space in exchange for approving the plan. Since the taxpayer did not establish the value of the consideration received from the city, the taxpayer was not entitled to a charitable contribution deduction.

6. Conservation Easement That Benefits Donor Results in No Deduction (*Wendell Falls Development LLC v. Commissioner*, T.C. Memo. 2018-45, April 4, 2018).

Between 2004 and 2007, the taxpayer bought 27 contiguous parcels of North Carolina raw land, totaling 1,280 acres. The taxpayer planned to subdivide the land into residential areas, commercial spaces, an elementary school, and a 125-acre park. In 2005, the taxpayer and the county discussed the county's possible purchase of the 125 acres for use as a county park. Ultimately the taxpayer and the county decided that the county would buy the park from the taxpayer for just over $3 million if the taxpayer placed a conservation easement on the property. This went down in 2007.

On its 2007 return, the taxpayer claimed a $1,798,000 charitable contribution deduction for the conservation easement. The appraisal attached to the return valued the easement at $4,818,000. The return computed the deduction as if the county had paid $3,020,000 to the

taxpayer for an easement worth $4,818,000, resulting in a $1,798,000 deduction. In fact, however, the county paid the $3,020,000 to the taxpayer for the land, not the easement. So the taxpayer then filed an amended return claiming a deduction of $4,818,000. The Service disallowed the deduction in its entirety, so the taxpayer filed a petition to the Tax Court.

At the Tax Court, the taxpayer's expert testified that the value of the easement was $5,919,000. The Service's expert valued the easement at $1,600,000. But ultimately the court held the taxpayer was entitled to no deduction at all, for two reasons. First, the court concluded that the taxpayer received a substantial benefit from the donation. It was to the taxpayer's benefit that the 125 acres be restricted to park use. The court noted that one of the taxpayer's managing members wrote in an email to the county that the taxpayer "need[ed] to ensure that the County uses the park for its intended use." This convinced the court that the taxpayer expected to receive value from the park and intended the easement to ensure that the 125 acres would be used solely as a park.

Second, the court ruled that the easement had no value because the restriction did not diminish the value of the 125 acres. The taxpayer's own development plan for the entire 1,280 acres indicated that the highest and best use of the 125 acres was as parkland in the middle of a planned community. Using the 125 acres as a park would make the planned community more desirable, and this increased the value of the residential and commercial lots that the taxpayer intended to develop and sell.

7. Provision Allowing Conservation Easement to be Held by Non-Charity Doomed Deduction (*Salt Point Timber LLC v. Commissioner*, T.C. Memo. 2017-245, December 11, 2017).

The taxpayer granted a conservation easement encumbering 1,000 acres to the Lord Berkeley Conservation Trust, an eligible charity, for $400,000. The taxpayer claimed a $2,130,000 charitable contribution deduction after determining the value of the easement to be $2,530,000. The Service disallowed the deduction in full, pointing to a provision in the donation agreement that called for the easement to be replaced by "a comparable conservation easement" encumbering an adjacent property if certain conditions were met. The agreement did not expressly state that the holder of the replacement easement must be a "qualified organization."

The specific provision in the donation agreement provided as follows:

> "Notwithstanding any provision to the contrary, in the event that (i) any of the Protected Property is transferred to the owner of an adjacent property * * *, (ii) the adjacent property is encumbered by a comparable conservation easement, and (iii) the owner of the adjacent property and the holder of the conservation easement agree to modify the conservation easement on the adjacent property to encumber the transferred property by the adjacent property's conservation easement, the parties agree to amend this easement to release the transferred property from this easement."

The agreement does not define a "comparable conservation easement." The court found there was no express condition that the holder of the replacement easement be a "qualified organization." It rejected the taxpayer's claim that the text should be understood to mean that the holder of the easement must always be a qualified organization since applicable state law (South Carolina) effectively limits the holders of conservation easements to qualified organizations. By its own terms, the statutory definition is only for the purposes of "this chapter" of state laws. But even if state law dictates who can hold a replacement easement, it does not require the holder to meet the specific Code requirements for a nongovernmental organization to be deemed a "qualified organization."

The taxpayer then argued that even if the court is correct, the possibility that the easement would ever be held by anyone other than a qualified organization is so remote as to be negligible. But the court found that the conditions for replacing the easement are not sufficiently unlikely that they can reasonably be ignored. After all, it reasoned, if these conditions were really improbable enough to be ignored the parties would not have bothered to put this provision in the agreement.

8. Deduction for Donated House Falls to Pieces (*Platts v. Commissioner,* T.C. Memo. 2018-31, March 19, 2018).

The taxpayer was a 50-percent partner in a real estate development partnership. The partnership sold lots for residential development. At some point, the partnership donated a house to the Pine Valley Bible Camp, a charity, with the understanding that camp volunteers would disassemble the house and move the building materials to the camp. They did so in October 2000. On his federal income tax return for 2001, the taxpayer reported a donation of an intact house worth $176,255 to the Pine Valley Bible Camp. The reported value represented the full appraised value of the intact house (not just half) as of August 31, 1999, as stated in an independent appraisal prepared by an appraiser in late 2002. Petitioner wrote to his CPA that he and his wife had donated an intact house to their church in the prior year and wanted to deduct half of its value on their return. In an accompanying letter dated both August 31, 1999, and August 31, 2000, petitioner estimated that the value of the intact house was $163,200.

The Tax Court agreed with the Service that the taxpayer was not entitled to any charitable contribution deduction on these facts. For one thing, the taxpayer did not contribute an intact structure; "he merely contributed building parts." The taxpayer did not provide an appraisal of the building parts. The existing appraisal of an intact structure is not relevant in determining the value of the various parts extracted from that structure.

Second, the taxpayer made the donation in October, 2000, so he cannot deduct it on his 2001 return.

Third, the appraisal prepared attached to the return was not a qualified appraisal for several reasons. The appraisal was prepared in November of 2002, after the due date of the 2001

return. (A qualified appraisal must be received by the donor before the due date (including extensions) of the return on which a deduction is first claimed.) Also, the valuation date in the appraisal was August 31, 1999, but the donation did not happen until October, 2000. A qualified appraisal must be made no earlier than 60 days before the date of donation. Finally, the appraisal relates to the value of the donated property as a freestanding dwelling rather than building parts. With so many key errors, the taxpayer was hardly in substantial compliance with the substantiation requirements. Accordingly the taxpayer received no deduction for the building parts in 2001.

9. The Service is Thinking Through Some Issues with Donor Advised Funds (*Notice 2017-73*, December 4, 2017).

The Service has announced that it and the Treasury Department are considering issuing proposed regulations under §4967 that would address certain longstanding issues regarding donor advised funds (DAFs) and their sponsoring organizations. Importantly, the new regulations would clarify two important questions.

First, that certain distributions from a DAF that pay for the purchase of tickets that enable a donor or donor advisor (or certain related persons) to attend or participate in a charity-sponsored event would result in a “more than incidental benefit” to the donor and thus trigger the 125% excise tax under §4967. This result would apply even if the DAF limited its distribution to cover only the portion of the ticket price that would be eligible for a charitable contribution deduction if made by the donor or donor advisor directly. This result would also apply to distributions to cover a deductible portion of membership fees charged by a charity.

Second, that certain distributions from a DAF that the recipient charity treats as fulfilling a pledge made by a donor or donor advisor would *not* result in a more than incidental benefit under §4967, provided that the sponsoring organization made no reference to the existence of any individual’s pledge when making the DAF distribution.

C. FEDERAL WEALTH TRANSFER TAXES

1. Inter-Generational Split Dollar Arrangement Takes a Couple of Blows (*Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, June 18, 2018).

When the decedent was 90 years old and unable to manage his own affairs, his son (acting through a power of attorney and as trustee of the decedent’s revocable trust) created an irrevocable trust naming the son’s cousin as trustee. The son and his descendants were the primary beneficiaries of the new trust. The new trust and the revocable trust then entered into three split-dollar agreements related to three life insurance policies (one on the son and two on the life of the son’s spouse) with an aggregate death benefit of close to $80 million. The revocable trust borrowed $10 million from an unrelated party and used the borrowed funds to pay lump-sum premiums on all three policies. The new trust was designated as the owner of the policies. The arrangement between the revocable trust and the new trust was the revocable

trust would be reimbursed for the $10 million premium advanced either at termination of the arrangement or after the deaths of the insureds. If the agreement terminated before the death of an insured, the new trust could either: (a) retain the policy, in which case the revocable trust would receive the greater of the premiums paid or the cash surrender value of the policy, or (b) transfer the policy to the lender in full or partial satisfaction of the revocable trust's liability to the lender (with any excess of the surrender value over the loan balance payable back to the revocable trust). If the agreement did not terminate before death, the revocable trust had the right to receive from the death benefit the greater of: (a) the remaining balance on the loan, (b) the total premiums paid by revocable trust, or (c) the policy's cash surrender value immediately before the insured's death. The new trust would keep any excess of the death benefit over the amount paid to revocable trust.

The decedent reported $7,575 in gifts to the new trust, using the economic benefit regime of the split-dollar insurance regulations. When the decedent died the next year, the cash surrender value of the three policies was just over $9.6 million. But what amount should be included in the decedent's gross estate attributable to rights held by the revocable trust? The decedent's estate maintained that because termination of the split-dollar arrangements was so unlikely (it would not make sense for the new trust to consent to the termination), the termination rights had no value as of the decedent's death. The estate thus concluded that the value of the decedent's interests in the split-dollar agreements was limited to the value of the death benefit rights, which it calculated at $183,700 given the young ages and long life expectancies of the insureds.

The Service, applying §§2036, 2038, and 2703, valued the decedent's rights in the split-dollar agreements at the $9.6 million cash surrender value. It also assessed penalties for negligence and valuation misstatements. Before the Tax Court, estate sought partial summary judgment that none of §§2036, 2038, or 2703 applied to the split-dollar arrangement.

The Tax Court denied the estate's request for summary judgment. It held that the rights to terminate the agreement and to recover at least the cash surrender value were held by the revocable trust on the date of the decedent's death (even though such rights were exercisable in conjunction with the new trust), and that they gave the decedent the power to designate the persons who would possess or enjoy the transferred property. That was enough to trigger §2036(a)(2). Moreover, the retained rights were effectively powers to alter, amend, revoke, or terminate, bringing the arrangement also within the application of §2038(a)(1).

The estate argued for the "bona fide sale" exceptions to §§2036 and 2038, but the court refused to view the arrangement as a sale. The concluded the facts did not establish a "legitimate and significant nontax reason" for the transfer. In addition, the revocable trust's interest in the policies was not worth the same amount as the amount transferred. Because the new trust could veto the revocable trust's attempt to terminate the agreements from the moment the agreement was entered into, the value of the revocable trust's retained rights was never equal to the $10 million transferred.

The court also agreed with the Service as to the application of §2703(a). Recall that §2703(a) provides that the value of property is determined without regard to "any option, agreement, or other right to acquire or use the property" for less than fair market value or "any restriction on the right to sell or use" the property. The estate wanted partial summary judgment that the new trust's power to veto termination of the split-dollar agreements should not be disregarded under Section 2703(a), but the court rejected the motion. The court reasoned that §2703(a) applies because "the split dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value." They are also a restriction on the right to sell or use property, said the court, because "the split-dollar agreements, and specifically [the new trust's] ability to prevent termination, also significantly restrict decedent's right to use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreement and withdraw his investment from these arrangements." The court rejected the estate's claim that the split-dollar agreements are like promissory notes or partnership interests, to which §2703(a) does not apply. The split-dollar agreements are not like promissory notes because the new trust provided nothing to fund these arrangements. They are also not like partnership interests since there is no state-authorized entity in play here.

Importantly the court did not rule on the possible application of §2703(b), the exceptions to §2703(a), because the motion related only to the application of §2703(a).
But the estate was not done! It then argued that the difference between the $10 million that the revocable trust paid for the policies and the $183,700 that he received in return would be accounted for as gifts, and that to count it also as part of the decedent's gross estate under §§2036, 2038, or 2703 would effectively double-count that amount. The court rejected this argument because the decedent never reported the difference as a gift; the parties agreed that only the economic value of the insurance coverage was a gift. The court also rejected the estate's claim that the difference between the $183,700 and the cash surrender value will be reflected as gifts after the decedent's death. That may be true, said the court, but the gift of current life insurance protection to the new trust after the decedent's death "would not be a gift from the decedent but rather from whoever happens to succeed to decedent's interests in the split-dollar agreements." Thus, there would be no double-counting.

Howard Zaritsky offers the following takeaways from *Cahill*:

> *Estate of Cahill* strongly suggests that the Tax Court agrees with the IRS assertion that the estate tax value of the rights of a deceased insured in an intergenerational split-dollar life insurance arrangement is at least equal to the cash value of the policy, rather than the present value of the right to be repaid under the split-dollar agreement. The court in *Estate of Cahill* merely refused to grant summary judgment to the decedent's estate on these issues, so it is not a firm explanation of how to value the estate's interest in the policy, but its application of Sections 2036, 2038, and 2703 should cause practitioners to exercise extreme caution in entering into these arrangements.

> *Estate of Cahill* is not a definitive statement of the estate tax treatment of intergenerational split-dollar life insurance. The court here refused to conclude that, as a matter of law, the IRS positions were wrong. These issues will now go to trial, where the estate may attempt to establish that the original transaction had an independent nontax purpose and that the original transfer was actually for a full and adequate consideration.
>
> Nonetheless, the court appears already to have concluded that the original transfer was not for full and adequate consideration, so its position in this case will very likely reflect the ultimate disposition – that the estate tax value of the decedent's interest in an intergenerational split-dollar arrangement will be equal or close to the policy's full cash value. If that is true, then there is little or no estate tax benefit to using an intergenerational split dollar arrangement. Taxpayers who did so will face prolonged negotiations and fights with the IRS, with relatively little likelihood of a favorable outcome. This is not the end of this discussion, but the outlook for intergenerational split-dollar arrangements as an estate tax savings vehicle is not good.

And consider these insights from Steve Akers regarding the court's application of §§2036 and 2038:

> Planners have been concerned that the reasoning of the *Powell* case (decided only about a year before the *Cahill* case) could be extended to almost any arrangement involving multiple parties. *Powell* applied §2036(a)(2) to the decedent's limited partnership interest to include a pro rata value of the partnership assets in the decedent's estate (without any discount attributable to the limitations on the rights of limited partners under state law) because the decedent "in conjunction with" other partners could at any time vote to dissolve the partnership. … Under the *Powell* facts, the partnership agreement provided that the partners could unanimously vote to dissolve the partnership. Even absent that express provision, however, the partners (or the participants in any joint undertaking) could always unanimously agree to undo the partnership or other relationship.
>
> Anecdotal reports are that IRS officials have been asserting a broad application of the *Powell* reasoning in estate tax audits, and *Cahill* is the first reported case applying the *Powell* reasoning, and it is extending the "in conjunction with" analysis to a contractual arrangement rather just applying the analysis to another partnership.

Steve Akers adds the following observations on the §2703(a) issue:

> The key issue that arises in determining whether §2703(a) applies to any particular "property" is whether the property being tested under §2703(a) is an asset with inherent characteristics that impact its value or whether the property is an asset subject to some agreement or restriction that allows someone to acquire or use the asset at less

than its fair market value or that restricts the right to use or sell the asset, which restriction must be ignored under §2703(a) in valuing the "property."

For example, is an automobile that has a governor limiting its maximum speed to 30 miles per hour valued as an under-30 MPH vehicle (with a minimal value), or is it valued as an automobile subject to a restriction on the right to its use because the governor restricts it from exceeding 30 MPH, which restriction must be ignored in valuing the automobile under §2703(a)?

The estate argued that the decedent transferred $10 million in return for a bundle of contractual rights and that any characteristics impacting the value of the bundle of contractual rights were just inherent in the nature of what was acquired. The estate argued that its rights under the split dollar agreements in their entirety was the "property" (rather than having any interest in the policies burdened by restrictions). The court acknowledged that the estate owned contractual rights, but viewed these rights as including a right to terminate the contract (and access the cash surrender value) but only with an agreement and restriction that impacts that value (i.e., the requirement of obtaining the irrevocable trust's consent), which restriction was subject to §2703(a). Is that appropriate?

2. ***Cahill*** **Applies in Another Intergenerational Split-Dollar Arrangement (*****Estate of Morrisette v. Commissioner*****, Order on Motion for Partial Summary Judgment, June 21, 2018).**

In 2006, Clara's revocable living trust entered into two split-dollar life insurance arrangements with three separate dynasty trusts, one for each of her three sons and their families. Each dynasty trust bought two universal life insurance policies, one on the life of each of the other brothers. To fund these policies, the dynasty trusts and Clara's revocable trust entered into a split-dollar arrangement. Under the arrangement, Clara's trust would transfer about $10 million to each dynasty trust, and the trustees of those trusts would use the funds to pay the premiums on the policies. Upon the death of a son, Clara's revocable trust would receive a portion of the death benefits from the policies on the life of the deceased son. With respect to each policy, the amount payable to Clara's revocable trust would be the greater of the cash surrender value of the policy or the total premium payments made on the policy. The dynasty trusts owning the policies would then receive the balance of the death benefits, to be used to buy stock owned by (or held in trust for the benefit of) the deceased son. If the split-dollar arrangement terminated before the death of a son, Clara's revocable trust would still be entitled to receive the "greater of" amount described above.

This is a so-called "intergenerational split-dollar arrangement." Howard Zaritsky explains:

> Intergenerational split-dollar involves using the economic benefit regime with a collateral assignment non-equity split-dollar agreement, to avoid both gift and GST taxes and to reduce estate taxes. Under this arrangement, a senior-

generation member (in this case, Clara's revocable trust) pays that part of the premiums on the policies insuring the lives of one or more middle-generation members (in this case, Clara's sons). The death benefits are payable to a trust for the benefit of lower-generation members (in this case, the three dynasty trusts). Typically, the senior-generation family member pays the portion of the premium equal to the value of the present insurance coverage, determined under Table 2002 (IRS Notice 2002-8), or the insurer's alternative term rate, if lower.

> Proponents of this concept argue that the senior generation makes no taxable gifts by paying these premiums; rather, he or she is advancing funds with a full right to recover the greater of the cash value or the total premiums paid from the policy death benefits. Moreover, when the senior generation family member dies, the value of the right of recovery in his or her estate is merely a "collateralized receivable" that must be paid at the insured child's death. The economic benefit regime impairs the value of these receivables, potentially reducing their value for estate tax purposes. The receivables are mere unsecured promises to pay uncertain amounts at an uncertain time, with no current return on their value and with ongoing tax liabilities.

Consistent with this strategy, Clara filed federal gift tax returns reporting gifts to each dynasty trust using the economic benefit regime under Regulation §1.61-22. Under that approach, the gift is equal to the cost of the current life insurance protection as determined under Table 2001 minus the amount of the premium paid by the dynasty trust. That reduced the total annual gifts from 2006 to 2009 to amounts ranging from just over $64,000 a little over $206,000. Following Clara's death in 2009, the estate valued the revocable trust's right to receive future repayments from the dynasty trusts at about $7.5 million.

But the Service determined that the entire $30 million transferred to the dynasty trusts in 2006 was a gift. That sent the estate to Tax Court, where it argued that the economic benefit regime should apply in determining the amount of the gift. In a reviewed opinion, the Tax Court granted the estate's motion for partial summary judgment on this issue. Clara's trust was entitled to recover all of the premiums paid on the policies (at a minimum), and that recovery was secured by the death benefits. The transaction was thus a valid split-dollar arrangement.

In 2016, the Tax Court ruled on whether the loan regime or economic benefit regime applied to this arrangement. Because the dynasty trusts were the owners of the policies, one would think the loan regime would apply. But the regulations provide that the donor is the deemed owner of the policies where the arrangement is donative in nature and the donee receives only the current life insurance protection from the policies. The court determined this exception applied here, especially after noting that the preamble to the regulation contains an example explaining this exception that uses facts nearly identical to those in the case at bar. Because Clara's trust retained the greater of the total premiums paid or the cash surrender value of the policies, the dynasty trusts did not have any additional economic benefit. The dynasty trusts had no access

to the cash values of the policies. Thus the economic benefit regime properly applied to this arrangement.

Next up, the court has to value the right to repayment that is included in Clara's gross estate. That, in turn, depends on whether §2703 applies. Section 20703(a) generally states that property is to be valued without regard to any option, agreement, or other right to acquire or use the property at a price less than fair market value and without regard to any restriction on the right to sell or use the property. The estate argued that §2703 does not apply since Clara's only right under the split-dollar arrangements was the death benefit, and the death benefit is free of any restriction on the right to sell or use. According to the estate, the termination restriction (that neither party could unilaterally terminate the arrangements) is not a restriction for purposes of §2703. The Service replied that the termination restriction plainly falls under §2703(a), meaning Clara's rights under the split-dollar arrangements should be valued as if she had the right to unilaterally terminate the agreements. Citing *Cahill*, the Tax Court denied the estate's motion for summary judgment that §2703(a) does not apply. So the saga continues.

3. Full Inclusion of GRAT Corpus Required When Annuitant Fails to Survive (*Badgley v. United States*, 9th Cir., May 17, 2018).

In 1998, the decedent created a grantor-retained annuity trust ("GRAT") by transferring her one-half interest in a family partnership and three parcels of rental property. The trust instrument provided that the decedent would receive annual annuity payments for 15 years or her prior death (payable quarterly) equal to 12.5% of the date-of-gift value of the property transferred to the GRAT. The trust instrument provided that upon termination of the decedent's annuity rights, the trust corpus would pass to her two daughters. Between 2002 and 2012, the GRAT's share of partnership income was larger than the annuity obligation owed to the decedent. The partnership made cash distributions to the GRAT during this time, all payable to a bank account in the name of the GRAT. The decedent controlled the account and used it to make the quarterly annuity payments to her personal accounts. The decedent transferred the excess funds to other investment accounts.

The decedent date late in 2012, before the expiration of her annuity interest. Her federal estate tax return originally reported a total gross estate of about $36.8 million, a figure that included the value of the assets held in the GRAT. But the executor then filed a $3.8 million refund claim, maintaining that the full value of the GRAT was not includible in the decedent's estate. When the Service took no action on the claim, the executor brought a refund suit.

The executor first argued that §2036(a) did not apply because the statute is limited to cases where the decedent retained the right to "income" (or possession or use or enjoyment) from gifted property. The executor argued that there is a difference between "a fixed annuity payment payable out of transferred property" on the one hand, and the retention of a "right to income" on the other. Income fluctuates, but a fixed annuity payment does not. Moreover, the decedent's annuity could have been satisfied from principal instead of income, meaning the two concepts are distinct. The Service replied that §2036(a) applied, both because the decedent

died with rights to (or control over) income through her right to annual annuity payments from the GRAT, and because she possessed and enjoyed the property through her “other interests and powers” in the family partnership.

The court sided with the Service. The decedent’s annuity, it concluded, comprised some possession, enjoyment, or right to income from the transferred property. There was no evidence that any of the three rental properties were ever sold to fund the annuity. Thus, the annuity necessarily drew either from the GRAT's current or accumulated income.

The executor then argued that the regulation requiring full inclusion in the decedent’s gross estate was invalid. The court upheld the regulation after performing the two-part *Chevron* test. The regulation’s approach was a reasonable interpretation of an issue not clearly answered by Congress. The court thus denied the estate’s refund claim, granting the Service’s motion for summary judgment.

4. Decedent’s Revocable Trust was a Substitute Limited Partner and Not a Mere Assignee (*Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178, October 24, 2018).

Acting under a power of attorney, the decedent’s daughter formed a Texas limited partnership. The general partner was a limited liability company managed by the daughter, and the limited partners were the decedent, his children, and an ex-daughter-in-law (she and the kids took their interests by gifts from the decedent). The partnership was funded in 2008 with marketable securities and fixed-income investment assets. On the same day, the decedent created a revocable living trust that named the daughter as sole trustee. The daughter then transferred the decedent’s 88.99% limited partner interest to the trust.

The decedent died in 2011. The estate’s federal estate tax return reported the partnership interest and valued it at nearly $4.59 million using the alternate valuation date election and applying a 37.2% blended discount for lack of marketability, control, and liquidity. The Service determined that the discount should have been limited to 18% instead, thus leading to a deficiency at the heart of this case.

At the Tax Court, the estate took the position that the decedent’s interest should be valued as an *assignee* interest rather than as a *limited partner* interest. Texas law provides that the assignee of a limited partner interest is entitled to distributions but cannot become or exercise the rights and powers of a partner. Texas law also states an assignee has no rights to information or accountings from the partnership. According to the estate, this justifies a larger discount. The Tax Court rejected this argument, finding that the interest transferred in this case was not a mere assignee interest. The partnership agreement provided that an assignee could become a substitute limited partner if (1) the general partner consents to the transferee’s admission, (2) the transferee acquires the interest by means of a permitted transfer, and the transferee agrees to be bound by the partnership agreement. The court observed that all three requirements were met here: the daughter signed the agreement as manager of the LLC-

general partner, thus consenting to its terms, and the daughter, as trustee of the revocable trust, signed the assignment document which specifically stated that the trust agreed to abide by the terms of the partnership agreement. Thus the revocable trust was a limited partner and not a mere assignee.

The court then held that there should be no discount for lack of control since the decedent's 88.99% interest was sufficient to remove the general partner and, thus, dissolve the partnership. As to the marketability discount, the court adopted the analysis of the Service's expert concluding an 18% discount was appropriate.

5. No Estate Tax Marital Deduction Adjustment for Right of Recovery or for Post-Death Income (*Estate of Turner v. Commissioner*, November 20, 2018).

The decedent and his wife formed a family limited liability partnership in 2002. They contributed almost $8.7 million in cash, certificates of deposit, and stock (mostly in banks) to the partnership in exchange for all of the interests in the entity, though they still retained enough income-producing assets to meet their annual cash flow needs. Over time, they managed to give away the bulk of the partnership interests such that, at the decedent's death, the decedent owned a 27.8% limited partner interest and a 0.5% general partner interest. But the Service argued that the decedent's initial share of all the contributed property should be included in his gross estate, rather than the 27.8% limited partner and 0.5% general partner interests, because the entity should be disregarded.

In a prior decision in 2011, the Tax Court held that the assets contributed to the partnership by the decedent had to be included in his gross estate. The estate argued that it qualified for the bona fide sale exception to §2036(a), but the court disagreed. The estate came back to the Tax Court in 2012, arguing that there is still no deficiency because it was entitled to a larger marital deduction equal to the increased value of the gross estate. The problem with this claim, though, is that while all of the partnership assets are included in the decedent's gross estate, the partnership interests gifted to children and other beneficiaries during life means that at least some portion of those assets does not pass to the surviving spouse, a key element to the marital deduction. The court held that it makes no sense to give a marital deduction for the share that actually went to the kids via their partnership interests since those interests will not be included in the spouse's gross estate when she dies, and that's a threshold requirement for securing a marital deduction.

After the 2012 decision, the issue arose of whether the estate must reduce the marital deduction by the amount of estate tax that the Service claims must be paid from estate assets passing to the widow. The court held that such a reduction was not required. While the will did not address apportionment of estate tax, the executor may (under §2207B) recover estate tax from the persons who received the gifted partnership interests during the decedent's lifetime. Indeed, because of the executor's duty to carry out the terms of the will, the executor must

exercise the right of recovery in order to prevent the marital deduction property from bearing the decedent's estate's tax burden, a result contrary to the decedent's expressed intent.

Another issue was whether the estate may increase the amount of the marital deduction for post-death income that was not included in the gross estate but was generated by property for which the marital deduction was claimed. The court held that such an adjustment was not proper, finding that the post-death income is not eligible for the marital deduction because it was not included in the gross estate.

D. FEDERAL INCOME TAX

1. Retired Pilot's Exclusion of Unwanted Group-Term Life Insurance Policy Crashes (*Ramsey v. Commissioner*, 5th Circuit, July 23, 2018).

The taxpayer retired from his job as a pilot for Delta Airlines before the taxable year in question (2011), but he continued to receive compensation from his former employer. His 2011 W-2 reported income of nearly $12,000, $891 of which was attributable to a life insurance policy Delta purchased for the taxpayer. The taxpayer's 2011 return included all of the income shown on the W-2, but left out some $18,000 in dividends and capital gains. When the Service issued a notice of deficiency in connection with the omitted income, the taxpayer filed two amended 2011 returns, the latter of which included the omitted dividends and capital gains but excluded the $891 attributable to the life insurance policy.

In a 2017 memorandum decision, the Tax Court held that the $891 in compensation attributable to the policy was includible in the taxpayer's gross income. Section 79(a) provides that an employee shall include in gross income the cost of group-term life insurance provided by an employer, but only to the extent that the cost of the policy exceeds the sum of $50,000 plus any amounts paid by the employee toward the purchase of the insurance. The Tax Court observed that it had no facts available to determine the extent to which §79(a) would exclude any portion of the $891 amount reflected on the taxpayer's W-2 from Delta. The taxpayer argued that the policy was not gross income because: (a) he did not ask for and did not want life insurance; and (b) he had excluded the amount allocable to life insurance on his 2010 return and the Service did not contest this position.

The Tax Court rejected the taxpayer's arguments. First, the inclusion of the insurance in the initial 2011 return and the first amended return was an admission that can only be overcome by "cogent evidence," and the taxpayer's assertions that he told Delta to stop the coverage were not enough to meet this standard. Second, every year stands alone, so the fact that the Service did not challenge the taxpayer's position on the 2010 return does not preclude it from challenging the position taken on the 2011 return.

On appeal, the Fifth Circuit affirmed. Finding no errors, it agreed with the Tax Court's findings and adopted its rationale in a two-page opinion.

2. Claim That Disallowing Business Expense Deductions for Marijuana Business is Unconstitutional Goes Up in Smoke (*Alpenglow Botanicals LLC v. United States*, 10th Cir., July 3, 2018).

The taxpayer operates a legal medical marijuana business in Colorado. The Service disallowed all of the taxpayer's business deductions other than those used to compute the cost of goods sold, citing §280E. That provision disallows a deduction for any trade or business expenses where the trade or business consists of trafficking in controlled substances in violation of Federal law. Marijuana is such a controlled substance. After losing its refund claim in federal district court, the taxpayer appealed to the Tenth Circuit, claiming (among other things) that §280E violates the Sixteenth and Eighth Amendments to the United States Constitution.

The taxpayer argued that §280E violates the Sixteenth Amendment because it "prevent[s] the deduction of expenses that a business could not avoid incurring." The Tenth Circuitr rejected the argument, noting that while expenses that qualify as cost of goods sold and ordinary and necessary business expenses are similar, "the cost of goods sold relates to acquisition or creation of the taxpayer's product, while ordinary and necessary business expenses are those incurred in the operation of day-to-day business activities. The cost of goods sold is a well-recognized *exclusion* from the calculation of gross income, while ordinary and necessary business expenses are *deductions*." The court observed that even if the taxpayer's claim that It is effectively being taxed on its gross receipts was correct, "it is not a violation of due process to impose a tax on gross receipts regardless of the fact that expenditures exceed the receipts."

The taxpayer's Eighth Amendment claim was that §280E operates as a penalty. But an earlier case from the Tenth Circuit held that §280E is not a penalty because "[t]he disallowance of a deduction is not an exaction imposed as a punishment. Deductions are not a matter of right. Neither do they turn upon equitable considerations. They are a matter of legislative grace." So the court had little trouble rejecting this claim too.

3. Speaking of Pot, Tax Court Snuffs Complaint of "High" Taxes (*Loughman v. Commissioner*, T.C. Memo. 2018-85, June 18, 2018).

The taxpayers, a married couple, were the sole owners of a Colorado S corporation licensed Palisades to grow and sell medical marijuana. The S corporation returns claimed deductions for compensation of officers, wages, repairs and maintenance, rents, taxes and licenses, interest, depreciation, advertising, employee benefit programs, and other items. The Service disallowed these deductions under §280E.

Before the Tax Court, the taxpayers focused on the disallowed wages. They argued that §280E resulted in discriminatory treatment of S corporation owners of marijuana businesses because the disallowed officer wages attributable to trafficking increased the pass-through incomes of the taxpayers. In effect, they argued, the same income was taxed twice: once as wages and again as S corporation income. The Tax Court rejected this argument, noting that §280E applies equally regardless of whether the taxpayers themselves or a third party received the wages.

4. Ranch Wasn't a Hobby, But Passive Loss Limits Still Applied (*Robison v. Commissioner*, T.C. Memo. 2018-88, June 19, 2018).

The taxpayers, a married couple, purchased a large ranch in Utah back in 2000. They first used the ranch for horse breeding, but when that fizzled they switched to cattle ranching. In the process, they consulted with other ranchers, trainers, breeders, a local vet, an attorney with experience in ranch operations, and their accountant. They employed a professional ranch manager and kept detailed livestock records and activity logs. The logs showed one taxpayer spent about 1,500 hours per year on the ranching activity, while the other spouse spent about 800 hours annually on the ranch. The taxpayers did all sorts of work on the ranch, from cleaning, feeding, and branding to managerial duties. Despite these efforts, the ranch never turned a profit. Over the years 2000 through 2015, the taxpayers claimed over $9 million in losses on their joint income tax returns. The Service determined that the activity was a hobby and thus disallowed the claimed losses on the returns for the years at issue (2010 through 2014). The Service also determined that even if the ranching activity was not a hobby, the taxpayers did not materially participate in the activity so the claimed losses would be disallowed as passive activity losses. As a result of the Service's determinations, the taxpayers faced a deficiency in excess of $1 million.

The Tax Court concluded that the ranching activity was not a hobby. They conducted the ranch in a businesslike manner, sought out knowledgeable experts, and spent substantial time and effort running the ranch. The court felt these factors outweighed the fact that the activity had a long history of losses and the taxpayers had substantial income from other sources.

Although the court found a profit motive, it also concluded that the passive loss limits of §469 applied. The court downplayed the activity logs because they appeared to be created after the fact and in preparation for trial. The records did not show what the taxpayers specifically did on a daily basis and exactly how much time they spent on matters directly relating to the ranch. The court observed from the records that a significant portion of the taxpayers' time spent on ranch activities was in the capacity of investors not involved in day-to-day management, and these hours could not count in the tests for material participation. It thus sustained the deficiency.

5. Disability Benefits Included in Gross Income (*Palsgaard v. Commissioner*, T.C. Memo. 2018-82, June 13, 2018).

The taxpayer was a physician until March, 2009, when she suffered a physical injury that left her permanently disabled. She received social security disability benefits in the amount of $30,274 in 2013, but her federal income return did not report this amount. The Service assessed a deficiency, concluding that $25,733 of the benefits were includible in gross income under §86(a).

Before the Tax Court, the taxpayer made two arguments. She first claimed that §86(a) did not apply to her benefits because she received disability benefits as opposed to regular social security benefits. Alas, §86(a) expressly includes disability benefits within the definition of "social security benefit," so that argument did not go far.

The taxpayer then argued that the benefits were excluded from gross income under §104, either as workers compensation or as damages on account of physical injury. The Tax Court held that the benefits are not workers compensation because they were received under the Social Security Act and not under a workers compensation statute. Unlike workers compensation, disability benefits are not contingent on a work-related injury, and there is no evidence the taxpayer suffered her injury on the job. The court also held that the disability payments are not "damages" received on account of physical injury. "Damages" requires prosecution of a lawsuit or a settlement in lieu of such. The taxpayer did not sue the government for disability benefits, and the benefits were provided under an insurance program and not in settlement of a lawsuit.

6. It Was a Very Bad Year for Documents Substantiating Claimed Deductions (*Singh v. Commissioner*, T.C. Memo. 2018-79, June 7, 2018).

On their 2013 joint return, the taxpayers claimed $38,000 in business expenses, a net operating loss of over $100,000, and some $60,000 in itemized deductions. The 2014 joint return showed $45,000 in business expenses, a net operating loss of about $95,000, and nearly $63,000 in itemized deductions. The Service assessed a deficiency after disallowing all of the above deductions. Before the Tax Court, the husband testified, but the court "found his testimony to be not credible, uncorroborated, self-serving, and/or conclusory in certain material respects." So the court focused on the documentation supporting the claimed deductions. But there's a problem—the taxpayers had no documents related to the taxable years at issue. The court explains in a footnote: "Mr. Singh … gave different reasons as to why those alleged records were not available. First, Mr. Singh claimed that the alleged records were lost because his accountant died in 2014. He then claimed that the alleged records were seized by the local county in which they lived in California. Finally, Mr. Singh testified that the alleged records were destroyed in a fire. As we observed previously, we found Mr. Singh's testimony … not to be credible in certain material respects. Moreover, even if we had believed Mr. Singh's testimony about the alleged records, we nonetheless would not have sustained on the record before us petitioners' position with respect to any of the issues presented." So yeah, the court sustained the deficiency (oh, and the imposition of an accuracy-related penalty).

E. OTHER TAX DEVELOPMENTS OF NOTE

States May Charge Sales Tax on Internet Purchases Even Where the Seller Does Not Have a Physical Presence in the State (*South Dakota v. Wayfair, Inc.*, United States Supreme Court, June 21, 2018). In the 1992 case of *Quill Corp. v. North Dakota*, the Supreme Court held that the Dormant Commerce Clause barred states from compelling retailers to collect sales or use taxes from mail order and internet sales made to their residents unless those retailers have a

physical presence in the taxing state. Given the post-1992 boom of electronic commerce, states were losing a lot of revenue. South Dakota alone, it seems, was losing between $48 and $58 million in sales and use taxes from the application of *Quill*. So the South Dakota Legislature enacted a law requiring out-of-state sellers to collect and pay sales tax "as if the seller had a physical presence in the State." The Act only applied to sellers that delivered more than $100,000 of goods or services annually into South Dakota or engaged in 200 or more separate transactions annually for the delivery of goods or services into South Dakota. A group of online retailers with no employees or real estate in South Dakota filed suit in state court, claiming the Act's requirements violated *Quill*. The trial court granted their motion, and the South Dakota Supreme Court affirmed.

But the Supreme Court (5-4) reversed, declaring that because the physical presence rule of *Quill* is unsound and incorrect, *Quill* is hereby overruled. Writing for the majority, Justice Kennedy noted that the physical presence rule from *Quill* has long been criticized as giving out-of-state sellers an advantage. Physical presence is not required, just that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." A business need not have physical presence in a state to satisfy the requirements of due process. Here, the Act applies only to sellers who engage in a significant quantity of business in South Dakota, and respondents are large, national companies that undoubtedly maintain an extensive virtual presence.

Justice Kennedy observed that 41 states, two territories, and the District of Columbia have asked the Court to overrule *Quill.* "Helping respondents' customers evade a lawful tax unfairly shifts an increased share of the taxes to those consumers who buy from competitors with a physical presence in the State. It is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions. And it is also essential to the confidence placed in the Court's Commerce Clause decisions. By giving some online retailers an arbitrary advantage over their competitors who collect state sales taxes, *Quill*'s physical presence rule has limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field."

It is interesting to note that Justices Thomas, Ginsburg, Alito, and Gorsuch joined Justice Kennedy in the majority. The dissenters were the unlikely bloc of Justices Roberts, Breyer, Sotomayor, and Kagan.

DEALING WITH UNCLE SAM, EVERYONE'S LEAST FAVORITE RELATIVE IN THE FAMILY BUSINESS

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I. INTRODUCTION

A. SCOPE OF MATERIALS

These materials are intended as a primer on basic business tax issues most relevant to the closely-held enterprise that's already operating as a going concern. These materials are not concerned with the "choice of entity" question facing entrepreneurs at the inception of the business. There are many other excellent, comprehensive resources to assist planners at the inception of the business. See, e.g., Dwight Drake, BUSINESS PLANNING: CLOSELY HELD ENTERPRISES (4th ed. 2013); Richard A. Shaw and Thomas J. Nichols, *Choice of Entity in Light of Recent and Proposed Tax Changes*, 68 NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION, Ch. 13 (2010); Richard A. Mann, Michael O'Sullivan, Larry Robbins, and Barry S. Roberts, *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773 (2004).

Instead, these materials offer a brief overview of the basic income tax mechanics of each entity form and a discussion of several particular estate planning strategies available (and the particular pitfalls present) depending on the entity that walks through the door with the client. We are not concerned here with whether the client should do business as a corporation or partnership; rather, we are concerned with what to do once the business has already been operating for some time and has proven successful. The answers to that question often depend on the form in which the business operates. These materials do not address strategies applicable to all closely-held business interests. The installment payment of federal estate tax attributable to closely-held business interests under IRC §6166, for example, is not covered in these materials because this benefit applies to C corporations, S corporations, and partnerships. Instead, these materials focus on techniques that are unique to certain of the entity forms.

B. THE INTERNAL REVENUE CODE SEES ONLY THREE ENTITIES

A client's business will almost always come in one of seven forms: (1) a sole proprietorship; (2) a general partnership; (3) a limited partnership; (4) a limited liability partnership; (5) a limited liability company; (6) an S corporation; and (7) a C corporation. For federal tax purposes, however, there are only three types of business entities. The first form described above (sole proprietorship) is simply disregarded for federal tax purposes, so all items of income and deduction attributable to the business are added to the owner's other items of income and deduction on his or her (or their) Form 1040.

The next three forms (general partnership, limited partnership, limited liability partnership) are treated as partnerships for federal tax purposes, meaning they will subject to the marvelous complexities of Subchapter K. Any of these three forms are welcome to elect corporation status, but that is rarely done for domestic entities.

The fifth form, the limited liability company, will be treated as a sole proprietorship for federal tax purposes if it has only one owner; if it has multiple owners it will be treated as a partnership unless the owners elect to have the entity taxed as a corporation.

The last two forms, the corporations, have no choice. From a federal tax perspective, they are corporations and nothing else. Of course, an S corporation is a pass-through entity, meaning that the entity will generally not be liable for payment of federal income tax. The items of income, gain, loss, deduction, and credit of an S corporation are attributed to its shareholders in proportion to their ownership interests as if they derived such items themselves (though the character of any given item is determined at the entity level). Subsequent distributions of after-tax earnings from the S corporation are not again subject to tax as dividends. This is the major distinction between S corporations and C corporations. C corporations are separate taxable entities. Their taxable incomes are subject to a different progressive rate table, and distributions of after-tax earnings and profits are gross income to the recipient shareholders. Under current law, this "double tax" is mitigated to some extent because dividends received from domestic corporations and certain foreign corporations are taxed at the same rate as net capital gains (*i.e.,* at zero percent, 15 percent, or 20 percent, though the latter two rates will be 3.8 percent higher where the IRC §1411 surcharge on net investment income applies). This preferential rate for "qualified dividend income" applies to dividends on common and preferred shares from both closely-held and publicly-traded corporations.

II. C CORPORATIONS

A. THE BASIC MECHANICS

1. Formation

From a tax perspective, forming a corporation is one of life's easier tasks. Generally, a taxpayer will not have to recognize gain on the transfer of property to a corporation solely in exchange for shares of the corporation's stock. IRC §351(a). Taxpayers will have to recognize any realized gain, however, if: (1) they receive property from the corporation in addition to the corporation's stock, IRC §351(b); (2) they do not own at least 80 percent of the corporation's stock, IRC §351(a); (3) they contribute services (rather than property) to the corporation, IRC §351(d); or (4) the amount of any indebtedness secured by the contributed property exceeds the taxpayer's adjusted basis in such property at the time of contribution, IRC §357(c).

EXAMPLE: Abbott and Costello each contribute a capital asset to a newly-formed corporation in exchange for 50 percent of the corporation's stock. Although neither of them owns 80 percent of the stock individually, all contemporaneous capital contributions are aggregated. Thus, neither will recognize the realized gain from the transaction because their transfers will be aggregated.

If a taxpayer enjoys non-recognition upon contribution, the basis of the shares received from the corporation is equal to the aggregate adjusted bases of the property transferred. IRC §358. Likewise, the corporation's basis in the contributed property is the same basis the contributing shareholder had in the property. IRC §362(a). If a taxpayer recognizes gain from the capital contribution, the taxpayer's basis in the acquired stock (and the corporation's basis in the contributed property) is generally its fair market value.

2. Operation

The C corporation is a separate taxable entity. It completes a Form 1120 to report its taxable income and, as of 2018, pays tax at a flat rate of 21 percent. IRC §11. C corporations may also be subject to additional "penalty taxes" where the corporate form is abused. These penalty taxes are discussed later in these materials.

3. Distributions

The signature feature of subchapter C is the double tax on corporate earnings. A corporate distribution will be included in the shareholder's gross income to the extent the distribution represents the "earnings and profits" of the corporation. IRC §§301(c)(1); 316(a). The distribution, however, will subject to a maximum tax rate of 23.8 percent. See IRC §§1(h)(11); 1411. Additional amounts in excess of the corporation's earnings and profits are

presumed to be a return of the shareholder's contributed capital. IRC §301(c)(2). Consequently, the additional amounts received are tax-free to the extent of the shareholder's stock basis. If the shareholder's stock basis is used up and additional amounts still remain, the excess will be taxed as capital gain. IRC §301(c)(3). If the corporation distributes property, the shareholder takes a fair market value basis in the property. IRC §301(d).

If distributions of cash or property trigger the double tax, should distributions of the corporation's own stock also be taxable to the shareholder? In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Supreme Court held that pro rata stock distributions were not taxable to the shareholders. Taxpayers then pushed the envelope: they created elaborate classes of stock that could be converted into cash or property or the corporation's common stock at the demand of a shareholder. The Service objected to these elaborate classes of stock as disguised dividend distributions, and some courts agreed. Congress has since cleared the air through a general rule proclaiming that stock distributions are tax-free. IRC §305(a). That general rule is subject to a number of exceptions, see IRC §305(b), but most proportionate stock distributions remain tax-free. If a shareholder receives stock tax-free, the shareholder must allocate his or her basis in the old shares among the old and new shares. IRC §307(a).

4. Liquidation

"Liquidation" refers to the death or dissolution of the business entity. Under most state statutes, the assets of the entity are sold and the proceeds are used to pay off the entity's creditors. Any remaining proceeds are distributed proportionately to the owners. Instead of selling assets, liquidating entities may distribute assets to creditors and owners.

Unlike formation, liquidation is rarely painless from a tax perspective. Since a double tax has not been imposed on such assets (or, in the case of a sale, the proceeds), liquidating distributions to shareholders are taxable. IRC §331. Similarly, the corporation recognizes gain and loss upon a liquidating distribution. IRC §336. If a subsidiary corporation liquidates, there is a potential for a triple tax: once to the liquidating subsidiary, again to the parent corporation upon its liquidation, and finally to the shareholders of the parent corporation. To mitigate the adverse consequences attendant with these general rules, most subsidiary corporations may liquidate on a tax-free basis. IRC §332.

B. PLANNING OPPORTUNITIES WITH C CORPORATIONS

1. Reduced Rate on Gain from Sale of Qualified Small Business Stock

IRC §1202(a)(1) generally excludes half of the gain from the sale or exchange of qualified small business stock held for more than five years. The other half of such gain is subject to a preferential tax rate of 28 percent. IRC §§1(h)(1)(E); 1(h)(4); 1(h)(7). In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all).

Under the American Recovery and Reinvestment Act of 2009, the exclusion increased to 75 percent of the gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before January 1, 2011. IRC §1202(a)(3). Where the special 75 percent exclusion applies, then, the effective rate of tax on the entire gain is only seven percent. The Creating Small Business Jobs Act of 2010, however, went one step further: qualified small business stock acquired from September 28, 2010, through December 31, 2010, was eligible for a 100-percent exclusion. The Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended the 100-percent exclusion for stock acquired through 2012, and the American Taxpayer Relief Act of 2012 further extended the 100-percent exclusion to stock acquired in 2013. It was extended again through 2014 by the Tax Increase Prevention Act of 2014. Finally, the Consolidated Appropriations Act of 2016 made the 100-percent exclusion permanent for stock acquired after September 27, 2010. The following example clarifies the mechanics of the exclusion based on the acquisition date of the qualified small business stock:

EXAMPLE: Taylor realized $100,000 of gain from the sale of qualified small business stock. Taylor held the stock for more than five years. The amount Taylor may exclude from gross income depends on when Taylor *acquired* the stock, not the date of the sale. Specifically:

If the stock was acquired…	The portion of the $100,000 gain excluded is…
On or before Feb. 17, 2009	$50,000
After Feb. 17, 2009 but before Sep. 28, 2010	$75,000
After Sep. 27, 2010	$100,000

Only C corporation stock can claim this benefit. Specifically, “qualified small business stock” is any stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is a qualified small business. IRC §1202(c)(1). A “qualified small business” is one with aggregate gross assets of $50 million or less at all times after August 10, 1993, and before the time immediately after the date of issuance. IRC §1202(d)(1). “Aggregate gross assets” is measured as the sum of cash plus the adjusted bases of all corporate assets (assuming that the basis of all contributed property is equal to its fair market value as of the date of contribution). IRC §1202(d)(2).

In addition to these requirements, the corporation must meet an “active business requirement” during substantially all of the shareholder’s holding period in order for IRC §1202 to apply. IRC §1202(c)(2)(A). This requires that at least 80 percent of the value of the corporation’s assets be used in the active conduct of a trade or business engaged in any activity *other than*: (1) professional services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or other business in which the principal asset is the reputation or skill of

one or more of its employees; (2) banking, insurance, financing, leasing, investing, or similar business; (3) farming; (4) extraction or production of natural resources eligible for percentage depletion; or (5) operation of hotels, motels, restaurants, or similar businesses. IRC §1202(e).

Depending on the applicable percentage exclusion (based on when the stock was acquired), the benefit of IRC §1202 exclusion may be significant. If IRC §1202 does not apply but the client holds the stock for more than one year, the gain will be long-term capital gain subject to a preferential tax rate generally ranging from zero to 23.8 percent. In case of IRC §1202 stock acquired before February 17, 2009, the cost of losing the 14 percent rate applicable to IRC §1202 stock may not be very significant. To the extent a client can save much more than this additional tax amount by making a subchapter S election or otherwise operating the business in a more profitable or tax-savvy manner that sacrifices the IRC §1202 exclusion, a planner should not be afraid to recommend such action. Of course, where the seven percent (or zero percent) preferential tax rate applies, the comparative benefit of IRC §1202 is stronger; depending on the amount of gain at issue, foregoing pass-through taxation or similar strategies might be desirable.

2. Like-Kind Exchange of Qualified Small Business Stock

One less heralded benefit of owning IRC §1202 stock is the ability to engage in a tax-deferred like-kind exchange under IRC §1045(a). As long as the selling shareholder purchases stock in another qualified small business within 60 days of the sale, he or she can elect to defer all non-recapture gain from the sale (provided the new stock costs at least as much as the amount realized from the sale of the old stock). The shareholder's basis in the new small business stock is reduced by the amount of gain deferred by the election. IRC §1045(b)(3).

> EXAMPLE: Troy sells qualified small business stock in X Corporation with a basis of $13,000 to an unrelated buyer for $20,000. Within 60 days of this sale, Troy purchases qualified small business stock in Y Corporation from an unrelated seller for $20,000. Troy does not recognize any gain from the sale of the X Corporation shares but Troy's basis in the Y Corporation shares is $13,000 ($20,000 cost less $7,000 gain deferred from the sale of X Corporation stock). If Troy spends only $5,000 for the Y Corporation shares, Troy must recognize the $7,000 gain from the sale of X Corporation stock. Troy's basis in the Y Corporation shares would be $5,000.

3. Ever Thought of an S Election?

If the C corporation qualifies as a small business corporation under IRC §1361(b), its shareholders may elect S corporation status to ameliorate the impact of the double tax on C corporation earnings. IRC §1362(a). The S election usually causes no immediate tax consequences to the corporation or the shareholders (but see IRC §1363(d) and discussion *infra*), although built-in gains on assets held by the C corporation at the time of its conversion to an S corporation may have to be recognized by the S corporation. IRC §1374. This is better

than a conversion from C corporation to partnership because that requires a deemed liquidation of the corporation, a taxable event to the corporation and the shareholders. IRC §§ 331(a); 336(a).

The S election may have other benefits beyond avoiding the double tax. If the C corporation is unable to use the cash method of accounting (under IRC §448(b), a C corporation generally cannot use the cash method unless: (1) it is engaged in farming; (2) substantially all of its activities consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (3) its average annual gross receipts for the three prior taxable years does not exceed $25 million), conversion to S corporation status will permit the entity to use the cash method unless the S corporation is a "tax shelter." IRC §448(a). A tax shelter is any "syndicate" within the meaning of IRC §1256(e)(3)(B) or a "tax shelter" as defined in IRC §6662(d)(2)(C)(iii) (yes, a "tax shelter" means "a syndicate or a tax shelter"). IRC §§448(d)(3); 461(i)(3).

If the C corporation is currently paying or may soon face liability for the personal holding company penalty tax in IRC §541, conversion to S corporation status will eliminate the penalty tax. IRC §1363(a).

COMMENT: A C corporation is a personal holding company if: (1) at least 60 percent of its "adjusted ordinary gross income" for the taxable year is "personal holding company income," and (2) at any time during the last half of the taxable year not more than five individuals own (directly or indirectly) more than 50 percent in value of the corporation's stock. IRC §542(a). Personal holding company income includes dividends, interest, royalties, annuities, rents, compensation for the use of corporate property by shareholders, and income from estates and trusts. IRC §543(a).

4. Other Chances to Minimize Double Taxation

Most C corporations can lessen the impact of the double tax by transferring earnings and profits into deductible payments of compensation, rent, or interest. While this is helpful to the corporation, it is generally worse for the shareholders in that these disguised distributions are ordinary income potentially subject to tax at rates far in excess of the preferential rate applicable to qualified dividend income. IRC §1(h)(11). One might expect that the competing interests of corporations and their shareholders might offset each other to the point that the Service might not care whether payments from corporations to shareholders are characterized as nondeductible (but tax-preferred) dividends or deductible (but fully taxable) forms of ordinary income. But in some cases these strategies are effective in reducing the total tax bite to corporation and shareholder.

EXAMPLE: Adam owns all of the stock in *Corp*, a C corporation. *Corp* has taxable income in Year One of $100,000. *Corp* will pay $21,000 in tax on this income (flat tax of 21 percent),

leaving $79,000 of after-tax earnings. If *Corp* distributes the $79,000 as a dividend to Adam in Year Two, *Corp* gets no deduction, but Adam will pay tax of only $18,802 on the dividend (23.8 percent), leaving *A* with $60,198 after tax. If *Corp*'s taxable income in Year Two is also $100,000, it will again have $79,000 of after-tax earnings. So after two years, the combined after-tax income from Year One ($60,198) and Year Two ($79,000) is $139,198.

If *Corp* makes no distribution but pays Adam rent in the amount of $79,000 for Year Two, *Corp* would get a $79,000 deduction for Year Two but Adam would have to include this amount in gross income. Assuming Adam can deduct 20 percent of this amount under §199A as qualified business income, Adam will pay 37 percent tax on $63,200, or $23,384. After tax, then, Adam will have $55,616, a result worse for him than when the $79,000 is paid in the form of a dividend. But *Corp* gets to reduce its Year Two taxable income to $21,000, which in turn results in a tax liability of $4,410 (21 percent of $21,000). That leaves *Corp* will $95,590 after tax, meaning *Corp* comes out way ahead. The combined after-tax income from both years is $151,206 ($55,616 from Year One and $95,590 from Year Two), a better result than what is achieved with a dividend distribution.

Even if Adam cannot claim the §199A deduction, and thus pays $29,230 tax on the $79,000 of rents (37 percent), the combined after-tax result ($145,360) still beats the combined result of a dividend distribution of the same amount.

Making deductible payments in lieu of a distribution will not always result in less tax, however, as this next example shows.

EXAMPLE: Assume the same facts from the prior Example as regards Year One. Recall from that Example that after two years, the combined after-tax income from Year One ($60,198) and Year Two ($79,000) is $139,198.

If *Corp* makes no distribution but pays Adam a $79,000 salary in Year Two, *Corp* would get a $79,000 deduction for Year Two but Adam would have to pay tax of $35,273.50 on the compensation (assuming Adam is in the 37-percent bracket and pays his share of employment taxes), leaving Adam with $43,726.50 after tax. This is a worse result for Adam than the dividend distribution (treating the amount received from *Corp* as compensation reduces the after-tax amount by over $16,000) but a better result for *Corp* (the compensation deduction reduces *Corp*'s taxable income to $21,000, which in turn results in a tax liability—$4,410—that is over $14,000 less than would otherwise result). Even when one factors in the employment taxes paid by *Corp* in Year Two (just over $6,000), *Corp* comes out ahead. But on these numbers notice that the combined after-tax income from both years ($133,273, which represents $43,726.50 from Year One and $89,546.50 from Year Two) is less than is the case when the corporation pays a dividend instead of salary.

The lesson here, then, is that one must run the numbers to determine whether a corporate deduction will offset the added tax hit to the shareholder. In some but not all cases, paying deductible rent, interest, or compensation will yield a better result than paying a dividend.

5. Redemptions to Pay "Death Taxes"

If the estate tax value of the decedent's stock in a corporation (C or S) comprises more than 35 percent of what we might call the decedent's "adjusted gross estate," IRC §303(a) treats the redemption of an estate's interest in a closely-held corporation as a sale of the stock (even if the transaction would otherwise be treated as a distribution with respect to the stock under IRC §302) to the extent the redemption proceeds do not exceed the sum of all estate, inheritance, legacy, and succession taxes imposed by reason of death plus funeral and administrative expenses deductible under IRC §2053. The redemption must occur within the estate tax return's assessment period to qualify for this benefit. IRC §303(b)(1).

The statute does not use the term "adjusted gross estate." It's just shorthand for the base used by IRC §303(b)(2), namely the value of the gross estate less the amounts deductible under IRC §§2053 (administrative expenses) and 2054 (casualty losses during administration).

C. PLANNING CHALLENGES WITH C CORPORATIONS

1. Penalties on Excessive Retained Earnings

Congress worries that the shareholders of a closely-held corporation prefer for the corporation to accumulate and retain its net earnings instead of paying dividends. Distributions of after-tax earnings are taxable to the shareholders. But if the corporation retains its after-tax earnings, the value of the corporation's stock increases without current taxation to the shareholders. The shareholders can thus defer the double tax on their shares of after-tax earnings until they either sell the stock (at an inflated price because of the retained surplus) or liquidate the corporation (at which point the retained earnings would finally be distributed). To thwart this deferral strategy, IRC §§531-537 impose an "accumulated earnings tax," a surtax levied on retained earnings in excess of the reasonable needs of the business where such retention has the purpose of avoiding income tax to the shareholders.

Prior to 2003, dividends were taxed at a higher rate than net capital gain. In those days, shareholders had even more incentive to keep after-tax earnings inside the corporation and then sell the stock at an inflated price because of the retained earnings. Absent the accumulated earnings tax, the shareholders could achieve tax alchemy by converting ordinary income into net capital gain. Now that most dividend distributions are taxed at the same rate as net capital gains, part of the incentive to avoid dividend distributions is lost. But the accumulated earnings tax remains. Sure, shareholders would still benefit from deferral of the

double tax if the accumulated earnings tax did not exist, but deferral alone is hardly a grave sin.

A corporation's accumulated earnings tax is equal to 15 percent of its "accumulated taxable income." IRC §531. The accumulated taxable income figure roughly represents the corporation's undistributed taxable income (computed with some adjustments) in excess of amounts retained for the reasonable needs of the business. IRC §535(a). Note that the tax is imposed only with respect to the corporation's earnings in a single taxable year. Those earnings are not again subject to tax in later years as they continue to be retained.

Accumulations of $250,000 or less are deemed to be retained for the reasonable needs of the business (in the case of a personal service corporation, i.e., one engaged in any of the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, where the owners provide the services, the threshold is reduced to $150,000). IRC §535(c)(2). So if a corporation's retained earnings are within this threshold, there is no accumulated earnings tax exposure.

The tax is not self-assessed; rather it is a penalty imposed by the Internal Revenue Service. The Service initiates the issue by sending a notice to the corporation that all or part of a proposed notice of deficiency includes the accumulated earnings tax. At that point, the burden of proof shifts to the corporation to prove it is not liable for the tax. IRC §534.

In reviewing the financial statements for a client's corporation, the planner should consider whether the corporation is vulnerable to the accumulated earnings tax. Annual retained earnings in excess of the applicable threshold described above should be a red flag. If there is exposure, the planner should consider any of a number of possible solutions, including: (1) paying higher salaries to the owners in order to reduce retained earnings in a deductible way; (2) documenting the corporation's long-term capital-intensive plans that require accumulation of after-tax earnings; and (3) making a subchapter S election, if possible.

2. Funding the Buy-Sell Agreement

Shareholders of a closely-held C corporation may prefer that the corporation redeem the shares of a retiring or deceased shareholder (a "redemption agreement"), as opposed to having the surviving shareholders to purchase the shares directly (a "cross-purchase agreement"). Using entity funds to purchase the stock offers centralized funding (together with increased certainty of funding, for it is easier to monitor the reserves of the corporation than to continually police the saving habits of the other shareholders). In addition, where insurance will be used to fund the purchase, the C corporation needs fewer pre-tax dollars to fund premium payments to the extent the corporation is in a lower tax bracket than the shareholders.

But a redemption agreement carries some risks when the business operates as a C corporation. *First*, payments to the retiring shareholder may be treated as dividends, and while the preferential tax rate applicable to qualified dividend income helps it does not substitute for the lack of stock basis that could be used to reduce the tax bite. *Second*, to the extent there is net buildup in the value of life insurance contracts funding the C corporation's payment obligation, there is increased risk of alternative minimum tax. IRC §56(g)(4)(B)(ii). *Third*, if the C corporation uses a sinking fund or similar reserve to save up for a future redemption, there is additional risk that the Service will assert liability for accumulated earnings tax. While the corporation should be successful in proving that an accumulation of earnings to fund a redemption agreement is a reasonable business need, the corporation still faces the hassle of having to make this showing. *Finally*, corporate-owned life insurance is an asset of the corporation that, in turn, drives up the estate tax value of the corporation's stock when a shareholder dies. See Treas. Reg. §§20.2031-2(f); 20.2042-1(c)(6). Together these risks may not outweigh the benefits of centralized funding, but they should be factored in to the decision of whether to use a redemption agreement.

III. S CORPORATIONS

A. THE BASIC MECHANICS

1. Formation

Unless a specific provision in subchapter S applies, the rules applicable to C corporations also apply to S corporations. IRC §1371. Because subchapter S is silent as to incorporation issues, the rules previously described for C corporations apply to S corporations. The only wrinkles upon formation of an S corporation pertain to the *eligibility* requirements to be an S corporation and the *timing* rules applicable to the subchapter S election.

a. Eligibility Rules

Not every corporation can elect to be treated as an S corporation. There are limits as to the number and types of shareholders that a corporation may have, although these limits are easily circumvented in most cases. There is also a limit as to the corporation's capital structure, a limit intended to ensure that the pass-thru of tax items remains relatively easy to administer.

As a threshold matter, **only domestic corporations** can elect to be treated as S corporations. IRC §1361(b)(1). A domestic corporation is any corporation organized in the United States or under the law of the United States or any particular state. IRC §7701(a)(4). A corporation organized in both the United States and a foreign country qualifies as a domestic corporation. Treas. Reg. §301.7701-5(a). See also PLR 9512001 (corporation

organized in United States and in foreign country is eligible to make S election and will not be treated as having two classes of stock).

An S corporation can have **no more than 100 shareholders**. (From 1997 through 2004, there was a 75-shareholder limit.) With some exceptions, every person holding stock in an S corporation counts toward the 100-shareholder limitation. Rev. Rul. 59-187, 1959-1 C.B. 224. Spouses and their estates are treated as one shareholder for purposes of applying the limitation, IRC §1361(c)(1), regardless whether the spouses own shares jointly or separately or solely by operation of community property laws. Furthermore, all "members of a family" are treated as one shareholder for purposes of the 100-shareholder limitation. IRC §1361(c)(1)(A)(ii). Members of a family are the common ancestor, the lineal descendants of the common ancestor (up to a maximum of six (!) generations), and the current *and former* spouses of the lineal descendants or the common ancestor. IRC §1361(c)(1)(B). This effectively eviscerates the 100-shareholder limitation. (The determination of whether there is more than six generations separating the common ancestor from the youngest generation of shareholders is made on the latest of: (1) the date the S election is made; (2) the first date on which the common ancestor or a lineal descendant (or spouse) owns stock in the S corporation; and (3) October 22, 2004 (the date of enactment for the American Jobs Creation Act of 2004).)

Very generally, subchapter S welcomes most individual shareholders (and their estates, see IRC §1361(b)(1)(B)) but exhibits hostility toward entity shareholders. A discussion of **trusts as shareholders** of S corporation stock appears later in these materials.

COMMENT: There is no limitation as to how long an estate may hold S corporation stock. This is not the case for testamentary trusts, which, as discussed *infra*, must distribute S corporation stock or otherwise qualify as a permissible S corporation shareholder within two years.

Most individuals are eligible S corporation shareholders. In Revenue Ruling 2004-50, 2004-1 C.B. 977, the Service ruled that a federally recognized Indian tribal government is not an eligible S corporation shareholder, meaning that the corporation in which the tribe owns shares cannot make a subchapter S election. The Service noted that only individuals and certain estate and trusts can hold S corporation shares under IRC §1361(b)(1). Since the Indian tribe is exempt from taxation under established authorities, and because the tribe is not subject to federal income tax as an individual under IRC §1, the Service determined that the tribe was not an "individual" for purposes of qualifying the corporation for election to subchapter S status.

But a corporation cannot make an S election if it has a **nonresident alien** shareholder, IRC §1361(b)(1)(C), and if a nonresident alien individual becomes a shareholder in an S corporation, the corporation will lose its S election, IRC §1362(d)(2)(A), and will generally be precluded from re-electing S status for five years. IRC §1362(g). A nonresident alien individual

is an individual that is neither a citizen of the United States nor a resident of the United States. IRC §7701(b)(1)(B).

An individual is a resident of the United States if he or she meets either the "green card test" or the "substantial presence test." Both of these tests are objective; the intent of the individual and other such subjective measures (like domicile) are irrelevant. An individual meets the green card test if he or she is a lawful permanent resident of the United States at any time during the calendar year. IRC §7701(b)(1)(A)(i). An individual meets the substantial presence test if he or she is present in the United States on at least 31 days of the current year and at least 183 total days of the current and two preceding calendar years. IRC §§7701(b)(1)(A)(ii); 7701(b)(3)(A). Presence, for these purposes, is determined using a composite, weighted measure of the days of physical presence over a three-year period. All days in the current calendar year are added to one-third of the days in the first preceding calendar year and to one-sixth of the days in the second preceding calendar year.

If a current S corporation (or a C corporation or a partnership whose owners wish to make an S election) wants to pass shares to a nonresident alien individual, the S corporation and the nonresident alien should form a partnership or other pass-thru entity for federal income tax purposes. This preserves the S election while permitting the nonresident to participate in the profits and losses of the enterprise. See Michael Schlesinger, S CORPORATIONS: TAX PLANNING AND ANALYSIS 12 (CCH 2000). Schlesinger notes that this structure would survive scrutiny under the partnership anti-abuse rules in Regulation §1.701-2 because the S corporation's shareholders are taxed on their shares of the S corporation's income while the nonresident alien is taxed on his or her share of the partnership's profits.

EXAMPLE: Adam and Beth each own 10 shares in an S Corporation. Evita, a nonresident alien individual, wants to join Adam and Beth as an equal stakeholder, and both of the existing owners want Evita involved in the business. To protect the corporation's S election, the corporation and Evita form a limited liability company to be taxed as a partnership for United States income tax purposes. The corporation contributes all of its business assets to the LLC in exchange for two-thirds of the membership interests in the LLC, while Evita makes proportionate contributions of cash and/or property in exchange for a one-third interest in the LLC. The LLC's operating agreement provides that all tax items shall be allocated according to the membership interests, meaning the S corporation is taxed on two-thirds of the LLC's taxable income and that Evita is taxed on one-third of the LLC's taxable income. The share allocable to the S corporation passes through in equal shares to Adam and Beth. This structure should accomplish the objectives of Adam, Beth, and Evita without sacrificing the S election.

COMMENT: In the above example, if the LLC distributes some of the assets contributed by Evita to the S corporation (or if the LLC distributes some of the assets contributed by the S corporation to Evita) within seven years of their transfer to the LLC, the parties may have to

recognize gain under the disguised sale rules in subchapter K. See IRC §§ 704(c)(1)(B); 707; 737.

Planners in community property states need to pay special attention to the nonresident alien prohibition. If an employee of an S corporation is married to a nonresident alien, the non-employee spouse may have a community property interest in any shares acquired by the employee as compensation. This would terminate the S election. Even if the shareholder-employee holds the S corporation shares as separate property, it may be possible for the non-employee spouse to acquire a community property interest in the shares to the extent the employee-shareholder otherwise receives inadequate compensation for the services he or she performs on behalf of the corporation. See William C. Staley, *S Corporations and Estate Planning*, at 6 (Glendale Estate Planning Council, Nov. 15, 2005).

Corporations, partnerships, limited liability companies, and other **business entities are not eligible to be shareholders** of S corporation stock. IRC §1361(b)(1)(B). Disregarded entities (such as single-member limited liability companies) are permissible shareholders if their owners are eligible S corporation shareholders. The Service will often ignore transitory ownership of S corporation stock by a partnership in the process of converting to an S corporation, even though there is no Code or regulation authority to forgive momentary ownership by an ineligible entity. See, e.g., PLRs 200237014, 200237011, 9010042, and 8934020.

Since 1998, organizations described in IRC §401(a) or IRC §501(c)(3) that are exempt from tax under IRC §501(a) can be S corporation shareholders. IRC §1361(c)(6). Translation? Employee stock ownership plans (ESOPs) and certain charitable organizations can hold S corporation stock. For eligible exempt organizations other than ESOPs, tax items from the S corporation pass through as unrelated business taxable income (UBTI). IRC §512(e).

An S corporation can only have **one class of stock**. IRC §1361(b)(1)(D). For this purpose, differences in voting rights among shares of common stock are disregarded. IRC §1361(c)(4). Estate planners like to see S corporations with voting and nonvoting shares, because nonvoting shares in a closely-held business make ideal assets for gifts and other wealth transfers from a discount planning perspective. An S corporation has a single class of stock if all shares have equal rights to distributions and liquidation proceeds. Treas. Reg. §1.1361-1(l)(1). Whether all shares have equal economic rights is determined with reference to what the regulations call the corporation's "governing provisions." Treas. Reg. §1.1361-1(l)(2)(i). These include the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements related to distributions and liquidation.

b. Election

All shareholders must consent to make a subchapter S election. IRC §1362(a). An election is effective for the taxable year following the year of election, except that an election

made in the first two and a half months of a taxable year is effective as of the first day of the taxable year. IRC §1362(b). The Service will consider requests for relief from the effects of a late election. Unless a special situation applies, however, the corporation usually must request relief through a private letter ruling that will require payment of a user fee. See Rev. Proc. 2014-1, 2014-1 I.R.B. 1. The Service has identified a number of special situations:

• *A partnership, LLC, or other noncorporate eligible entity failed to timely file the Form 2553 and has not elected to be treated as a corporation.* If the entity can show reasonable cause for its failure to timely file the S corporation election (and the entity classification election on Form 8832), then requests for relief made within six months after the due date for the tax return for the first year the entity intended to be an S corporation will be honored and the entity will be given additional time to make the required elections. Rev. Proc. 2004-48, 2004-1 C.B. 172.

• *A corporation failed to timely file the Form 2553 but has reasonable cause for its failure to do so*. Requests for relief made within two years of the original due date for the S election will be considered by the Service provided either: (1) the corporation has not yet filed a return for the first year in which the election was intended and the request for relief comes within six months of the due date for that return; or (2) the corporation did file a return for the first year in which the election was intended and all of the shareholders have reported consistently with an S election on all of their affected returns for the year(s) in which the election was intended. Rev. Proc. 2003-43, 2003-1 C.B. 998.

• *The corporation filed a Form 1120S and, within six months, the Service did not notify the corporation or any shareholder of any problem with S corporation status*. If the shareholders reported their income consistent with S corporation status for the year(s) in which the S election was intended, then the corporation qualifies for automatic relief. Rev. Proc. 97-48, 1997-2 C.B. 521. To claim the relief, a completed Form 2553 must be filed with the words "FILED PURSUANT TO REV. PROC. 97-48" printed at the top of the Form.

2. Operation

In general, an S corporation will not pay income tax, since items of income, gain, loss, deduction, and credit pass through to the shareholders on a "per share" or "pro rata" basis. IRC §1366. Thus, if an S corporation has two equal shareholders, each must include one-half of the corporation's tax items on his or her own individual income tax return. The ultimate treatment of a tax item (as capital gain or ordinary income, for example) will depend upon the particular shareholder; consequently, some items pass through separately, while others are "netted" at the corporate level before passing through to the shareholders.

At the close of each taxable year, an S corporation shareholder's stock basis is adjusted to reflect both the shareholder's pro rata share of the S corporation's pass-through items and any distributions made during the year. IRC §1367(a). The adjustments to basis

occur in this order (Treas. Reg. §1.1367-1(f)): (1) increase stock basis by the shareholder's share of income items; then (2) decrease stock basis by the amount of nontaxable distributions; then (3) decrease stock basis by the shareholder's share of noncapitalized, nondeductible expenses; then finally (4) decrease stock basis by the shareholder's share of loss and deduction items.

COMMENT: Examples of noncapital, nondeductible expenses include illegal bribes, fines, penalties, expenses related to tax-exempt income, disallowed losses under IRC §267, and the disallowed portion of meal and entertainment expenses under IRC §274.

3. Distributions

The tax treatment of distributions from S corporations depends upon whether the S corporation has accumulated earnings and profits. Only C corporations can have "earnings and profits." IRC §312. Corporations that have always been S corporations do not have accumulated earnings and profits.

Distributions from "pure" S corporations (those that have never been C corporations) are tax-free to the extent of the shareholder's stock basis. IRC §1368(b)(1). Any distributions in excess of a shareholder's basis is treated as gain from the sale or exchange of property (i.e., as long-term capital gain if the stock has been held for more than one year, or short-term capital gain if the stock has been held for one year or less). IRC §1368(b)(2). Whether a shareholder has sufficient stock basis to absorb a distribution is tested at the end of the year, after all items of income and other increases to basis occur, but before any reductions to stock basis due to losses, deductions, and nondeductible expenses. Treas. Reg. §1.1367-1(f). This ordering rule maximizes the chances that any particular distribution will be tax-free. If an S corporation distributes appreciated property instead of cash, the distribution triggers gain to the corporation. IRC §§1371(a); 311(b). Like any gain, it passes through pro rata to the shareholders, with resulting increases to stock basis.

If an S corporation has accumulated earnings and profits, the distribution rules are slightly more complicated. A three-tier regime applies to such distributions. *First*, that portion of the distribution not in excess of the corporation's "accumulated adjustments account" ("AAA") is taxed under the rules applicable to distributions from S corporations without earnings and profits (i.e., tax-free to the extent of stock basis, with any excess treated as capital gain). IRC §1368(c)(1). If an S corporation makes more than one distribution during the taxable year, and if the total amount of such distributions exceeds the positive balance in the corporation's AAA, the AAA is allocated proportionately to all of the distributions. Treas. Reg. §1.1368-2(b).

Second, the remainder of the distribution is treated as a dividend to the extent of the corporation's accumulated earnings and profits. IRC §1368(c)(2).

Third, if the distribution exceeds accumulated earnings and profits, the balance is treated under the rules applicable to distributions from S corporations without earnings and profits. IRC §1368(c)(3).

The AAA is an entity-level account that begins at zero when the corporation's S election takes effect. Treas. Reg. §1.1368-2(a)(1). It is then adjusted upward and downward, generally by the same items that adjust a shareholder's basis under IRC §1367. IRC §1368(e)(1)(A); Treas. Reg. §§1.1368-2(a)(2), -2(a)(3). There are some differences, however, between the adjustments to the AAA and the adjustments to stock basis. For one thing, the AAA can go below zero. IRC §1368(e)(1)(A). And, importantly, no adjustment is made to the AAA for tax-exempt income or for expenses related to tax-exempt income. Thus, for example, death benefits received by an S corporation generally do not affect AAA even though the corporation has an increase in cash because the death benefits are excluded from gross income under IRC §101(a). Likewise, premium payments on life insurance policies should not affect AAA if the corporation will receive the death benefits on a tax-free basis.

Also, taxes paid by the corporation for years attributable to the corporation's period as a C corporation can adjust stock basis but such amounts do not affect the AAA. As these exceptions suggest, AAA is generally a reflection of the S corporation's items of income and deduction of tax consequence that have been passed through to the shareholders (in other words, perhaps, the corporation's previously taxed income).

Redemptions carry out a ratable share of the corporation's AAA if the redemption is treated as a sale or exchange under either IRC §302(a) or IRC §303(a). Treas. Reg. §1.1368-2(d)(1)(i). If the corporation makes both regular distributions and redemption distributions in the same taxable year, the AAA is adjusted first for ordinary distributions and then for any redemption distributions. Treas. Reg. §1.1368-2(d)(1)(ii).

Shareholders seeking to avoid the complexity of IRC §1368(c) may consider distributing the entire amount of the corporation's accumulated earnings and profits. This "purging" distribution permits future distributions to be tested under the simpler regime of IRC §1368(b). There are two ways to make a purging distribution. First, the corporation can elect to treat any distributions as coming first from accumulated earnings and profits and then from the AAA. Treas. Reg. §§1.1368-1(f)(1)(i); 1.1368-1(f)(2)(i). In effect, this election swaps the first two tiers of the three-tier regime. The practical effect of this election is that distributions are includible as dividends to the extent of earning and profits and *then* tax-free to the extent of stock basis. If one expects the preferential rates for qualified dividend income to expire in the near future, the election might be beneficial to the distributee-shareholders in the long term. At the same time, the election can be beneficial to the other shareholders.

The second way to make a purging distribution is for the corporation to elect a deemed dividend distribution. Under this approach, the corporation makes no actual distributions but the shareholders are taxed as though the corporation made a pro rata

distribution of its accumulated earnings and profits at a time when its AAA is zero, followed by the shareholders' contribution of those same dollars back to the corporation, all on the last day of the taxable year. Treas. Reg. §§1.1368-1(f)(1)(ii); 1.1368-1(f)(3). This alternative keeps capital within the corporation's hands but may leave the shareholders without the dollars required to pay the tax associated with the deemed dividend.

4. Liquidation

The rules applicable to C corporation liquidations apply to S corporation liquidations. Thus, the corporation realizes gain and loss upon the distribution of assets to shareholders, and such gains and losses pass through to the shareholders like other income and deduction items. These gains and losses affect a shareholder's stock basis like other pass-through items.

B. PLANNING OPPORTUNITIES WITH S CORPORATIONS

1. Leverage the Purchase of Additional Shares

Normally, interest paid on debt incurred to purchase investment property ("investment interest") is deductible by the borrower only to the extent of his or her "net investment income." IRC §163(d)(1). This limitation does not apply to interest paid on debt incurred to purchase stock in an S corporation or a partnership. Instead, such interest is deemed to be paid on debt incurred to purchase the pass-through entity's inside assets. Reg. §1.163-8T. Accordingly, if all of the entity's assets are used in the conduct of a trade or business, the interest paid on debt incurred to buy stock in the S corporation or partnership will be considered business interest. That's good news because business interest is not subject to the same limitation applicable to investment interest (in other words, business interest is deductible without regard to the currently taxable income generated by the entity's business). IRC §§163(a); 163(h)(2)(A). So if the client is thinking about purchasing additional shares (or if the client wants to help another to purchase the client's shares in the S corporation), this benefit is worth keeping in mind when running the numbers.

2. The Employment Tax Loophole for Sole-Shareholder S Corporations

While all of the operating profits of a disregarded single-member LLC or sole proprietorship are subject to employment taxes, only the salary paid to the sole shareholder of an S corporation is considered "wages" subject to employment taxes. Rev. Rul. 73-361, 1971-2 C.B. 331. Operating income of an S corporation not distributed in the form of salary is not self-employment income. Rev. Rul. 59-221, 1959-1 C.B. 225. See also IRS Publication 533. As a result, sole shareholders of S corporations have an incentive to receive no salary from their S corporations and take all of their incomes in the form of distributions.

Of course, if an S corporation pays no salary to its sole shareholder-employee, the Service may recharacterize some portion of the corporation's distributions as wages for

employment tax purposes. Rev. Rul. 74-44, 1974-1 C.B. 287. There are many cases in which the Service has been successful in converting a portion of S corporation distributions into wages for purposes of employment taxes. See, e.g., *Mike J. Graham Trucking, Inc. v. Commissioner,* T.C. Memo 2003-49, affd in unpublished opinion (3d Cir. 2004); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), affd in unpublished opinion (3d Cir. 2004). The taxpayers in both *Graham Trucking* and *VSC* argued that distributions from S corporations could not be treated as compensation because §530 of the Revenue Act of 1978 states that employment taxes do not apply if the S corporation has never treated the shareholder-employee as an employee for any period and if all filed returns are consistent with this assumption. The taxpayers conveniently forgot the language in §530 that says that employment tax relief does not apply if the corporation "had no reasonable basis for not treating such individual as an employee." The courts in both cases held that there was no precedent for treating the shareholder-employees as contractors or non-employees within their respective industries, and there were no audits of the corporations that upheld such treatment by the corporations. Accordingly, there was no basis for the corporations not to treat the taxpayers as employees, so some portion of the corporations' distributions must be treated as wages. See James A. Fellows and John F. Jewell, *S Corporations and Salary Payments to Shareholders: A Major Issue for the IRS*, 2006 THE CPA J. 46 (May 2006) (available at http://www.nysscpa.org/cpajournal/2006/506/essentials/p46.html).

Still, it appears the Service is not exercising its recharacterization power as much as it could: nearly a decade ago, a report of the Treasury Inspector General for Tax Administration claimed that some 36,000 sole shareholder-employees received no salaries from their S corporations. Statement of J. Russell George, Inspector General, Treasury Inspector General for Tax Administration before the Senate Finance Committee (May 25, 2005), available at http://www.treas.gov/tigta/congress/congress_05252005. htm. See also Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (2005) at 426 (estimating that treating all net income from partnerships and S corporations as self-employment income could increase revenues by $57.4 billion over the nine-year period from 2006 to 2014); Tony Nitti, *S Corporation Shareholder Compensation: How Much is Enough?*, AICPA THE TAX ADVISER (August 1, 2011). The same report indicated that the percentage of S corporation profits paid to their sole shareholder-employees dropped from 47.1 percent in 1994 to 41.5 percent in 2001. To the extent sole proprietors and owners of disregarded entities have 100 percent of the business profits subject to employment taxes, there remains an advantage to keeping salaries modest and maximizing distributions from an S corporation.

The question becomes how much salary to pay to the sole shareholder-employee of an S corporation. The cautious approach is for the S corporation to pay its shareholder-employee the same salary that he or she would require if the shareholder-employee were only an employee of the entity. See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41ST ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-3 (2006). More aggressive clients may prefer the lemming approach: keep salaries to about 41 – 47 percent of the S

corporation's net profits so as to be consistent with other S corporations, even if a non-shareholder-employee would insist upon a higher salary from the corporation.

3. Shift Built-in Gains to Your Low-Bracket (or Idiot) Co-Owners

When a shareholder contributes property with a value in excess of its adjusted basis to an S corporation, the corporation generally takes the contributing shareholder's basis in the property. IRC §362(a). When the S corporation subsequently sells the appreciated property, the gain from the sale, like any gain, is apportioned proportionately among the shareholders. The built-in gain is not allocated automatically to the contributing shareholder, which is not the case for a partnership. IRC §704(c)(1)(A). See discussion *infra* on partnerships. This provides contributing partners with an opportunity to shift gain to other, lower-bracket taxpayers without having to worry about the assignment of income doctrine.

EXAMPLE: *A* and *B* form an S corporation when *A* contributes inventory worth $100,000 (in which *A*'s basis is $10,000) and *B* contributes $100,000 cash. *A* and *B* are given equal shares in the corporation's single class of stock. If the corporation sells the inventory for $100,000 to an unrelated party, the corporation's $90,000 gain (ordinary income if the property is inventory in the hands of the corporation) will be allocated equally among *A* and *B*. Notice that $45,000 of the gain attributable to the period during which *A* held Blackacre is effectively shifted to *B*. If *B* is related to *A* and is in a lower tax bracket than *A*, this could be a beneficial result. Of course, *B* may not see it that way, so an "opportunity" for *A* is a "challenge" for *B*.

4. Manufacturing Basis to Claim Net Losses

An S corporation shareholder may deduct his or her proportionate share of the corporation's losses to the extent of the shareholder's stock basis and any basis in debt owed by the corporation to the shareholder. IRC §1366(d)(1). Losses in excess of these basis limitations are carried forward to subsequent taxable years, IRC §1366(d)(2), but time value of money considerations suggest we should do what we can to give the shareholder enough basis in the year the loss passes through to the shareholder.

If a client's share of an S corporation loss exceeds the client's stock basis and debt basis, the planner should explore techniques to give the client sufficient basis to claim the loss currently. A simple solution is for the client to make a loan or capital contribution to the S corporation, but the client may not have the dollars immediately available or may want to get basis now but pay later. It is not enough for the client to contribute a promise to pay to the corporation; there is no basis credit for the client's own note until actual payments are made on the note. But if the corporation has another shareholder, the client could consider giving a note to the other shareholder in exchange for some or all of the other shareholder's stock. Paying for stock with a note gives the client immediate stock basis that can be used to claim the loss flowing from the S corporation, while deferring the actual out-of-pocket cost

to the client. See Jeanne E. Sullivan, *Structure and Techniques for S Corporations for 2007 and Beyond*, 31ST ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 11 (2007) at 61.

C. PLANNING CHALLENGES WITH S CORPORATIONS

1. Beware the Interests Given to Employees

If an employee of an S corporation owns more than two percent of the corporation's outstanding stock (or more than two percent of the total combined voting power of the corporation's stock) on any day of the taxable year, the employee is no longer eligible to receive "employee fringe benefits" on a tax-free basis. IRC §1372(a); Reg. §1.707-1(c). If the majority shareholder seeks to reward key employees with stock, it might have the unintended consequence of forfeiting some of these important benefits.

To be more precise, IRC §1372(a) states that so-called "2-percent shareholders" of an S corporation are to be treated as partners in a partnership for purposes of applying Code provisions related to employee fringe benefits. Regulation §1.707-1(c) treats fringe benefits paid to employee-partners as "guaranteed payments" because they are paid without regard to the partnership's income for services rendered. The same regulation states that a partner who receives guaranteed payments is not, by virtue of the payments, regarded as an employee of the partnership. Accordingly, the value of a fringe benefit "is not excludible from the partner's gross income under the general fringe benefit rules (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners) because the benefit is treated as a distributive share of partnership income … for purposes of all Code sections other than sections 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income." Rev. Rul. 91-26, 1991-1 C.B. 184. See also Albert B. Ellentuck, *S Corporation's Treatment of Employee-Shareholder Fringe Benefits*, THE TAX ADVISER (May 2003).

Examples of benefits not excludable by so-called "2-percent shareholders" are: (1) the cost of accident and health insurance plans under IRC §§105 and 106; (2) meals and lodging furnished on the business premises for the convenience of the employer under IRC §119; (3) the cost of group-term life insurance coverage under IRC § 79; and (4) cafeteria plans under IRC §125. When a 2-percent shareholder receives one of these taxable fringe benefits, it is to be treated as additional compensation subject to Federal withholding and employment taxes. Rev. Rul. 91-26, 1991-1 C.B. 184. That means the S corporation likely gets a deduction for the extra compensation, and this deduction will pass through to the shareholders *pro rata* like any other deduction item.

Not all fringe benefits excluded from the gross incomes of employees are lost; benefits that remain excludable include: (1) dependent care assistance under IRC §129 (IRC §129(e)(3) provides that the exclusion is available to self-employed individuals as well as employees; because partners in a partnership and 2-percent shareholders in an S corporation are deemed

to be self-employed, as discussed *supra*, the exclusion is available to partners and 2-percent shareholders in an S corporation); (2) educational assistance programs under IRC §127, IRC §127(c)(2); and (3) several of the fringe benefits listed in IRC §132, including no-additional-cost services, qualified employee discounts, de minimis fringes, working condition fringes, and on-premises athletic facilities. Reg. §§1.132-1(b)(1); 1.132-1(b)(2)(ii); 1.132-1(b)(3); 1.132-1(b)(4).

2. Getting Basis Credit for Entity Debt

As mentioned above, S corporation shareholders need basis (either stock basis or debt basis) in order to claim their shares of the corporation's net losses. While partners in a partnership are entitled to basis credit for their shares of the partnership's debts, the same is not true for shareholders of an S corporation. It is not sufficient for a shareholder to guarantee the S corporation's debt in order to give the shareholder basis credit for the debt. (If the shareholder makes an actual payment on the guarantee, he or she gets basis credit for the amount paid.)

The preferred approach is for the lender to make the loan to the shareholder who then loans those proceeds to the S corporation. By structuring the loan arrangement in this fashion, the shareholder makes a loan to the corporation, which expressly entitles the shareholder to basis credit. In fact, as long as proper formalities are observed and the shareholder in fact assumes liability for servicing the debt, the refinancing of an entity debt into a shareholder debt can give the shareholder debt basis. See *Miller v. Commissioner*, T.C. Memo. 2006-125 (restructuring of corporation's line of credit under which shareholder assumed the debt gave shareholder basis credit to the extent of the shareholder's liability). As the *Miller* court observed, "The same result as a 'back to back' loan is reached where a shareholder substitutes his own note for the note of his S corporation on which he was a guarantor, thereby becoming the sole obligor on the new indebtedness. In such 'note substitution' scenarios, so long as the S corporation's indebtedness to the third-party lender is extinguished, so that the shareholder becomes the sole obligor to the lender, the shareholder's assumption of what was formerly the S corporation's legal burden serves as a constructive furnishing of funds to the S corporation for which the S corporation becomes indebted to repay to the shareholder."

It is worth noting that to the extent the shareholder incurs personal liability in order to have the loan structured in such a way as to give the shareholder basis credit for the debt, the shareholder bears a genuine risk that a direct loan to the corporation would not present. But since many loan arrangements with closely-held S corporations require personal guarantees from the shareholders already, structuring the loan to pass through the shareholder may not affect the shareholder's liability for repayment.

3. Debt as a Second Class of Stock

Speaking of debt, planners have to tread carefully here. Shareholder loans to an S corporation may be recharacterized as equity, which would give the S corporation an impermissible second class of stock. A loan to an S corporation will be treated as stock if the transaction constitutes equity under general principles of federal tax law or if the principal purpose of the transaction is to circumvent the single-class-of-stock or eligible-shareholder rules. Treas. Reg. §1.1361-1(l)(4)(ii)(A). To be safe, all loan arrangements from shareholders to S corporations should come within one of the three safe harbors outlined in the regulations: (1) short-term unwritten advances that never exceed $10,000 in the aggregate (Treas. Reg. §1.1361-1(l)(4)(ii)(B)(1)); (2) debts owed solely to the shareholders and in proportion to their stock holdings (Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2)); and (3) "straight debt." Straight debt is a written, unconditional obligation to pay a sum certain (on demand or on a specified due date) held by a United States citizen or resident, an estate, or an eligible trust shareholder and which does not provide for contingent interest (that is, interest computed or payable that is contingent on corporate profits, the borrower's discretion, the payment of dividends, or similar factors) and is not convertible to into stock. Treas. Reg. §1.1361-1(l)(5)(i).

The debt-as-second-class-of-stock problem can arise in situations planners may not expect. For example, if an S corporation redeems a portion of the shares of a retiring or deceased shareholder, the applicable buy-sell agreement usually permits the S corporation to pay the purchase price in installments. If the buy-sell agreement requires the S corporation to pay interest on the deferred payments, the obligation may create a second class of stock unless it qualifies under straight debt safe harbor. Planners should review the provisions of a buy-sell agreement involving S corporation stock to make sure this situation does not arise by accident.

4. The Perils of Former C Corporations

If an S corporation used to be a C corporation, the planner has to proceed carefully. Three separate Code provisions come into play for former C corporations, although the last two are more significant because they continue to haunt the former C corporation for quite a while following the subchapter S election.

The first provision is IRC §1363(d), which forces a corporation using the LIFO method of inventory valuation to recapture as gross income the excess of the FIFO value of its inventory over the LIFO value of its inventory at the close of the corporation's last taxable year as a C corporation. The recapture amount is treated as gross income in such last taxable year, but the increase in tax caused by this recapture is payable in four equal annual installments without interest. Unless the planner is helping the business to elect S corporation status, the planner will likely not have to address this issue.

The second provision is IRC §1374, proof that the S election does not provide a perfect conduit for former C corporations. This provision imposes a tax on the disposition of "built-in gains." It is the S corporation that is liable for payment of this tax. The basic theme behind the IRC §1374 tax on built-in gains is that gains and losses attributable to taxable years prior to the S election should be taxed as though the corporation were still subject to subchapter C.

EXAMPLE: *X* Corporation purchased raw land for $100 three years ago. Today, the land is worth $500, and the corporation wants to sell the land to an unrelated purchaser. If *X* sells the land, *X* will be taxed on the $400 gain. If *X* then distributes the after-tax proceeds of the sale to its shareholders (as a dividend), the after-tax profit will be taxed again. The shareholders of *X* thus have an incentive to make the S election prior to the sale. If *X* makes an S election prior to the sale, the $400 gain will pass to the shareholders under IRC §1366, and subsequent distribution of the proceeds will be tax-free under IRC §1368. In effect, the election allows *X* to convert two levels of tax into one level of tax.

Congress reacted to this situation by enacting IRC §1374. Now, when the gain occurs during years in which the corporation was subject to two layers of tax, it is appropriate to tax that gain twice even though the entity is currently a valid S corporation.

The IRC §1374 tax applies to any "net recognized built-in gains" during each of the first several years following the former C corporation's subchapter S election (known as the "recognition period"). Legislation in 2009 shortened the recognition period to seven years for 2009 and 2010 only. IRC §1374(d)(7)(B). Under the Creating Small Business Jobs Act of 2010, the recognition period for taxable years beginning in 2011 only was shortened to five years, and the American Taxpayer Relief Act of 2012 extended the five-year recognition period through 2013. The Tax Increase Prevention Act of 2014 extended the five-year recognition period through 2014. Finally, the Consolidated Appropriations Act of 2016 made the five-year recognition period permanent.

The tax is computed by applying the highest rate under IRC §11 (now 21 percent) to the net recognized built-in gain for the taxable year or, if less, the corporation's taxable income for the taxable year. IRC §§1374(b)(1); 1374(d)(2)(A). The cumulative amount of net recognized built-in gains during the recognition period cannot exceed the corporation's "net unrealized built-in gain" as of the date of the S election. IRC §1374(c)(2). Note that the tax applies to any disposition that results in a recognized built-in gain, whether in the form of a sale or a distribution to the shareholders. IRC §§311(b); 1374(d)(3).

The tax imposed under IRC §1374 passes through to the S corporation's shareholders as a loss with the same character as the corresponding gain giving rise to the tax. IRC §1366(f)(2). This lessens the impact of the double tax to some extent.

There are several ways to avoid or lessen the burden of the IRC §1374 tax. Perhaps the most common solution is to wait out the recognition period: the tax does not apply to dispositions of built-in gain property that occur after the recognition period expires. The tax can be deferred if the corporation effects a like-kind exchange of the built-in gain property under IRC §1031, although the IRC §1374 taint is preserved in the asset(s) received in the like-kind exchange. IRC §1374(d)(6). Regulations provide that if an S corporation acquires some asset before or during the recognition period with a principal purpose of reducing or eliminating the IRC §1374 tax (because the asset will generate a loss, deduction, or credit that can be used to reduce the corporation's taxable income below the amount of net recognized built-in gain), such loss, deduction or credit shall be ignored for purposes of computing the IRC §1374 tax. Treas. Reg. §1.1374-9. Finally, one could consider a charitable contribution of the built-in gain property. The S corporation does not recognize gain upon making the gift to charity (so the IRC §1374 tax cannot apply), and the deduction flows through to the shareholders. The shareholders reduce their stock bases by their shares of the corporation's adjusted basis in the contributed property, which insures that the lurking gain is not later taxed upon sale of the shares or liquidation of the corporation. IRC §1367(a). First introduced in 2006, this rule expired four times before being made permanent by the Protecting Americans from Tax Hikes Act of 2015.

The third provision is IRC §1375, which imposes a penalty tax at the entity level when two conditions exist: (1) an S corporation has "accumulated earnings and profits" (which by definition only applies if the S corporation was formerly a C corporation), and (2) the S corporation's "passive investment income" exceeds 25 percent of its total gross receipts. If the IRC §1375 tax is imposed for three consecutive years, the corporation will face the "death penalty": its S election is terminated and the corporation will revert to C corporation status. IRC §1362(d)(3).

Why the concern with the amount of passive income generated by a corporation? One treatise explains the policy of these rules as follows:

> These statutory measures restrict attempts to use S corporations as incorporated pocketbooks for their shareholders by investing the corporations' retained earnings in marketable securities and other passive investments of a type that the shareholders would have purchased had the earnings been paid out as dividends. This ploy is particularly likely to happen when the C corporation has liquidated its business assets. The passive-investment-income limitation can also be viewed as a rough-and-ready offset to the fact that a C corporation can be converted to S status without subjecting its accumulated earnings to tax at the shareholder level as if the earnings were distributed in a quasi-liquidation.

Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (7th student ed. 2000) at 6-19. Basically, Congress wants to limit the benefits of subchapter S to corporations engaged in active businesses.

The mechanics of the IRC §1375 tax are relatively simple. The corporation's "excess net passive income" is multiplied by the highest rate of tax under IRC §11 (21 percent). IRC §1375(a). Excess net passive income is computed under this formula:

$$\frac{(PII) - (25\% \text{ of } GR)}{(PII)} \times (NPI) = \text{Excess Net Passive Income}$$

PII = **passive investment income** (royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of securities). See IRC §§1362(d)(3)(C)(i); 1375(b)(3).
GR = **gross receipts** (the total amount received or accrued under the corporation's accounting method). See Treas. Reg. §1.1362-2(c)(4)(i).
NPI = **net passive income** (passive investment income less those deduction directly connected with the production of passive investment income other than net operating loss carryovers and dividends-received deductions). See IRC §1375(b)(2).

The corporate-level taxes are coordinated because built-in gains and losses are taken out of the definition of passive investment income. IRC §1375(b)(4). Instead of passing through as a loss, the amount of IRC §1375 tax serves to reduce the amount of each item of passive investment income passing through to the shareholders. IRC §1366(f)(3).

There are some planning suggestions for minimizing exposure to the IRC §1375 tax. If the corporation had relatively little earnings and profits at the time of the S election, it may be advisable to distribute the subchapter C earnings and profits to the shareholders, especially since those earnings will be taxed at preferential tax rates to the shareholders in the hopes of avoiding a 21 percent tax imposed on the corporation. IRC §1368(e)(3) permits the shareholders to declare that distributions come first from subchapter C earnings and profits and then from subchapter S earnings (the accumulated adjustments account), although the default distribution rules apply the opposite assumption. Once the subchapter C earnings and profits are gone, the IRC §1375 tax (and the risk of the death penalty under IRC §1362(d)(3)) cannot apply. Alternatively, the shareholders can try their very best to manage gross receipts so that the amount of passive income does not cross the 25 percent threshold.

5. Beware Trusts Holding S Corporation Stock

Only certain domestic trusts qualify as S corporation shareholders. If S corporation falls into the hands of an "ineligible" shareholder, the S election is lost and the corporation becomes a C corporation unable to elect S corporation status for five years unless it successfully obtains discretionary relief from an inadvertent termination of the S election.

Although many trusts qualify as eligible shareholders of S corporation stock, some common trust arrangements do not qualify. For instance, a charitable remainder trust is not an eligible shareholder of S corporation stock. Planners should therefore not advise clients to fund charitable remainder trusts with S corporation stock because doing so would sacrifice the S election.

Generally there are five kinds of trusts that qualify as S corporation shareholders.

The first is the **qualified subchapter S trust**, or QSST. IRC §1361(d). Among other things, a QSST must be a domestic trust. See IRC §§7701(a)(30)(E); 7701(a)(31)(B). Under these rules, a trust is a domestic trust only if: (a) a court within the United States has primary supervision over the administration of the trust, and (b) one or more United States fiduciaries control all substantial decisions of the trust. The regulations give some examples of the "substantial decisions" related to a trust that a fiduciary may have. Treas. Reg. §301.7701-7(d)(1)(ii). These include, among others: (1) whether and when to make distributions of income and principal; (2) the amount of distributions; (3) whether a receipt is allocated to income or principal; (4) the selection of a beneficiary; and (5) whether to appoint a successor trustee to succeed another trustee that is unable or willing to serve or continue to serve.

Further, the QSST may have only one income beneficiary during that beneficiary's life (unless each beneficiary has a separate share of the trust, see IRC §663(c)) who is a United States citizen or resident. Spouses are treated as one current income beneficiary if they file jointly and each is a United States citizen or resident. The trust instrument must require that all income be distributed currently (or such income must in fact be paid at least annually to the current income beneficiary). A QSST may permit distributions of principal only to the current income beneficiary during his or her life. No one else may be entitled to distributions of income or principal during the trust term, and no payments can be made from the trust that discharge someone else's obligation to support the current income beneficiary. The trust instrument must provide that the current income beneficiary's income interest terminates at his or her death or, if earlier, upon expiration of a fixed term. If a QSST terminates during the current income beneficiary's life, all assets must be distributed to him or her.

To become a QSST, the current income beneficiary must make a QSST election. If the corporation loses its S election solely because the current income beneficiary of an otherwise valid QSST fails to make a QSST election, the S election may be preserved if a QSST election is filed within two years of its original due date. See Rev. Proc. 2003-43, 2003-1 C.B. 998.

In the case of a trust owning shares in a C corporation that becomes an S corporation, the QSST election is made on Part III of the Form 2553, Election by a Small Business Corporation. If the corporation's S election is already in effect when the trust receives the shares, the QSST election is made by signing and filing a statement with the service center where the corporation files its income tax return. Treas. Reg. §1.1361-1(j)(6)(ii). The statement must: contain the name, address, and taxpayer identification number of the

current income beneficiary, the trust, and the corporation; identify the election as one made under IRC §1361(d)(2); specify the date on which the election is to become effective (cannot be more than 2 months and 15 days before the date the election is filed); specify the date(s) on which stock was transferred to the trust; and provide all information required to prove that the trust meets the requirements of a QSST.

The current income beneficiary reports all S corporation items attributable to the stock held by the QSST on his or her personal tax return. If the trust sells the S corporation stock, gain or loss is recognized by the trust (although the sale is considered to have been made by the current income beneficiary for purposes of the at-risk rules in IRC §465 and the passive loss rules in IRC §469). See IRC §1361(d)(1)(C).

For purposes of the 100-shareholder limitation, the current income beneficiary is treated as the shareholder of the stock. IRC §1361(c)(2)(B)(i).

The second is the **electing small business trust**, or ESBT. See IRC §1361(e). A trust can qualify as an ESBT if it has only individuals, estates, and/or qualified exempt organizations (any organization described in IRC §170(c)(2) – (5) is a qualified exempt organization, as is any IRC §170(c)(1) organization that holds a contingent interest and is not a potential current beneficiary) as present, remainder, or reversionary beneficiaries. A person who may take under the exercise of a power of appointment is not considered a beneficiary of the trust for this purpose unless such power is actually exercised in that person's favor.

A trust cannot qualify as an ESBT if any person has acquired an interest in the trust by purchase. A purchase includes any transaction in which the basis of the acquired property is its cost. IRC §1361(e)(1)(C). In addition, each "potential current beneficiary" of the trust must be an eligible shareholder of S corporation stock if the trust is to qualify as an ESBT. A potential current beneficiary is one entitled to (or who may currently) receive distributions of income or principal from the trust. IRC §1361(e)(2). The trust cannot be a charitable remainder trust or otherwise exempt from federal income tax.

An eligible trust becomes an ESBT when the trustee(s) with authority to legally bind the trust sign and file an election statement with the service center where the corporation files its income tax return. Treas. Reg. §1.1361-1(m)(2)(i). The statement must include: the name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the corporation; a statement that an ESBT election pursuant to IRC §1361(e)(3) is being made; the date when the trust first owned stock in the corporation; the date the election is to take effect (cannot be more than 2 months and 15 days before the date the election is filed); and representations that the trust meets all of the requirements of an ESBT and that all potential current beneficiaries are eligible shareholders of S corporation stock.

While the requirements for an ESBT are easier to meet than the requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself must pay a flat tax equal to the highest rate applicable to trusts and estates under IRC §1(e) (currently 37 percent) on the trust's taxable income attributable to the S corporation items, the exemption amount for alternative minimum tax purposes is reduced to zero, and no capital loss carryovers are permitted. IRC §641(c). The trust continues to pay tax at the slightly progressive rates of IRC §1(e) on income attributable to other assets.

For purposes of the 100-shareholder limitation, each potential current beneficiary is counted as a shareholder. IRC §1361(c)(2)(B)(v). During any period that there is no potential current beneficiary of an ESBT, the trust itself is treated as the shareholder for purposes of applying the 100-shareholder limitation.

In computing an ESBT's income attributable to the S corporation, the only items taken into account are: (1) the trust's shares of the S corporation's item of income, gain, loss, deduction, and credit; (2) gain or loss from the trust's sale of the S corporation stock; (3) state or local income taxes and administrative expenses allocable to the S corporation stock; and (4) interest paid or accrued on debt used to acquire stock in the S corporation. IRC §641(c)(2)(C).

The third kind of trust eligible to be an S corporation shareholder is a good, old-fashioned **grantor trust**. IRC §1361(c)(2)(A)(i). A grantor trust is any trust that is deemed to be owned by the grantor or another person under any of IRC §§671-678. For more on the use of grantor trusts in estate planning, see (ahem) Samuel A. Donaldson, *Understanding Grantor Trusts*, *in* 40 HECKERLING INSTITUTE ON ESTATE PLANNING 2-1 (Tina Portuando ed., 2006).

A grantor trust is effectively disregarded for federal income tax purposes because all of the trust's tax items are reported by the deemed owner. Accordingly, if the deemed owner is an eligible shareholder of S corporation stock, transfers of S corporation stock to a grantor trust will not jeopardize the company's S election. For purposes of the 100-shareholder limitation, the deemed owner is counted as the shareholder. IRC §1361(c)(2)(B)(i). This is true even where the trust contains *Crummey* powers that give the beneficiaries a power to withdraw some or all of the amounts contributed to the trust so that a gift of S corporation stock to the trust qualifies for the federal gift tax annual exclusion. See, e.g., PLR 200732010 (grantor trust with *Crummey* powers is an eligible shareholder of S corporation stock because the grantor's ownership of the trust under IRC §674 trumped the beneficiaries' ownership of the trust under IRC §678(a).

The fourth kind of eligible trust is a **former grantor trust**. IRC §1361(c)(2)(A)(ii). As its name implies, a former grantor trust is a trust that was a grantor trust (with a United States citizen or resident as the deemed owner) immediately before the deemed owner's death and that continues after such death. Although the trust is no longer a grantor trust because of the deemed owner's demise, the trust itself remains an eligible S corporation shareholder

regardless of its dispositive scheme until the day before the second anniversary of the deemed owners death. After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. The estate of the deemed owner is counted as the shareholder for purposes of the 100-shareholder limitation. If no one is the deemed owner of the trust, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock.

The final kind of eligible trust is a **testamentary trust**. All testamentary trusts are permitted S corporation shareholders for a two-year period beginning on the date the stock is transferred to the trust. IRC §1361(c)(2)(A)(iii). After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. During the two-year grace period, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock if no one is the deemed owner of the trust. The testator is treated as the shareholder for purposes of applying the 100-shareholder limitation.

IV. PARTNERSHIPS

A. THE BASIC MECHANICS

1. Formation

Like a corporation, formation of a partnership is also a painless event. A partner will not recognize gain or loss upon a transfer to the partnership in exchange for an interest unless the contribution consists of services. IRC §721. Note that a partner does not need to be an 80-percent owner to achieve non-recognition, as does the shareholder of a corporation. To preserve any gain or loss not recognized, the partner's basis in the partnership interest equals the sum of the bases of the properties transferred to the partnership in exchange for the interest. IRC §722. The partnership also takes a carry-over basis in the property received from the partner. IRC §723.

2. Operation

The tax items of a partnership pass through to the partners. IRC §§701; 702. Unlike an S corporation, however, the partners of a partnership are generally free to allocate these tax items among the partners as they wish, so long as these allocations have "substantial economic effect." IRC §704(b). Thus, equal partners in a partnership may agree to allocate all losses to one partner and all tax-exempt income to the other partner, so long as the allocations have "substantial economic effect." The flexible tax allocations make the partnership a more attractive business vehicle to most business owners.

Allocations have "economic effect" if the partnership agreement requires, for the full term of the partnership, that: (1) capital accounts be created and maintained in the manner

set forth in the regulations (see Treas. Reg. §1.704-1(b)(2)(iv)); (2) liquidating distributions be made in accordance with the partners' positive capital account balances; and (3) any partner with a deficit balance in his or her capital account following liquidation of the partnership be unconditionally obligated to restore the amount of the deficit (see Treas. Reg. §1.704-1(b)(2)(ii)(b)). A partner's capital account balance is the amount he or she would be entitled to receive upon liquidation of the partnership. A capital account is increased by the net value of any contributed cash or property and the partner's share of partnership income items. It is decreased by the value of any distributions to the partner and the partner's share of partnership loss and deduction items

If the partnership agreement complies with the first two requirements but does not comply with the third requirement, the allocation can still have economic effect under an alternate test. See Treas. Reg. §1.704-1(b)(2)(ii)(d). Assuming the economic effect test is met, an allocation will be respected if it is **substantial**. While various standards for substantiality are provided in the regulations—a general rule as well as a rule for shifting and transitory allocations—the focus is whether the allocation will affect substantially the dollar amounts to be received by the partners from the partnership. See Treas. Reg. §1.704-1(b)(2)(iii).

3. Distributions

As you would expect, distributions from a partnership are generally tax-free since the partners have already taken the partnership's tax items into account on their own income tax returns. No gain is recognized upon a distribution to a partner except to the extent the amount of cash distributed exceeds the partner's outside basis immediately before the distribution. IRC §731(a)(1). No gain or loss is recognized by the partnership. IRC §731(b). If a partner receives cash or property regardless of the partnership's profitability, however, the distribution may constitute a "guaranteed payment" that will be treated as compensation income. IRC §707. Further discussion of the partnership distribution rules appears later in these materials.

4. Liquidation

The basis of property (other than money) distributed to a partner in liquidation of the partner's interest in the partnership is an amount equal to the partner's basis in the partnership interest reduced by any money distributed in the same transaction. IRC §732(b). Liquidation of a partner's interest is defined as the termination of the partner's entire interest in the partnership by means of a distribution or series of distributions. See IRC §761(d). Loss is not recognized by a partner upon a distribution *except* that loss *is* recognized on a distribution in liquidation of a partner's interest where no property other than cash, unrealized receivables, and inventory items are received by the partner. IRC §731(a)(2). The amount of the loss (which is considered to be loss from the sale or exchange of the partnership interest) is equal to the excess of the partner's basis in the partnership interest

over the sum of the cash distributed to the partner and the adjusted basis of the distributed property under IRC §732.

B. PLANNING OPPORTUNITIES WITH PARTNERSHIPS

1. The IRC §754 Election and the Adjustment to Inside Basis

If the partnership makes an election under IRC §754, the partnership's basis in its assets ("inside basis") will be adjusted, but only with respect to the transferee partner. Specifically, the entity will increase its inside basis by the excess of the transferee partner's outside basis (freshly stepped-up under IRC §1014, remember) over his or her share of the partnership's inside basis. Alternatively, if the transferee partner's outside basis was stepped-*down* under IRC §1014, the entity will reduce its inside basis by the excess of the transferee partner's share of inside basis over his or her outside basis. This adjustment to inside basis affects not just the allocation of gain and loss to the transferee partner upon a disposition of a partnership asset. It determines the partner's share of inside basis for purposes of depreciation deductions and distributions, as well.

Notice that if the estate planner succeeds in claiming a significant valuation discount for the value of the partnership interest included in the deceased partner's gross estate, there is an adverse effect on the adjustment to inside basis (though usually not to such an extent that the valuation discounts have no net value).

EXAMPLE: Mom dies holding a five percent general partner interest and a 20 percent limited partner interest in a partnership. The partnership's assets have a combined liquidation value of $1,000,000 and an aggregate inside basis of $200,000. Mom's estate values the five percent general partner interest at $40,000 (assuming a 20 percent blended valuation discount against the $50,000 liquidation value attributable to the general partner interest) and it values the 20 percent limited partner interest at $120,000 (assuming a 40 percent blended valuation discount against the $200,000 liquidation value attributable to the limited partner interest). Both interests pass to Son. Son's aggregate outside basis is $160,000, the sum of the date-of-death values of the general and limited partner interests included in Mom's gross estate.

If the partnership has a valid IRC §754 election in effect, the $50,000 of aggregate inside basis (that portion of the inside basis attributable to Mom's interests) is increased to $160,000, *not* to its $250,000 liquidation value. Thus, while the IRC §754 election eliminates the disparity between inside and outside bases with respect to Son, the election does not completely eliminate the inherent gain attributable to the interests now held by Son; if the partnership sells all of its assets, $90,000 of gain will be allocable to Son. Of course, this beats the $200,000 gain that would have been allocable to Son had no IRC §754 election been made. And the estate tax savings from an aggregate $90,000 discount likely exceeds the income tax

burden from $90,000 of extra gain. But it shows that the higher the discount, the less beneficial the IRC §754 election becomes to the decedent's successor in interest.

Note that if the deceased partner's surviving spouse is also a partner in the partnership, and if the spouses owned their interests as community property, the surviving spouse's interest in the partnership also triggers an adjustment to inside basis if the IRC §754 election is in effect.

2. S Corporation Election

Unincorporated domestic entities (like partnerships) can elect to be treated as corporations for federal tax purposes. Treas. Reg. §301.7701-3. Any such organization that elects status as a corporation can also elect to be taxed as an S corporation. See, e.g., Priv. Ltr. Rul. 199942017. To the extent a partnership wants to avail itself of the benefits of S corporation status, the partners can simply make this two-step election to achieve the desired status.

The key obstacle, of course, is that an electing unincorporated entity must meet the eligibility requirements of an S corporation in order for the S election to become effective. The entity, for example, cannot have more than 100 owners and no owner may be a nonresident alien individual. See IRC §1361(b)(1)(A), (b)(1)(C). These are easy enough to spot, but the "single-class-of-stock" requirement for S corporations under IRC §1361(b)(1)(D) can be harder to police. The Service will not issue rulings as to whether a limited partnership qualifies as a small business corporation eligible to elect S corporation status. Rev. Proc. 2011-3, 2011-1 I.R.B. 111, §5.11. No doubt this is because the varying rights and obligations of general and limited partners may well constitute a second class of stock. See Rev. Proc. 99-51, 1999-2 C.B. 760. We know that a limited partnership agreement does not create a second class of stock as long as distributions to the partners are to be made in accordance with the partners' respective cumulative interests. See, e.g., Priv. Ltr. Ruls. 200326023, 200326024, and 200326025. In the last of these private rulings, the shareholders of an S corporation (S1) formed a limited liability partnership (LLP) that made a double-election to be treated as an S corporation. The shareholders then contributed their S1 stock to LLP and S1 elected to be treated as a qualified subchapter S subsidiary corporation (or "Q-Sub"). LLP then created a wholly-owned limited liability company (LLC) that is disregarded for federal tax purposes as an unincorporated organization with only one owner. LLP transferred some of its S1 stock to LLC. Because LLC is disregarded, S1's Q-Sub election is not lost. S1 then converted to a limited partnership, with LLC as the general partner and LLP as the limited partner. As a limited partnership, S1 made a triple-election (electing to be a corporation, an S corporation, and a Q-Sub). At the end of the day, then, the shareholders owned all of the interests in LLP (an S corporation for tax purposes) which in turn held all of the limited partner interests (and, through a disregarded entity, all of the general partner interests) in a limited partnership (a Q-Sub for tax purposes). The Service approved this transaction in the ruling.

If the partnership agreement requires distributions in accordance with positive capital account balances and such capital accounts are not in proportion to the partners' percentage interests, however, the partnership likely has more than one class of stock, making the S election unavailable. See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41ST ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-7 (2006). Disproportionate operating distributions from the partnership should not create a second class of stock provided the entity makes corrective distributions to make distributions proportionate. See, e.g., Priv. Ltr. Rul. 200524020.

3. Allocating Items in the Year of a Partner's Death

Upon the death of a partner, IRC §706(c)(2)(A) provides that the taxable year of the partnership closes with respect to the deceased partner. The deceased partner's final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a *pro rata* allocation based on the number of days in each period. Treas. Reg. § 1.706-1(c)(2)(ii).

EXAMPLE: *A*, *B*, and *C* are equal general and limited partners in a partnership. *A* dies on July 1, Year One. The partnership's income for Year One consists of two gains: a $900 gain in March and a $300 gain in November. If the partnership makes an election to close its books on July 1, the proportionate shares of the partners would be as follows:

Partner	March Gain Share	November Gain Share
A	$300	zero
B	$300	$150
C	$300	$150

If, on the other hand, the partnership does not close its books, the proportionate shares of the partners for Year One would be as follows:

Partner	March Gain Share	November Gain Share
A	$150	$50
B	$375	$125
C	$375	$125

In this example, *B* and *C* are inclined to close the books, for their proportionate shares under a closing of the books ($450) is less than their shares if no such election is made ($500). Of course, if the November gain were larger than the March gain, the incentive would be the opposite.

The point is that the fiduciary and the surviving partners should work together to determine which approach is better. The same is generally true of S corporations. IRC §1377(a),

presumes that S corporation items will be allocated *pro rata* on a daily basis unless the surviving shareholders agree to an interim closing of the books.

C. PLANNING CHALLENGES PRESENTED BY PARTNERSHIPS

1. The Estate Planning Drawbacks of Special Allocations

Partners are generally free to allocate the income, gain, loss, deduction, and credit items of the partnership among themselves however they may agree, subject to the constraint in IRC §704(b) that such allocations have "substantial economic effect." Detailed regulations give guidance for ensuring that allocations meet this amorphous standard. The regulations provide two safe harbors under which an allocation will be deemed to have "economic effect." Treas. Reg. § 1.704-1(b)(2)(ii). The first safe harbor applies where the partnership agreement requires: (1) the determination and maintenance of capital accounts in accordance with specific rules provided elsewhere in the regulations; (2) that liquidating distributions be made in accordance with the positive capital account balances of the partners; and (3) that any partner with a deficit balance in his or her capital account at liquidation be required to restore the deficit balance to the partnership within a stated period. Treas. Reg. § 1.704-1(b)(2)(ii)(b). The second safe harbor applies where the partnership agreement requires: (1) both of the first two conditions of the first safe harbor (maintenance of capital accounts according to specific rules and liquidating distributions according to positive capital account balances); (2) the operation of a "qualified income offset" provision; and (3) that no allocation to a partner may cause or increase a deficit balance to that partner's capital account in an amount greater than the amount that partner is obligated to restore upon liquidation of the entity. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

Both safe harbors require the partnership to maintain capital accounts using specific accounting rules set forth in the regulations. Treas. Reg. § 1.704-1(b)(2)(iv). In some cases, compliance with these accounting rules proves to be difficult (i.e., expensive).

Special allocations of partnership income and deduction items are common in partnerships that conduct an active trade or business in which the partners participate. From an estate planning perspective, however, they may pose two problems. First, the use of special allocations might run afoul of IRC §2701. Section 2701 values certain retained interests in a partnership at zero for purposes of valuing subordinate equity interests transferred to certain family members. If all interests in a partnership have identical distribution and liquidation rights, IRC §2701 does not apply. Accordingly, estate planners usually advise the partners to make sure all income and deduction allocations are made according to the partners' interests in the partnership, regardless of whether such interests have voting or management rights. Differences in voting and management rights (as well as differences in liability for entity debts) do not by themselves create subordinate equity interests, so creating voting and nonvoting partnership interests does not trigger application of IRC §2701's zero-value rule. Treas. Reg. § 25.2701-1(c)(3).

Second, where the planner intends to have a partner give some portion of his or her partnership interest to a donee, the planner must be cognizant of IRC §704(e)(2). It states that where there has been a gift of a limited partner interest in a partnership, the recipient's distributive share of the partnership's income is limited in two ways. *First*, the donor must be adequately compensated for any services rendered to the FLP. In other words, the donor cannot perform services at no charge for the partnership and pass along the savings to the recipient. For example, suppose Parent gives Child a 40 percent limited partner interest in a partnership, retaining a ten percent general partner interest and a 50 percent limited partner interest. The partnership's taxable income for the year is $100,000. In that same year, Parent performed services for the partnership valued at $40,000. An allocation of $40,000 of the $100,000 taxable income to Child would violate IRC §704(e)(2) because it does not consider the services performed by Parent. Instead, the $40,000 in services should be treated as compensation to Parent, leaving $60,000 to be allocated according to the partners' interests in the partnership. In sum, Parent would be allocated income totaling $76,000 ($40,000 for Parent's services plus 60 percent of the partnership's remaining $60,000 income, or $36,000), while Child would be allocated $24,000 of income (40 percent of the partnership's $60,000 income after services).

Second, if the recipient's interest was funded with donated capital, the donor and the recipient must be allocated income in proportion to the donated capital. In effect, the maximum income allocable to a recipient partner is the income allocable to the recipient partner's interest in partnership capital. Thus, if Mom and Dad form a partnership with contributed capital and gift a 20 percent limited partner interest to Child, Child must report 20 percent of the partnership's income attributable to the contributed capital. Combining the two rules under IRC §704(e)(2), the regulations state that family partnership income must be distributed proportionate to capital interests after distributing reasonable compensation to the donor for services rendered to the partnership. Treas. Reg. § 1.704-1(e)(3).

If the partnership is a holding company (one not actively conducting a trade or business), it is rare to see special income or deduction allocations. Given the risks described above, it might be better *not* to follow the capital account rules in the regulations, provided the partnership agreement requires all allocations to be in accordance with the partners' interests in the partnership. Remember: failure to fall within one of the two safe harbors for economic effect means only that the Service can reallocate items if it determines that an allocation with not made in accordance with the partners' interests in the partnership. It does not mean that all allocations are *per se* invalid.

2. Distributions within Seven Years of Capital Contributions

Normally, property distributions from a partnership are tax-free. IRC §731(a). Cash distributions from a partnership are taxable to the extent the cash distributed exceeds the recipient partner's basis in the partnership interest immediately prior to the distribution. IRC

§731(a)(1). But if the partnership liquidates within seven years of a partner's contribution of property to the partnership, two Code provisions can convert a tax-free liquidation into a taxable one. For more on the federal income tax aspects of liquidating a partnership formed for estate planning purposes, see Samuel A. Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 CAP. U. L. REV. 15 (2006). Look, *someone* has to cite my works.

First, IRC §704(c)(1)(B) provides that if property distributed to one partner was contributed to the partnership by another partner within seven years of the distribution, and if that property had built-in gain or loss at the time of contribution, then the contributing partner must recognize the built-in gain or loss at the time of the distribution.

EXAMPLE: *A* and *B* formed a partnership in Year One when *A* contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a five percent general partner interest and a 45 percent limited partner interest, and *B* contributed cash in the amount of $500,000 for a 50 percent limited partner interest. In Year Five, the partnership distributed the farmland to *B*. Assuming the value of the land has not changed since contribution, *A* must recognize *A*'s $200,000 built-in gain from the farmland in Year Five.

Recognition of the built-in gain is avoided if the property is distributed back to the contributing partner. For this purpose, any assignee or successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain allocable to the assignee-successor's interest. Treas. Reg. § 1.704-4(d)(2).

EXAMPLE: Assume the same facts from the prior example, If in Year Four *A* gave *A*'s general and limited partner interest to *C*, and if in Year Five the partnership distributed the farmland to *C*, neither *A* nor *C* recognizes gain from this distribution under IRC §704(c)(1)(B) since *C* was *A*'s successor in interest.

Second, IRC §737 generally provides that if a partner contributes appreciated property to the partnership and, within seven years of such contribution, receives a distribution of non-cash property, the contributing partner must recognize the IRC §704(c) built-in gain (or, if less, the excess of the distributed property's value over the partner's outside basis immediately prior to the distribution minus any cash received in the same distribution).

EXAMPLE: Assume the facts from the example involving *A* and *B* and the formation of their partnership in Year One. The partnership used the cash contributed by *B* to acquire a small parcel of vacant land in the suburbs. In Year Five, the partnership distributed the suburban land to *A*. Assuming the value of the contributed properties has not changed since contribution, *A* must recognize the $200,000 built-in gain from the farmland in Year Five.

As was the case with IRC §704(c)(1)(B), an assignee-successor to a contributing partner's interest is treated as a contributing partner for purposes of IRC §737's general rule. Treas. Reg. § 1.737-1(c)(2)(iii).

EXAMPLE: Assume the same facts from the prior example. If *A* gifted *A*'s general and limited partner interests to *C* in Year Four and the partnership distributed the suburban land to *C* in Year Five, *C* "steps into *A*'s shoes" and must recognize in Year Five the $200,000 built-in gain from *A*'s contribution of the farmland in Year One.

On its face, § 737 would apply if the contributing partner received back from the partnership the appreciated property originally contributed to the partnership. Regulations recognize that because such a "return-to-sender" distribution is not taxable under IRC §704(c)(1)(B), IRC §737 does not apply if the contributing partner receives the property he or she originally contributed to the partnership. Treas. Reg. § 1.737-2(d)(1). Oddly, however, there is no rule providing that an assignee-successor to the contributing partner's interest likewise qualifies for this exception. It is therefore possible that an assignee-successor must recognize gain under IRC §737 upon receipt of property originally contributed to the partnership by the assignee-successor's predecessor in interest—even though the receipt of the contributed property by the same party is expressly *not* subject to IRC §704(c)(1)(B). For a contrary view, *see* Ellen K. Harrison and Brian M. Blum, *Another View: Responding to Richard Robinson's 'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313, 315 (2003).

The moral of the story here is to postpone any distributions of IRC §704(c) property until the partnership has held such property for seven years, as IRC §§704(c)(1)(B) and 737 only apply to distributions made within seven years of contribution.

3. Distributions of Marketable Securities Treated as Cash Distributions

Under IRC §731(a)(1), no gain is generally recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. For purposes of this rule, however, IRC §731(c) provides that marketable securities are treated as cash (valued at fair market value as of the date of distribution). That, of course, creates the risk that a distribution of marketable securities will be a taxable event to the recipient partner.

EXAMPLE: *A* and *B* formed a partnership when *A* contributed a collectible with a value of $100,000 and a basis of $20,000 and *B* contributed $100,000 cash. The partnership used $50,000 of the cash to purchase Microsoft stock. The partnership then distributed the Microsoft stock to *A*. Under IRC §731(c), the stock distribution is treated as a cash distribution in the amount of $50,000, the value of the Microsoft shares distributed. *A* recognizes gain of $30,000 because the amount of deemed cash distributed exceeds *A*'s $20,000 outside basis.

By its terms, IRC §731(c) does not apply if: (a) the marketable securities received by the partner were those contributed by the same partner; (b) subject to some limitations, the marketable securities distributed were acquired by the partnership in a nonrecognition transaction (provided the total cash and marketable securities acquired by the partnership in the nonrecognition transaction is less than 20 percent of the value of the assets transferred by the partnership in such transaction and further provided that the distribution of the marketable securities occurs within five years of the partnership's acquisition of the securities (or, if later, within five years of the date when the securities became marketable)); (c) the distributed securities were not marketable when first acquired by the partnership and did not become marketable for at least six months (the partnership must distribute the securities within five years of the date upon which they became marketable and the issuer of the securities must not have issued any marketable securities prior to the time the partnership first acquired the distributed securities); or (d) the partnership is an "investment partnership" and is making a distribution to an "eligible partner."

This last exception requires elaboration. A partnership will qualify as an investment partnership if it has never been engaged in a trade or business and 90 percent or more of its assets, measured by value, have always consisted of portfolio assets. Treas. Reg. § 1.731-2(c)(3)(i). And an eligible partner is any partner that contributed nothing but such portfolio assets to the partnership. Treas. Reg. § 1.731-2(e)(2)(i).

Now let's return to the first exception: marketable securities will not be treated as cash for purposes of IRC §731 if they are distributed to the same partner that contributed them to the partnership. This is consistent with the "return-to-sender" exceptions under IRC §§704(c)(1)(B) and 737 described above. But here, as with IRC §737, there is no rule extending the exception to a distribution of marketable securities to an assignee-successor to the contributing partner's partnership interest. Regulation § 1.731-2(d)(1) states, in relevant part that "section 731(c) and this section do not apply to the distribution of a marketable security if-(i) the security was contributed to the partnership by the distributee partner…." No mention is made of a successor in interest here.

In short, then, those who receive a partnership interest by gift may have to recognize gain upon a distribution of marketable securities from the partnership even if those securities were contributed to the partnership by the donor. And the application of this rule does not expire after seven years.

One solution is to effect a proportionate distribution of any marketable securities. By doing so, one makes better use of the limitation in IRC §731(c)(3)(B), which reduces the amount of the deemed cash distribution by the recipient partner's share of gain on the distributed securities.

EXAMPLE: In Year One, *A*, *B*, and *C* formed a partnership when *A* contributed stock in Starbucks Corporation worth $900,000 (in which *A* had a basis of $720,000) in exchange for a four percent general partner interest and an 86 percent limited partner interest, while *B* and *C* contributed their undivided, one-half interests in a parcel of raw land worth a total of $100,000 (in which each had a basis of $20,000) in exchange for a ten percent limited partner interest (five percent held by *B* and five percent held by *C*. *A* died in Year Ten, leaving *A*'s general and limited partner interests in equal shares to *B* and *C*. At the date of *A*'s death, the Starbucks stock is worth $1.5 million, and the raw land is worth $500,000. *A*'s estate claims a 50 percent combined discount on the value of the partnership interests passing to *B* and *C*, reporting a combined value of $900,000 on *A*'s federal estate tax return (90 percent interest in a total liquidation value of $2 million, less 50 percent). Each beneficiary's aggregate outside basis in FLP is now $470,000 ($450,000 attributable to the 90 percent interest from *A* that was stepped-up under IRC §1014 plus $20,000 attributable to the ten percent interest acquired through their contribution).

If the partnership distributes the Starbucks stock in equal shares to *B* and *C*, each is deemed to receive a cash distribution of only $360,000 (not $750,000), because the $390,000 gain that would be allocated to each child from partnership's sale of the stock reduces the deemed cash distribution pursuant to IRC §731(c)(3)(B). (For convenience, this example assumes no IRC §754 election is in place.) This deemed distribution is not taxable to either *B* or *C* because each has an outside basis in excess of the deemed distribution amount. The distribution will reduce each of *B*'s and *C*'s outside basis to $110,000 ($470,000 minus $360,000 deemed cash). Note that IRC §704(c)(1)(B) does not apply in this example because the distribution occurs after the seven-year period during which IRC §704(c)(1)(B) is alive.

If, instead, the partnership distributes the raw land plus $500,000 of the Starbucks stock to *B* ($1 million total) and the remaining $1 million of Starbucks stock to *C*, the result changes. *C* is deemed to receive a cash distribution of $610,000 (not $1 million), because the $390,000 gain that would be allocated to *C* from the partnership's sale of the stock reduced the deemed cash distribution under IRC §731(c)(3)(B). Because *C*'s outside basis immediately prior to the distribution is $470,000, *C* must recognize $140,000 of gain thanks to the deemed cash distribution. The disproportionate distribution of the Starbucks stock to *C* in this case forced the recognition of gain that would not have occurred in a proportionate distribution of the stock. Notice here that the IRC §754 election might be detrimental to the successors in interest. An increase in inside basis lessens the benefit of the IRC §731(c)(3)(B) reduction for the distributee's distributive share of gain on the property. If the partnership would realize no gain if it sold the distributed property, there is no reduction in the amount of the deemed cash distribution. Thus, while the IRC §754 election is generally beneficial in the context of IRC §§704(c)(1)(B) and 737, it can be disadvantageous for purposes of IRC §731(c).

The IRC §731(c)(3)(B) gain limitation is handy where the partnership distributes marketable securities with a low inside basis. Partners should therefore be reluctant to distribute freshly-purchased marketable securities with an inside basis (nearly) equal to their

value. Likewise, marketable securities that have recently declined in value are less attractive candidates for distribution to donee-partners.

While a proportionate distribution of marketable securities may be helpful in avoiding IRC §731(c), it presents problems outside of the tax realm. Beneficiaries are often reluctant to hold assets as tenants in common (proof that the minority interest discount and, to a greater extent, the marketability discount are quite real). If so, then perhaps the best solution to the IRC §731(c) problem lies back in the exceptions: where possible, a partnership holding a substantial amount of marketable securities should own only portfolio assets at all times and care should be taken to make sure each partner is an "eligible partner." One *bad* solution would be to reallocate the partnership's gain to the distribute partner in an effort to maximize use of the IRC §731(c)(3)(B) gain limitation. Regulations give the Service the power to disregard a blatant attempt to avoid IRC §731(c)(1) through a change in partnership allocations. Treas. Reg. § 1.731-2(h)(1).

4. Sales of Partnership Interests Can Yield Ordinary Income

Subchapter K uses a hybrid aggregate-entity approach for the sale of an interest in a partnership. Generally, the sale gives rise to capital gain or loss because the selling partner is disposing of a capital asset. IRC §741. But the portion of the gain or loss allocable to "unrealized receivables" or "inventory items" will be treated as ordinary income or loss. IRC §751(a). This rule applies no matter whether the partner sells all or part of the partner's interest.

Unrealized receivables are any rights to payments for goods or services that have not previously been included in the partnership's gross income. The term also includes any gain attributable to assets the sale of which would give rise to ordinary income. IRC §751(c). **Inventory items** are any assets that are neither capital assets nor IRC §1231 assets. IRC §751(d). Accordingly, "inventory" means not only inventory but also, for example, supplies used in the partnership's business and gains from hedging transactions.

EXAMPLE: *A* owns a one-third interest in the *ABC* Partnership, a cash method partnership that develops real estate. *ABC* both constructs buildings for sale to customers and holds real estate for rental purposes. On January 1, *A* sells her partnership interest to *D* for $180,000 cash. *ABC*'s balance sheet at the time of the sale is as follows:

Asset	Basis	Value	Capital	Basis	Value
Cash	$ 45,000	$ 45,000	*A*	$110,000	$180,000
Accounts Receivable	$ 0	$ 60,000	*B*	$110,000	$180,000
Building for sale	$150,000	$180,000	*C*	$110,000	$180,000
Building for rent	$135,000	$240,000			
Goodwill	$ 0	$ 15,000			
	$330,000	$540,000		$330,000	$540,000

A's realized gain from the sale is $70,000. To determine the character of this gain, we must pretend *ABC* sold *A*'s share of all partnership assets for fair market value. Treas. Reg. §1.751-1(a)(2). The accounts receivable are "unrealized receivables" under IRC §751(c), and *A*'s share of the $60,000 partnership gain from a sale of the receivables is $20,000. In addition, the building held for sale is an inventory item of the partnership under IRC §751(d), and *A*'s share of the $30,000 gain to the partnership is $10,000. Accordingly, *A* must recognize $30,000 of ordinary income from the sale of her partnership interest ($20,000 from the receivables and $10,000 from the building for sale). The building held for rent is not IRC §751(a) property because it is not held for sale to customers. The property qualifies as IRC §1231 property under IRC §1231(b), so it is not an "inventory item" of the partnership. The remaining $40,000 of *A*'s $70,000 realized gain may be long-term capital gain, provided *A* held her partnership interest for more than one year.

5. No Tax-Free Mergers with Corporations

Only corporations can participate in tax-free reorganizations with other corporations. A merger between a partnership and a corporation is treated as a taxable exchange. If the partners anticipate selling their business to a corporation and wish to participate in a tax-free reorganization transaction, they may be tempted to "check the box" so that the partnership is taxed as a corporation. But if the partners make the election only shortly before engaging in the reorganization, there is a high risk that the transaction will not qualify for nonrecognition. This risk arises under the common law step transaction doctrine, where a proposed reorganization planned prior to the formation of a target corporation can be deemed a taxable exchange because there is no other business purpose for the corporation and because the transaction is, in substance, a taxable exchange. *West Coast Marketing Corp. v. Commissioner*, 46 TC 32 (1966).

There is no magic amount of time after electing corporate status that a former partnership should wait before the reorganization occurs. Instead, the principal focus should be on making sure there is some separate business purpose for converting the partnership to a corporation beyond qualifying the exchange for nonrecognition. See Robert R. Keatinge, *Tax Considerations in Choice of Business Entity*, 31ST ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 9, at 71 (2007). If the partners anticipate that the business might be acquired by a corporation, it is a good idea to create a corporation well in advance of discussions with a particular buyer. The partners can then move the business assets from the partnership to the corporation as discussions become serious. There is authority to suggest that funding a shell corporation followed shortly by the shell's acquisition by another corporation can qualify as a tax-free reorganization. *Weikel v. Commissioner*, T.C. Memo. 1986-58. *Weikel* has been criticized by other courts. See *Long Term Capital Holdings v. U.S.*, 330 F. Supp. 2d 122 (D. Conn. 2004); *Associated Wholesale Grocers v. U.S.*, 927 F.2d 1517 (10th Cir. 1990). Both of these cases observe that courts can still apply the step transaction doctrine to transactions even where the business purpose for the entity is established.

It is important to note that no such risk exists where the partners wish to take the business public instead of selling it to an acquiring corporation. A last-minute conversion or incorporation of the business on the eve of a public offering does not disqualify the conversion from nonrecognition. This is because the conversion qualifies for nonrecognition under IRC §351, which does not have a continuity of interest requirement that applies to reorganizations under IRC §368(a).

6. The Built-in Gain Problem Under IRC §704(c)

If a partner contributes "built-in gain property" to the partnership, subchapter K and corresponding regulations insure that the contributing partner's built-in gain cannot be shifted to another partner. Built-in gain property is property which, on the date of contribution to the partnership, has a fair market value greater than its tax basis. IRC §704(c)(1)(A); Treas. Reg. §1.704-4. When the partnership disposes of the built-in gain property, the built-in gain *must* be allocated to the contributing partner. IRC §704(c)(1)(A).