2019 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 July, 2018, through August, 2019. 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).

I. INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2019

FEDERAL INCOME TAX RATES FOR UNMARRIED INDIVIDUALS

(Adapted from Rev. Proc. 2018-57)

Taxable Income Exceeding	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Earned Income**	Medicare Surtax on Net Investment Income
\$0	10%	00/		
\$9,700	12%	U%	0%	
\$39,375	12%		2.9%	00/
\$39,475	22%		2.9%	0%
\$84,200	24%	15%		
\$160,725	32%			
AGI over \$200,000	3270			
\$204,100	35%		3.8%	3.8%
\$434,550	33%	200/	3.6%	5.6%
\$510,300	37%	20%		

^{*} Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

^{**} Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over \$200,000 for an unmarried individual and \$250,000 on a joint return (§3101(b)(2), for years after 2012).

FEDERAL INCOME TAX RATES FOR MARRIED COUPLES FILING JOINT RETURNS

(Adapted from Rev. Proc. 2018-57)

Taxable Income Exceeding	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Earned Income**	Medicare Surtax on Net Investment Income
\$0	10%	0%		
\$19,400	12%	U%		0%
\$78,750	12%		2.9%	
\$78,950	22%			
\$168,400	24%	1 5 0/		
AGI over \$250,000	24%	15%		
\$321,450	32%			
\$408,200	250/		3.8%	3.8%
\$488,850	35%	200/		
\$612,350	37%	20%		

^{*} Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

FEDERAL INCOME TAX RATES FOR TRUSTS AND ESTATES

(Adapted from Rev. Proc. 2018-57)

Taxable Income Exceeding	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Net Investment Income
\$0	10%	0%	
\$2,600			
\$2,650	24%		0%
\$9,300	35%	15%	
\$12,750	270/		
\$12,950	37%	20%	3.8%

^{*} Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

II. ADJUSTED BASIC EXCLUSION AMOUNT FOR FEDERAL WEALTH TRANSFER TAXES

The 2017 Tax Cuts and Jobs Act doubled 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. The 2017 Act provides that the basic exclusion amount will revert to \$5 million

^{**} Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over \$200,000 for an unmarried individual and \$250,000 on a joint return (§3101(b)(2), for years after 2012).

(adjusted for post-2011 inflation) after 2025. The estimated revenue loss from doubling of the basic exclusion amount is \$83 billion over ten years.

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
2018	\$11,180,000
2019	\$11,400,000

III. STATE INCOME TAXATION OF NONGRANTOR TRUSTS (North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust, United States Supreme Court, June 21, 2019)

A. Background

In this case, the grantor, a resident of New York, created a trust for his three children, including his daughter, Kimberley. The trust later split into three separate trusts, one for each child. The trustee of Kimberley's trust is a resident of Connecticut, and a Massachusetts firm manages the assets. Kimberley resides in North Carolina. The trust is a separate taxable entity, meaning it is neither a grantor trust (the income from which would be taxed to the grantor) nor a "beneficiary-owned trust" (the income from which would be taxed to Kimberley). North Carolina asserted it could tax Kimberley's trust on the undistributed income. The trust paid over \$1.2 million in state income tax for the years at issue and then commenced a suit for refund.

The issue is whether a state may tax a nonresident, nongrantor trust on its undistributed net income when the trust has no other contact with the state. Both the state trial court and the state supreme court held North Carolina could not tax the income. The North Carolina Department of Revenue then asked the United States Supreme Court to review, claiming a split of jurisdictions on the issue.

The split might have been overstated. Yes, North Carolina became the fourth state to conclude that a state lacks the power to tax when its only connection to the trust is the presence of an in-state beneficiary, joining Michigan, New Jersey, and New York. But the Department alleged in its petition for certiorari that four other states allow taxation of a trust with a resident beneficiary even where the beneficiary receives no distributions. It cites decisions from California, Connecticut, Illinois, and Missouri. Arguably those decisions did not apply to the facts at issue in this case, but that did not seem to get much attention.

The case attracted a number of amicus briefs. One brief, filed by a half-dozen law professors, argued that states should be able to tax trusts in these case, else the fat cats have an incentive to defer state income tax by creating nongrantor trusts in states that do not impose state income tax and directing trustees to accumulate income. Another amicus brief from four different professors concluded that "a beneficiary's residency in a taxing state necessarily creates a significant relationship between the taxing state and the trust income that is the object of the tax." A third brief, from 20 state attorneys general, urged that states be allowed to tax nonresident trusts so that the 43 states that impose state income tax avoid substantial losses and uncertainties as to the validity of their tax systems.

B. The Decision

In a unanimous decision, the Supreme Court held that "the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it." Writing for the Court, Justice Sotomayor cites a long line of cases that "reflect a common governing principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax." Justice Sotomayor cites two cases that invalidated a state's attempt to tax a beneficiary on the income from a trust over which none of the resident beneficiaries had control, possession, or enjoyment. She concludes that "When a tax is premised on the in-state residence of a beneficiary, the Constitution requires that the resident have some degree of possession, control, or enjoyment of the trust property or a right to receive that property before the State can tax the asset. Otherwise, the State's relationship to the object of its tax is too attenuated to create the 'minimum connection' that the Constitution requires." (emphasis added)

In this case, Kimberley did not receive income from the trust during the years at issue. (If she had, observed the Court, North Carolina could have taxed that income.) She also lacked any right to demand income or any portion of the trust corpus, and had no say in investment decisions. Perhaps importantly, the Court observed that the trust contained a spendthrift clause, "thus making the beneficiaries' interest less like a potential source of wealth that was property in their hands." Finally, the beneficiary could not necessarily count on receiving any specific amounts in the future, for while the trust was to terminate on Kimbeley's 40th birthday, New York law allowed the trustee to decant the trust assets into a new trust that would continue past her 40th birthday, which in fact happened.

The Court was not persuaded by the North Carolina Department of Revenue's claim that if a state can tax a trust with a resident trustee, it may also tax a trust with a resident beneficiary. The Court countered that while a beneficiary is required for a trust to exist, not all beneficiaries have the types of present interests and powers that give the state a sufficient nexus to the trust.

The state also raised the concern from the amicus briefs that a decision in favor of the trust would undermine state tax regimes. But in footnote 12 of its opinion, the Court observed that North Carolina is unique in its position that a resident beneficiary is by itself sufficient to support state income taxation of a trust:

The State directs the Court's attention to 10 other state trust taxation statutes that also look to trust beneficiaries' in-state residency, but 5 are unlike North Carolina's because they consider beneficiary residence only in combination with other factors, see Ala. Code §40–18–1(33) (2011); Conn. Gen. Stat. §12–701(a)(4) (2019 Cum. Supp.); Mo. Rev. Stat. §§143.331(2), (3) (2016); Ohio Rev. Code Ann. §5747.01(I)(3) (Lexis Supp. 2019); R. I. Gen. Laws §44–30–5(c) (2010). Of the remaining five statutes, it is not clear that the flexible tests employed in Montana and North Dakota permit reliance on beneficiary residence alone. See Mont. Admin. Rule 42.30.101(16) (2016); N. D. Admin. Code §81–03–02.1–04(2) (2018). Similarly, Georgia's imposition of a tax on the sole basis of beneficiary residency is disputed. See Ga. Code Ann. §48–7–22(a)(1)(C) (2017). Tennessee will be phasing out its income tax entirely by 2021. H. B. 534, 110th Gen. Assem., Reg. Sess. (2017) (enacted); see Tenn. Code Ann. §67–2–110(a) (2013). That leaves California, which (unlike North Carolina) applies its tax on the basis of beneficiary residency only where the beneficiary is not contingent.

Importantly, concluded the Court, this decision "does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries."

C. Thoughts on the Case

1. Lessons

The *Kaestner* case confirms that a state may not tax the income of a trust whose sole connection with the state is the presence of a discretionary beneficiary that neither receives a distribution nor has the power to compel one. The Court also affirmed that a state *may* tax the income of a trust that is administered within the state, favorably citing two earlier cases that specifically found that a trust administration within a state's borders gives that state jurisdiction to tax.

2. Beneficiary Residency May be a Factor, Just Not Dispositive

As noted above, the Court expressly deferred on the issue of whether the residency of an instate discretionary beneficiary was a legitimate factor that could be considered, along with other factors, in determining whether the state has a sufficient connection with the trust such that the state may tax the trust income.

3. Can a Beneficiary Be Taxed on Accumulated Income When Distributed?

No one disputes that a distribution of current income to a discretionary beneficiary may be taxed by that discretionary beneficiary's own state. In footnote 13, the Court noted that the trust did not challenge "the practice known as throwback taxation, by which a State taxes accumulated income at the time it is actually distributed." The footnote cited California Revenue & Tax Code Annotated §17745(b) as one example of a throwback statute. Thus we do not know whether a throwback statute violates the Due Process Clause.

4. A Mountain from a Mole Hill

Ultimately, the case is not terribly significant on its merits. The court simply held that the one state attempting to tax trust income on the basis of a discretionary beneficiary's residency within the state violates the Due Process Clause. Since only North Carolina's statute had been interpreted to allow taxation on such basis, the precise holding has a very limited scope. That might explain why the Court's decision was unanimous. In retrospect, this was a very easy case.

Why, then, were so many professionals nervous about this case? Within the last decade, a popular strategy for deferring state income tax has been through the use of so-called "incomplete gift nongrantor trusts," known conventionally (if not entirely accurately) as "INGs." Under this strategy, a grantor places assets into an irrevocable trust located in a state that does not impose income tax. As long as the trustee makes no income distributions to the grantor, state income tax is deferred. To preclude unnecessary use of the grantor's basic exclusion amount for federal wealth transfer tax purposes, the trust is commonly structured such that the grantor's transfer to the trust is not a completed gift for federal transfer tax purposes. Some worried that if North Carolina had the jurisdiction to tax a trust on the basis of a discretionary beneficiary's residency, it would likewise have the power to tax the grantor of an ING.

5. Play with the Facts

One wonders whether the Court would have reached the result it did if the facts were not so favorable to the trust. What if Kimberley held the power to remove and replace the trustee? Arguably, that might give her the requisite degree of "control" over trust property sufficient to meet the Court's announced test.

What if Kimberley could have shown eligibility to receive a discretionary distribution for health, education, maintenance, or support? North Carolina could argue that the trustee should have made a distribution to Kimberley and, on that basis, legitimately claim jurisdiction to tax. Again, we do not know for sure whether this fact alone would enable North Carolina to tax the trust on the income that could (or should) have been distributed to Kimberley.

The Court expressly mentioned that the trust contained a spendthrift clause. Would the result be different if Kimberley's interest was not subject to such a restriction? Does the power to

assign all or any portion of a beneficial interest rise to the level of "control" needed for a state to tax the trust?

The Court emphasizes that Kimberley had no involvement in trust administration during the years at issue. But the Court also noted that, in the year following the years at issue, when Kimberley was of sufficient age to receive a final distribution of the corpus and accumulated income, the trustee "after consulting with Kaestner and in accordance with her wishes ... rolled over the assets into a new trust instead of distributing them to her." If the decanting had happened during the years at issue, would implementation of Kimberley's "wish" to decant have given North Carolina sufficient jurisdiction to tax? The Court's express mention that the decanting occurred after the years at issue suggests it could have made a difference.

6. Post-Kaestner Planning

The decision seemingly approves of a plan by which a grantor residing in a state with comparatively high income taxes moves assets and administration to a state that does not impose income tax and at least defer collection of state income tax until final distribution to an in-state beneficiary. Perhaps the beneficiary could achieve complete forgiveness (not just deferral) by simply moving to a state that imposes no income tax, receiving distributions from the trustee, and then moving back to the beneficiary's original home state after some period of time. A planner would be loath to suggest that specific course of action, however, as it would seem easy prey for application of the step transaction doctrine. But in at least some cases it appears complete forgiveness of state income tax is a possibility.

7. Should States Amend Their Statutes?

A state revenue agency could comfortably assert jurisdiction to tax solely on the basis of trust administration occurring within its borders, as the Court greenlighted that single criterion as a constitutional basis for asserting the power to tax. It is important to remember, again, that only North Carolina took the approach that in-state residency of a discretionary beneficiary was, by itself, sufficient to assert jurisdiction to tax. North Carolina may choose to amend it statute, though it was the state's department of revenue that interpreted the statute. But the decision does not mean that other state income tax statutes violate due process or are otherwise in need of revision.

IV. PLANNING WITH THE \$10,000 CAP ON PERSONAL STATE AND LOCAL TAXES

A. Background

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 2017 Tax Cuts and Jobs 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.

The cap has a greater impact on taxpayers living in states with comparatively high state and local tax burdens. This table, adapted from Amelia Josephson, *Changes to State and Local Tax Deduction – Explained*, available at https://smartasset.com/taxes/trumps-plan-to-eliminate-the-state-and-local-tax-deduction-explained (January 30, 2019), shows the impact on residents in ten jurisdictions:

		1	
Jurisdiction	% of taxpayers who deduct	Average deduction for	
Julisalction	states and local taxes	state and local taxes	
New York	34.14%	\$21,038.02	
Connecticut	41.04%	\$18,939.72	
New Jersey	41.00%	\$17,183.33	
California	33.86%	\$17,148.35	
Washington, D.C.	39.19%	\$15,452.40	
Massachusetts	36.73%	\$14,760.99	
Illinois	32.34%	\$12,877.51	
Maryland	45.04%	\$12,442.78	
Rhode Island	32.83%	\$12,138.75	
Vermont	27.41%	\$11,843.95	

It is important to note that the \$10,000 cap applies only to the deduction under §164 for what might be called "personal" state and local taxes. It affects neither the deduction for "investment" state and local taxes under §212, nor the deduction for "business" state and local taxes under §162. Thus, a taxpayer with personal-use real estate might consider converting the real estate to rental property, operated either as an investment activity or, even better, a trade or business.

B. Lawsuit Contesting the Limit

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." In February, 2019, the Trump Administration asked the court to dismiss the case.

C. Making Donations in Lieu of Paying Taxes

1. The Scheme

Some states responded to the cap by creating programs under which taxpayers could effectively treat state and local tax payments as charitable contributions. As of last August, legislatures in four states (Connecticut, New Jersey, New York, and Oregon) had passed laws under which taxpayers making donations to the state would receive state income or property tax credits. New York, for example, permits taxpayers to contribute to "charitable gift trust funds" and receive a tax credit equal to 85 percent of the donation. New Jersey's statute allows localities to create charitable funds to which contributing taxpayers may claim a New Jersey property tax credit equal to 90 percent of the contribution. Other states, including California, Illinois, and Rhode Island, considered similar legislation.

2. Regulatory Response (*T.D. 9864*, June 11, 2019)

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-overform 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."

The proposed regulations were issued on August 27, 2018, and those regulations were finalized on June 11, 2019 in Treasury Decision 9864. The regulations do not specifically target the more recent legislation enacted in response to the \$10,000 deduction cap; instead, the regulations broaden the scope to consider the proper tax treatment of all arrangements under which states give tax credits for donations made to certain charities. There are over 110 such credits available in a majority of states.

The final regulations, set forth at Reg. §1.170A-1(h)(3), generally provide that a taxpayer who transfers cash or property to a charity must reduce the amount of the §170 charitable contribution deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive. An example from the final regulations illustrates the rule:

A, an individual, makes a payment of \$1,000 to X, an entity described in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by \$700 (0.70 \times \$1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the \$1,000 payment to X may not exceed \$300.

Regulation §1.170A-1(h)(3)(vii), Example 1. This new rule does not apply where a taxpayer receives a *deduction* on state and local tax for charitable contributions unless the deduction exceeds the value of the contribution. The new rule also does not apply to tax credits in an amount not in excess of 15 percent of the value of the contribution. The preamble to the final regulations explains that the de minimis rule makes sense because the tax savings in such a case is not enough that a taxpayer would make the donation just to avoid application of the \$10,000 cap on state and local taxes.

3. Forthcoming Safe Harbor Will Treat Disallowed Donation as Personal State and Local Tax (*Notice 2019-22*, June 11, 2019)

On the same day the regulations were finalized, the Service issued *Notice 2019-12*. It contains notice of a forthcoming safe harbor under which an individual "may treat as a payment of state or local tax for purposes of §164 the portion of a payment for which a charitable contribution deduction under §170 is or will be disallowed under the new regulation." Thus, in the example above, the taxpayer may treat the \$700 disallowed portion of the donation as a tax for purposes of §164. If the safe harbor applies and the taxpayer has not exhausted the \$10,000 cap on personal state and local taxes, the taxpayer can deduct the \$700 portion as an itemized deduction of personal state and local taxes.

The Notice indicates the forthcoming safe harbor will apply to "individuals who (i) itemize deductions for federal income tax purposes, (ii) make a payment to a §170(c) entity in return for a state or local tax credit, and (iii) would have been able to deduct a payment of tax to the state or local government in the amount of the credit."

D. Using Trusts to Avoid the Cap (Regulation §1.643(f)-1, January 15, 2019)

Some practitioners have suggested placing personal residences into a limited liability company and then transferring 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 new Regulation

§1.643(f)-1, finalized on January 15, 2019. The 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.

E. Application of the Tax Benefit Rule (Revenue Ruling 2019-11, March 29, 2019)

In Revenue Ruling 2019-11, issued on March 29, 2019, the Service issued guidance on the application of the so-called "tax benefit rule" to refunds of state and local tax payments by applying the rule in four different hypothetical fact patterns. Recall that the tax benefit rule requires inclusion in gross income of the recovery of any expenditure deducted by the taxpayer on a prior year's tax return. Section 111(a), however, limits the amount of inclusion to the extent the prior deduction actually saved tax. In other words, if the recouped expenditure was deductible but the deduction did not actually save tax, §111(a) excludes the recovery from the gross income.

In the first situation, the taxpayer paid \$4,000 in local real property taxes and \$5,000 in state income taxes in 2018. Because the total state and local tax paid was less than the \$10,000 cap under §164(b)(6), the cap did not apply. The taxpayer had other allowable itemized deductions of \$5,000, so the taxpayer claimed a total of \$14,000 in itemized deductions on the 2018 federal income tax return. In 2019, the taxpayer received a \$1,500 state income tax refund attributable to the overpayment of state income taxes in 2018. The Service ruled that the entire refund was includible in gross income. "Had [the taxpayer] paid only the proper amount of state income tax in 2018, A's state and local tax deduction would have been reduced from \$9,000 to \$7,500 and as a result, A's itemized deductions would have been reduced from \$14,000 to \$12,500, a difference of \$1,500. [The taxpayer] received a tax benefit from the overpayment of \$1,500 in state income tax in 2018."

In the second situation, the taxpayer paid \$5,000 in local real property taxes and \$7,000 of state income taxes in 2018, but because of the §164(b)(6) cap, the total state and local tax deduction was limited to \$10,000. The taxpayer had other allowable itemized deductions of \$5,000, so the taxpayer claimed a total of \$15,000 in itemized deductions on the 2018 federal income tax return. In 2019, the taxpayer received a \$750 state income tax refund attributable to the overpayment of state income taxes in 2018. The Service ruled that none of this refund was includible in the taxpayer's gross income for 2019. "Had [the taxpayer] paid only the proper amount of state income tax in 2018, [the taxpayer's] state and local tax deduction would have remained the same (\$10,000) and [the taxpayer's] itemized deductions would have remained the same (\$15,000)." Since the taxpayer received no tax benefit from the overpayment of \$750 in state income tax in 2018, §111(a) applied to exclude the refund.

In the third situation, the taxpayer paid \$5,000 in local real property taxes and \$6,000 in state income taxes in 2018, but again the §164(b)(6) applied to limit the total deduction on the taxpayer's 2018 federal income tax return to \$10,000. The taxpayer had other allowable itemized deductions of \$5,000, so the taxpayer claimed a total of \$15,000 in itemized deductions on the 2018 federal income tax return. In 2019, the taxpayer received a \$1,500 state income tax refund attributable to the overpayment of state income taxes in 2018. The Service ruled that \$500 of the refund was includible in gross income. "Had [the taxpayer] paid only the proper amount of state income tax in 2018, [the] state and local tax deduction would have been reduced from \$10,000 to \$9,500 and as a result, [the] itemized deductions would have been reduced from \$15,000 to \$14,500, a difference of \$500. [The taxpayer] received a tax benefit from \$500 of the overpayment of state income tax in 2018."

In the final situation, the taxpayer paid \$4,250 in local real property taxes and \$6,000 in state income taxes in 2018. The §164(b)(6) cap limited the deduction to \$10,000. The taxpayer had other allowable itemized deductions of \$2,500, so the taxpayer claimed a total of \$12,500 in itemized deductions on the 2018 federal income tax return. In 2019, the taxpayer received a \$1,000 state income tax refund attributable to the overpayment of state income tax in 2018. The Service ruled that \$500 of the rebate was includible in gross income. "Had [the taxpayer] paid only the proper amount of state income tax in 2018, [the] state and local tax deduction would have been reduced from \$10,000 to \$9,250, and, as a result, ... itemized deductions would have been reduced from \$12,500 to \$11,750, which is less than the standard deduction of \$12,000 that [the taxpayer] would have taken in 2018. The difference between [the] claimed itemized deductions (\$12,500) and the standard deduction [the taxpayer] could have taken (\$12,000) is \$500." The taxpayer thus received a tax benefit from \$500 of the overpayment of state income tax in 2018, and that's why \$500 of the refund is includible in gross income.

V. PROPOSED ANTI-CLAWBACK REGULATIONS (Prop. Reg. §20.2010-1(c), November 23, 2018)

The basic exclusion amount for federal wealth transfer tax purposes 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, \$9 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 applicable that year? 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 2017 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.

A. Proposed Regulations

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. Clawback's Kissing Cousin: Disappearing DSUE

Suppose one spouse dies in 2019, never having made a taxable gift, leaving the entire estate to the survivor. If the deceased spouse's executor timely files a federal estate tax return, the deceased spouse's unused \$11.4 million exclusion is added to the surviving spouse's basic exclusion amount. If the surviving spouse has likewise never made a taxable gift, the surviving spouse would have an applicable exclusion amount equal to \$22.8 million: the survivor's own \$11.4 million basic exclusion amount and the "deceased spousal unused exclusion amount" (what the so-called "portability" regulations call the "DSUE amount") of \$11.4 million. While the surviving spouse's basic exclusion amount continues to grow, the DSUE amount is fixed. For example, if the basic exclusion amount in 2020 grows to, say, \$12 million, the surviving spouse's

applicable exclusion amount would be \$23.4 million: \$12 million of basic exclusion amount plus the \$11.4 million DSUE amount. On this much there is no dispute.

Suppose further, however, that the surviving spouse is still alive in 2026, and that the basic exclusion amount in that year is only \$6 million, as might be the result under current law. Does the DSUE amount stay at \$11.4 million or does it too shrink to \$6 million? The applicable statute, \$2010(c)(4), provides as follows:

- **(4) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT** For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of—
 - (A) the basic exclusion amount, or
 - (B) the excess of—
 - (i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
 - (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

Section 2010(c)(4)(A) is not clear whether the "basic exclusion amount" refers to the amount at the time of the deceased spouse's death or the time of the surviving spouse's death. If it refers to the basic exclusion amount at the death of the first spouse to die, the DSUE amount would never shrink even though the survivor's basic exclusion amount might. But if it refers to the basic exclusion amount at the survivor's death, the DSUE amount could shrink. This creates the risk of the "disappearing DSUE," as explained by Mike Jones and DeeAnn Thompson in their article, Jones and Thompson on the Disappearing BEA, appearing in Leimberg Estate Planning Newsletter #2708 (Macrh 14, 2019).

Happily, the regulations already take the position that there is no "disappearing DSUE." Here is the language of Regulation §20.2010-2(c)(1) (with emphasis added):

(c) Computation of the DSUE amount -

- (1) General rule. Subject to paragraphs (c)(2) through (4) of this section, the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts -
 - (i) The basic exclusion amount <u>in effect in the year of the death of</u> <u>the decedent</u>; or
 - (ii) The excess of -
 - (A) The decedent's applicable exclusion amount; over
 - (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which

together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1).

Unwilling to let that settle the matter, some practitioners warn that the regulation pre-dates the scheduled reduction to the basic exclusion amount implemented by the 2017 Tax Cuts and Jobs Act. They argue that the emphasized language from the regulation intends only to make clear that the DSUE amount does not adjust for inflation like the basic exclusion amount. Perhaps this concern prompted the AICPA to recommend to Treasury that it issue guidance making clear that there is no disappearing DSUE.

VI. GUIDANCE ON THE DEDUCTION FOR QUALIFIED BUSINESS INCOME

A. Statutory Background

Enacted as part of the 2017 Tax Cuts and Jobs Act, §199A allows S corporation shareholders, partners, and sole proprietors (but not employees, C corporations, or C corporation shareholders) to deduct up to 20 percent of their "qualified business income."

Generally, "qualified business income" is the net amount 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 real estate investment trusts, cooperatives, and publicly-traded partnerships, as those items are subject to special rules. If the net amount from all eligible businesses is 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 the taxpayer from the business (and guaranteed payments paid to a partner by a partnership) are not qualified business income.

Whether a taxpayer may take the deduction, and the exact amount of the deduction, is a function of the taxpayer's taxable income without regard to the deduction. Very generally, taxpayers in the four lowest tax brackets may claim the deduction without limitation. Taxpayers in the three highest brackets, however, face phaseouts and restrictions depending on the nature of the business, the amount of W-2 wages paid to all employees by the business during the year, and the unadjusted bases of depreciable assets held by the business at the end of the year.

B. 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 were finalized on January 15, 2019, with only modest changes.

The 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 regulations.

1. Definition of Trade or Business and Rental Real Estate Safe Harbor

A taxpayer may only claim a §199A deduction in connection with a trade or business, not an investment or not-for-profit activity. The regulations generally adopt the definition of "trade or business" from §162 and related case law and administrative guidance for purposes of §199A. The 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.

Some practitioners asked Treasury for more guidance as to whether a rental real estate activity rises to the level of a trade or business. Treasury did not address this in the final regulations but did publish a "rental real estate safe harbor" in *Notice 2019-07*, also issued on January 15, 2019. If a taxpayer's rental real estate activity meets the safe harbor, it will be treated as a trade or business under §199A. If the activity does not meet the safe harbor, it may still be treated as an eligible business activity, but the taxpayer will have to take that reporting position on a return and sweat a potential Service examination.

There are three elements to qualify for the safe harbor:

- (1) Separate books and records reflecting the income and expenses for each rental real estate activity must be kept.
- (2) For taxable years beginning before 2023, 250 or more hours of "rental services" must be performed each year with respect to the rental activity. (For taxable years beginning after 2022, this test must be met in any three of the five consecutive taxable years ending with the taxable year.)
- (3) Starting in 2019, the taxpayer must keep contemporaneous records "including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services." Such records are to be made available for inspection at the request of the Service.

The safe harbor expressly does not apply in two situations. The first is where the taxpayer uses the real estate at any time in the taxable year as a residence. The second is where the taxpayer rents the property on a "triple net lease" basis. The Notice defines a triple net lease as one where the lessee must pay taxes, fees, and insurance, and be responsible for property maintenance in addition to paying rent and utilities.

The Notice defines "rental services" to include: "(i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors." The term does not include what the Notice calls "financial or investment management activities," like arranging for financing, planning or constructing permanent improvements, and time spent commuting to and from the property. Rental services can be performed by taxpayers or their employees, agents, and/or independent contractors.

2. No Effects on Outside Basis or Stock Basis

The 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.

3. Wages Paid by Another Party

Upper-income taxpayers will be limited in their deduction if the business does not pay enough in W-2 wages. As expected, the 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.

4. Unadjusted Basis Immediately After Acquisition

Businesses that pay very little in W-2 wages can make use of an alternate computation method that considers the aggregate unadjusted bases in depreciable assets used in the business that are on hand at the end of the taxable year. The 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.

5. 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 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.

6. 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 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 the proposed regulations, "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.

7. Allocation of Unadjusted Basis Among Partners and S Corporation Shareholders

Where depreciable property is held by a partnership or S corporation, the 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.)

8. 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 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.

9. Aggregation of Multiple Trades and Businesses

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

- (1) Each activity 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 <u>at least two</u> of the following three factors: (a) the businesses 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).

10. Specified Service Businesses – De Minimis Rule

The statute defines a specified service business as one that "(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." Upper-income taxpayers engaged in a specified service business face a phaseout or complete repeal of the §199A deduction.

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 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.

11. Specified Service Businesses – What Counts and Doesn't Count

The 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
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 advice 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	Arranging transactions between a	Services by real estate brokers or insurance
Services	buyer and seller with respect to	brokers
	securities	

12. 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 observed that Congress did not intend for this catch-all provision to apply broadly. So the 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**.

13. 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 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 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.

14. 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 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.

15. Trusts and Estates

Logically enough, the 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. Likewise, W-2 wages paid by a grantor trust are deemed paid by the grantor, and the trust's unadjusted basis immediately after acquisition of property used in the business is deemed to belong to the grantor.

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.

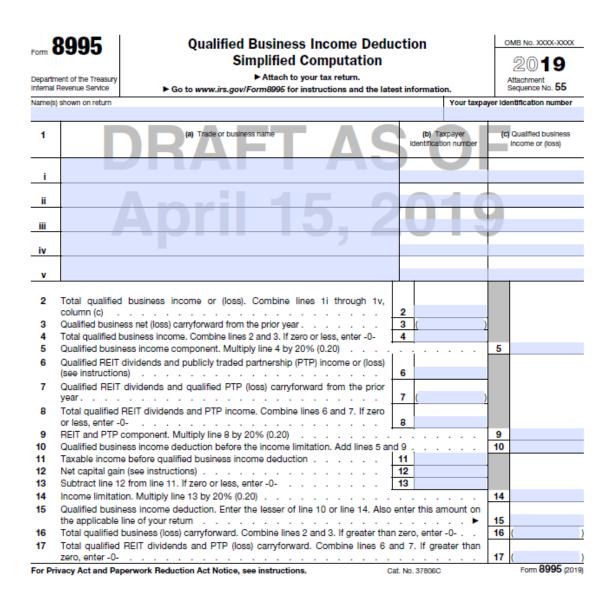
16. No Using Multiple Trusts to Generate Bigger Deduction.

Individuals with taxable incomes above a stated threshold (in 2018, \$157,500 for unmarried taxpayers and \$315,000 for joint filers; in 2019, \$160,700 for unmarried taxpayers and \$321,400 for joint filers) face additional limits on the deduction. Trusts and estates have the same thresholds 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 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, new Regulation §1.643(f)-1 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. While the proposed version of this regulation contained a rule providing that any tax savings triggered a presumption that federal income tax avoidance is a principal purpose for the use of multiple trusts, the final regulation does not contain this rule.

C. Forms for 2019

On February 15, 2019, the Service issued draft forms for computing the §199A deduction for 2019. The drafts were revised in April, 2019. Taxpayers with taxable incomes not more than \$160,700 (\$321,400 if married filing jointly) can use the new Form 8995, Qualified Business Income Deduction Simplified Computation provided the taxpayer is not a patron of an agricultural or horticultural cooperative.



Taxpayers not eligible to file the Form 8995 must instead use the new Form 8995-A, Qualified Business Income Deduction. This form has four sections that implement applicable phaseouts, limitations, and special rules for certain business activities, some of which are reproduced below.

Form 8995-A

Qualified Business Income Deduction

► Attach to your tax return.

► Go to www.irs.gov/Form8995A for instructions and the latest information

OMB No. XXXX-XXXX 2019 nent ce No. **55A**

Form **8995-A** (2019)

Part I Trade, Business, or Aggregation Information Complete Schedule A, B, C, and/or D, as applicable, before starting Part I. Attach additional worksheets when needed. See instructions. (b) Check if specified service (c) Check if aggregation (d) Taxpayer entification number (e) Check if 1 (a) Trade, business, or aggregation name Α Determine Your Adjusted Qualified Business Income В С 2 Qualified business income from the trade, business, or aggregation. Multiply line 2 by 20% (0.20). If your taxable income is \$160,700 or less (\$160,725 if married filing separately; \$321,400 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13. Allocable share of W-2 wages from the trade, business, or aggregation . Multiply line 4 by 50% (0.50) Multiply line 4 by 25% (0.25) Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property Multiply line 7 by 2.5% (0.025) . 8 Add lines 6 and 8 9 Enter the greater of line 5 or line 9. 10 10 W-2 wage and qualified property limitation. Enter the smaller of 11 line 3 or line 10 11 Phased-in reduction. Enter amount from Part III, line 26, if any. See instructions . . . 12 Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12 . 13 14 Patron reduction. Enter the amount from Schedule D. line 6. if any 14 Qualified business income component. Subtract line 14 from line 13 15 Total qualified business income component. Add all amounts reported on line 15 16 Form 8995-A (2019) For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 71661B Part III Phased-in Reduction Complete Part III only if your taxable income is more than \$160,700 but not \$210,700 (\$160,725 and \$210,725 if married filing separately; \$321,400 and \$421,400 if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III. С Enter amounts from line 3 17 Enter the amounts from line 10. 18 19 Subtract line 18 from line 17 19 20 20 Threshold. Enter \$160,700 (\$160,725 if married filing separately; \$321,400 if married filing jointly) 22 22 Phase-in range. Enter \$50,000 (\$100,000 if 23 married filing jointly) Phase-in percentage. Divide line 22 by line 23 24

Total phase-in reduction. Multiply line 19 by line 24 Qualified business income after phase-in reduction. Subtract line 26 Part IV Determine Your Qualified Business Income Deduction Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from Part II, line 16. 27 Qualified REIT dividends and publicly traded partnership (PTP) income or 28 Qualified REIT dividends and PTP (loss) carryforward from prior years . 29 Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-REIT and PTP component. Multiply line 30 by 20% (0.20) 31 Qualified business income deduction before the income limitation. Add lines 27 and 31 32 Taxable income before qualified business income deduction Net capital gain. See instructions 34 Subtract line 34 from line 33. If zero or less, enter -0-35 Income limitation. Multiply line 35 by 20% (0.20) . 36 Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 37 DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37 Total qualified business income deduction. Add lines 37 and 38. 39 40 Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or

greater, enter -0-

orm 8995-A (2019) Page **3**

Schedule A Specified Service Trades or Businesses

Complete Schedule A only if your trade or business is a specified service trade or business (see instructions) and your taxable income is more than \$150,700 but not \$210,700 (\$150,725 but not \$210,700 but not \$210,700 (\$150,725 but not \$210,725 firmarried filing separately; \$321,400 if married filing jointly). If your taxable income isn't more than \$160,700 (\$160,725 firmarried filing separately; \$321,400 if married filing jointly) and you're not a patron of an agricultural cooperative, don't file this form; instead, file Form 8995, Qualified Business Income Deduction Simplified Computation. Otherwise, complete Schedule D before beginning Schedule A. If your taxable income is more than \$210,700 (\$210,725 if married filing separately; \$421,400 if married filing jointly), your specified service trade or business doesn't qualify for the deduction.

Part I Non-Publicly Traded Partnership

				SSTB 1	SSTB 2	SSTB 3	
	1a	Trade or business name	1a				
	b	Taxpayer identification number	1b				
	2	Qualified business income or (loss) from the trade or business	2				
	3	Allocable share of W-2 wages from the trade or business	3				
	4 5	Allocable share of the UBIA of all qualified property	4				
	5	income deduction					
	6	Threshold. Enter \$160,700 (\$160,725 if married filing separately; \$321,400 if married filing jointly) 6					
	7	Subtract line 6 from line 5					
	8	Phase-in range. Enter \$50,000 (\$100,000 if married filing jointly)					
	9	Divide line 7 by line 8 9					
	10	Applicable percentage. Subtract line 9 from 100%					
	11	Applicable percentage of qualified business income or (loss). Multiply line 2 by line 10. Enter this amount on Schedule C or on page 1, Part II, line 2, for the corresponding trade or business, as appropriate. See instructions					
	12	Applicable percentage of W-2 wages. Multiply line 3 by line 10.	11				_
	12	Enter this amount on page 1, Part II, line 4, for the corresponding trade or business, as appropriate. See instructions	12				
	13	Applicable percentage of the UBIA of qualified property. Multiply					_
		line 4 by line 10. Enter this amount on page 1, Part II, line 7, for the corresponding trade or business, as appropriate. See					
	Part	Instructions	13				
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	14	Trade or business name	14				
	15	Taxpayer identification number	15				
	15 16	Taxpayer identification number	16				
	15 16 17	Taxpayer identification number	16		17		
um Qi	15 16 17 18	Taxpayer identification number . Qualified PTP income or (loss) . Total PTP SSTB income or (loss) . Combine all amounts on line 16 Taxable income before qualified business income deduction .	16		17		Page
	15 16 17 18 995-A (2	Taxpayer identification number	16				Page
	15 16 17 18	Taxpayer identification number	16	(a) Qualified	18	n for (c) Adjusted	l qualifie
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D. Choice of Entity These Days

Thanks to the addition of §199A, three variables impact the choice of business entity: (1) how the entity's income will be taxed (both for federal and state purposes); (2) whether the income from the business will be subject to the 3.8-percent net investment income surcharge under §1411; and (3) whether the income from the business will qualify for the §199A deduction. The effect of these variables is illustrated in the following table, adapted from a 2018 publication from Grant Thornton LLP, "Éntity Choice in the Wake of Tax Reform" (May 9. 2018). In the case of S corporations and partnerships, the table assumes all owners are individuals in the highest tax bracket (currently 37 percent).

	C corporation	S corporation or partnership (not eligible for §199A)	S corporation or partnership (eligible for §199A)
Business income	\$1,000	\$1,000	\$1,000
Tax on business income	\$210	\$370	\$296
Available for distribution	\$790	\$630	\$704
Tax on distribution	\$188		-
Total tax	\$398	\$370	\$296
Net to owner	\$602	\$630	\$704

The same publication observes that the final result depends on the amount of earnings distributed to owners. The following table, also adapted from the publication, compares the top marginal rates applicable when the entity distributes only amounts needed to pay taxes to the rates applicable when the entity distributes all after-tax earnings.

	C corp	S corp or p-ship (active, no §199A)	S corp or p-ship (passive, no §199A)	S corp or p-ship (active, §199A)	S corp or p-ship (active, after 2025)	S corp or p-ship (passive, after 2025)
Distributions only to pay taxes	21%	37%	40.8%	29.6%	39.6%	43.4%
Distributions of all after-tax earnings	39.8%	37%	40.8%	29.6%	39.6%	43.4%

As this last chart shows, a business with active owners engaged in an activity that qualifies for the §199A deduction that retains its after-tax profits to grow or reduce debt might well be better off as a C corporation, as the maximum combined federal income tax rate is 8.6 percent less than that applicable if the business is an S corporation or partnership. If it's a passive business, the

savings is even greater. But if the business plans to make generous distributions to owners over the years, the pass-through entity may still be the better choice.

Currently, the §199A deduction is set to expire at the end of 2025. If one assumes that the §199A deduction is only temporary, C corporations become more attractive.

If an owner plans to hold the business interest until death and never make a distribution of profits, current tax rates are such that the C corporation is the preferred entity. But more often business owners will sell the business or transition it to successors within the family, and in those cases, the pass-through entity still tends to give the better result.

VII. TAX COURT ALLOWS TAX-AFFECTING IN VALUING PASSTHROUGH ENTITY INTEREST (Estate of Jones v. Commissioner, T.C. Memo. 2019-101, August 19, 2019)

The decedent opened a sawmill in Eugene, Oregon, in 1954. As the business grew, the decedent needed to assure his business would have a steady supply of timber. In 1992, the decedent formed a limited partnership to acquire and hold timberland that the sawmill would use for inventory. The sawmill was the general partner and the decedent was the limited partner with the largest interest (his three daughters held smaller limited partner interests thanks to prior gifts not at issue here).

In 2009, the decedent made gifts of nonvoting stock in the sawmill and limited partner interests in the partnership to various trusts established for his children and their descendants. The decedent's 2009 federal gift tax return claimed the decedent gifted about \$3.6 million in stock and \$3.6 million in limited partner interests. The Service determined the gifted stock was worth \$15.3 million and the gifted limited partner interests were worth \$25.8 million. Throw on some interest and you have a total deficiency in excess of \$44.9 million.

So the case is one of valuation. The estate's expert, one who "has performed approximately 100 business valuations of sawmills and timber product companies," determined the value of the gifted stock was about \$4.3 million and the value of the gifted partnership interests was about \$3.9 million. The Service's expert, who "has performed several privately held business valuations," determined the value of the gifted partnership interests was just under \$26 million. (No mention is made of any determination by an expert for the Service as to the value of the gifted stock, indicating the real fight was about the valuation of the limited partner interests.)

The Service made several attacks against the report produced by the estate's expert. It first argued that the expert wrongly used an income-based approach instead of a net-asset-value-based approach in valuing the partnership. But the Tax Court held that the partnership should be valued as an operating company using the income-based approach. The timber was used to service the inventory needs of the sawmill and was thus part of the sawmill business. This means the partnership was not an ordinary holding company but instead part of a going concern, making use of an income-based approach more appropriate.

The Service also argued that it was improper for the estate's expert to use midyear revenue projections from 2009 in determining the value of the partnership interests. Due to the subprime mortgage crisis that year, the sawmill's management team commissioned midyear financial projections using the same process used for regular, yearly financial projections. Those midyear projections were considerably more pessimistic. The Service found it awfully convenient that those projections were used by the estate's expert in valuing the interests gifted, but the Tax Court concluded it was certainly proper, as they were the most recent set of financial reports available at the time of the gift.

The Service next argued that it was wrong for the estate's expert to "tax-affect" the businesses. If you're new to tax-affecting, the concept was explained masterfully by Lou Harrison in his 2013 article, Throwing Darts at the S Corporation Tax Affecting Valuation Dartboard – After Years of Tax Court Abuse, Do We Finally Know How to Hit a Bull's-eye?:

In valuing minority interests in C corporations, appraisers will typically start with a variable related to earnings on an after tax basis. C corporations pay tax at the entity level.

With S corporations, there is no corporate level tax. Earnings for S corporations will then always start off with a before tax number. In valuing minority interests in S corporations, appraisers will seek to "tax affect" S corporation earnings.

"Tax affecting" takes a variable in the S corporation valuation, like net earnings, and fictitiously reduces its value by C Corporation taxes. This could have the affect (sic) of reducing the overall valuation by 35% (the [themapplicable] C corporation tax rate). This is a substantial reduction, and every bit as important as the marketability and minority discounts.

The Service argued that tax-affecting was disallowed by the Tax Court in a 1999 case, *Gross v. Commissioner*. Thus, it contended, the estate's expert should have assumed a zero-percent tax rate instead of the 38-percent blended federal and state income tax rate actually employed. But here the court concluded that *Gross* was not intended to be read so broadly:

In *Gross* ..., we concluded that "the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation." We then concluded that, on the record in that case, a zero-percent corporate tax rate properly reflected those tax savings, rejecting the expert's offered justifications. More recently, in *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, ... we again rejected tax-affecting because the taxpayer's expert did not justify it but again acknowledged that the benefit of a reduction in the total tax burden borne by S corporation owners should be considered when

valuing an S corporation. And in *Estate of Giustina v. Commissioner*, [T.C. Memo. 2011-141] we rejected tax-affecting in the valuation of a partnership because we found the taxpayer's expert's method to be faulty: He used a pretax discount rate to present value post-tax cash flow. The question in those cases, as here, was not whether to take into account the tax benefits inuring to a flowthrough entity but how.

And here, said the court, the estate's expert more accurately reflected the tax consequences of the partnership's passthrough status. Among other things, the estate's expert reduced the estimated tax burden by benefit of avoiding a second tax on distribution to the owners. As the court concluded, the approach of the estate's expert in tax-affecting "may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

The Service then argued that intercompany loans between the sawmill and the partnership were improperly reflected in the report from the estate's expert, but the court quickly rejected this argument. It likewise rejected another argument that the claimed marketability discount (35 percent) was unreasonably high. As a result, the court ended up accepting the valuation of the estate's expert in full, resulting in a big win for the estate.

VIII. A LITTLE ADMINISTRATIVE LAW AND CONSTITUTIONAL LAW IN YOUR TAX LAW SOUP: REDUCED DONOR DISCLOSURE REQUIREMENT INVALIDATED (*Bullock v. Internal Revenue Service*, D. Mont., July 30, 2019)

For many years, the Service required most exempt organizations to report on their Forms 990 the names and addresses of donors who contributed \$5,000 or more during the taxable year. A duty to disclose information about donors who contributed more than \$1,000 applied to certain social clubs and fraternities where such amounts were used for charitable purposes. In *Revenue Procedure 2018-38*, issued on July 16, 2018, the Service, citing its discretionary authority under §6033(a)(3)(B) to relieve any exempt organization from the requirement to file an information return, announced that exempt organizations other than those described in §501(c)(3) were no longer required to provide donor information, effective for taxable years ending on or after December 31, 2018. Organizations benefitting from this new policy included the AARP and the NRA, as well as the Democratic Socialists of America and the conservative Americans for Prosperity. These groups can engage in political activity as long as they do not spend more than half of their budgets on political campaigns.

The governors of Montana and New Jersey sued the Service, claiming the revenue procedure was invalid under the Administrative Procedure Act ("APA"). The APA requires federal agencies to follow certain procedures in the implementation of legislative and interpretive rules. Legislative rules, those with the force and effect of law thanks to a congressional delegation of express rulemaking authority, must undergo a "notice and comment" process under which the agency publishes notice of a proposed rule in the Federal Register and provides a set period of time for public comment before finalization. Interpretive rules, those promulgated under general authority to prescribe rules that interpret congressional acts so as to implement and

enforce them, need not undergo notice and comment since interpretive rules merely explain the law and do not create new law.

Montana and New Jersey claim to have standing in the matter because donor disclosures are shared with state governments, and state governments use that information to track suspicious activity and to award state-level tax exemptions to the reporting organizations. The Service argued that this was not enough of an interest for the states to have standing to contest the revenue procedure, but the district court disagreed. It found that depriving states of the information that used to be required forced the states to come up with their own, separate enforcement mechanisms. The added cost of enforcement represented a sufficient injury so as to say the states had standing.

The Service then tried to convince the court that the states had no power to contest the revenue procedure because §6033(a)(3)(B) expressly gives the Service the power to relieve an organization from the obligation of providing information on a return. The court observed that while that interpretation of the tax statute is correct, it is irrelevant since the states contested the revenue procedure only for failure to comply with the APA. The states were not challenging the substance of the revenue procedure or the Service's authority to issue it under the Internal Revenue Code. They are instead claiming the revenue procedure is invalid because it was not properly issued.

So the key question became whether the revenue procedure was a legislative rule that required notice and comment or whether it was an interpretive rule that the Service could issue without such process. The court concluded the revenue procedure was no mere interpretation of what information has to be provided. Instead, it is a reversal of a 50-year practice of requiring information about large donors. Effectively, then, it is an amendment to the existing rule, making it a legislative rule that required notice and comment.

IX. POST-DEATH EVENTS REDUCE CHARITABLE DEDUCTION AMOUNT (Estate of Dieringer v. Commissioner, 9th Circuit, May 21, 2019)

The decedent owned a controlling interest in a closely-held real property management corporation that managed a number of commercial and residential properties in Portland, Oregon (oh, and a Wendy's franchise in Texas). The decedent's revocable living trust provided that the closely-held stock was to pass to a private foundation the decedent had created during her lifetime. Her estate claimed a charitable contribution deduction for the value of the stock as of the date of death, with no minority or marketability discounts. The deduction slightly exceeded \$18.8 million.

The Service reduced the amount of the deduction, however, as it concluded a series of post-death events undermined the decedent's intent to transfer control of the company to the foundation. The company elected to be taxed under subchapter S but didn't want the foundation to be subject to unrelated business income tax. So the company made arrangements to redeem all the decedent's voting stock and most of the nonvoting stock in

exchange for a note. The thinking was this was good for the foundation since it converted the foundation from shareholder to creditor, giving it higher status in the liquidation food chain. To give the company cash to pay off the notes, the decedent's sons made capital contributions in exchange for more stock.

The Tax Court agreed that while these post-death events occurred for valid, non-tax business reasons, they effectively served to reduce substantially the actual amount passing to the foundation. The redemption agreements valued the foundation's stock using a 15% minority interest discount and a 35% marketability discount. Ultimately, the per-share price of the stock was much less than the value of the stock at the date of the decedent's death. One son testified the decline in value was due to the poor business climate at the time (2009). But the Tax Court held the decline was due to the son's instruction to the appraisers to value the decedent's stock as a minority interest. Ultimately, said the court, the sons "thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest." So the estate tax deduction was reduced to the amount used in the redemption appraisal. The instruction to value the decedent's stock as a minority interest was then used by the court as grounds for upholding the Service's assessment of an accuracy-related penalty.

On appeal to the Ninth Circuit, the estate argued the Tax Court erred in taking post-death events into account in determining the amount of the charitable deduction. The Ninth Circuit rejected this argument, concluding that it was proper for the Tax Court to focus on the amount actually received by the foundation as opposed to the value of the stock at the date of death. Considering the amount actually received by a charity "prohibits crafting an estate plan or will so as to game the system and guarantee a charitable deduction that is larger than the amount actually given to charity." The appellate court observed that the son's conduct "manipulated the charitable deduction so that the Foundation only received a fraction of the charitable deduction claimed by the Estate." The estate argued that the Tax Court should have given more weight to the economic downturn occurring between the date of death and the date of the transfer to the foundation, but the Ninth Circuit found no clear error in the Tax Court's finding that the decline in value had very little to do with the significant reduction in value passing to the charity. The Ninth Circuit also upheld application of the accuracy-related penalty.

X. DIRTY PAINTINGS AREN'T WORTH <u>THAT</u> MUCH LESS (*Estate of Eva Franzen Kollsman v. Commissioner*, 9th Circuit, June 21, 2019)

The decedent owned two 17th-century Old Master paintings at the time of her death in 2005. One, "Dance Around the Maypole," was by Peter Brueghel the Younger; the other, "Orpheus Charming the Animals," was by Jan Brueghel the Elder. On the estate tax return, the estate claimed the value of the Maypole painting was \$500,000 and the value of the Orpheus painting was \$100,000. But in its notice of deficiency, the Service valued Maypole at \$1.7 million and Orpheus at \$300,000. And by the time the case reached the Tax Court, the Service argued Maypole was worth \$2.1 million and Orpheus was worth \$500,000. The increase stemmed largely from a post-death sale of Maypole for \$2,100,000.

The estate defended its position by arguing the paintings surged in value after the decedent's death because of the increased demand for works from the Old Masters and because both of the paintings were cleaned. But the Tax Court ruled that the appraisal from the estate (prepared by Sotheby's) lowballed the value of the paintings to curry favor with the estate so that the estate would use the appraiser to sell the works. The lower court found it "remarkable" that the Sotheby's appraisal included no comparables, unlike the appraisal from the Service's expert. Although the Tax Court adopted the conclusions of the Service's expert, it did award a modest discount for the cost of cleaning the paintings. That brought the final value of the painting down to \$1,995,000. It gave a larger discount to Orpheus (finding a date of death value of \$375,000) due mostly to uncertainty as to the authenticity of the work.

On appeal, the Ninth Circuit affirmed in an unpublished opinion. It found no clear error in the Tax Court's analysis. It agreed that the estate's expert "exaggerated the dirtiness of the paintings and the risk of cleaning them." It was unimpressed that the estate's expert "testified that when he arrived at his valuations, he was not interested in comparables." The estate asked the appellate court to abate the interest owed on the deficiency, but the Ninth Circuit panel concluded it lacked the jurisdiction to do so, as the imposition of interest is required by the statute and a court has no discretion to adjust the computation method set forth in the statute.

XI. FINAL REGULATIONS IMPLEMENT NEW RULE ALLOWING NONRESIDENT ALIENS TO BE POTENTIAL CURRENT BENEFICIARIES OF ELECTING SMALL BUSINESS TRUSTS (T.D. 9868, June 13, 2019)

Let's unpack the three specific terms in that headline. A "nonresident alien" (or "NRA") is an individual that is neither a citizen nor a resident of the United States. An individual is a resident of the United States if the individual either possesses a valid green card or satisfies a "substantial presence test" that measures the actual days of presence within the United States and then places those dates on a weighted scale favoring more recent presence. An "electing small business trust" (or "ESBT") is a trust that may own S corporation stock even though it does not require that all of the income be paid currently to a single beneficiary and even though it is not a grantor trust. An ESBT may thus give the trustee discretion to accumulate income, though such income will generally be subject to tax at the highest marginal tax rate. A "potential current beneficiary" (or "PCB") of an ESBT is any beneficiary that may currently receive a distribution of income or principal. In determining whether an S corporation has more than 100 shareholders, the maximum number allowed, every PCB of an ESBT counts.

While an NRA cannot own shares in an S corporation, the Tax Cuts and Jobs Act of 2017 allows NRAs to be PCBs of ESBTs. (Take a moment to savor the delicious melding of all those acronyms.) Treasury has issued final regulations implementing this rule, with a special emphasis on making sure that the income of an S corporation will still be taxed by the United States even where an NRA is the deemed owner of a grantor trust that elects to be an ESBT. Specifically, the final regulations require that the S corporation income of the ESBT be allocated (and taxed) to the ESBT if that income otherwise would have been allocated to an NRA deemed owner under

the grantor trust rules. The final regulations also making conforming revisions to other regulations. The final regulations apply to all ESBTs as of 2018.

XII. BEWARE OF SPECIAL ALLOCATIONS WHEN LLC ELECTS S CORPORATION STATUS (*Private Letter Ruling 201930023*, July 26, 2019)

A limited liability company validly elected to be taxed as an S corporation. Thereafter, the founding members of the LLC entered into an operating agreement. The agreement stated that all distributions would be made to the members in proportion to their respective membership interests, including upon liquidation. Subsequent to this, though, the members amended the agreement to provide that, upon liquidation, distributions would be paid to members with positive capital accounts in accordance with their respective positive capital account balances. This, of course, is common for entities taxed as partnerships, for the ability to make special allocations of income, gain, loss, deduction, and credit is usually conditioned on (among other things) such an agreement between the partners. But this is fatal to a subchapter S election since an S corporation must made all distributions (including liquidating distributions) on a *pro rata* basis.

The Service ruled that the amendment terminated the S election since liquidating distributions would not necessarily be made on a *pro rata* basis. But the Service also ruled that the termination was inadvertent and not motivated by tax avoidance. The members quickly agreed to a second amendment to the operating agreement which corrected the liquidating distribution language and provided for distributions on a *pro rata* basis in accordance with membership ownership percentages. Accordingly, the Service granted inadvertent termination relief, meaning the LLC kept its tax status as an S corporation without interruption. Ultimately, things turned out fine for the LLC, though it cost the members some anxiety and the price of a private ruling.

XIII. GUIDANCE ON THE EXCISE TAX APPLICABLE TO CERTAIN PRIVATE COLLEGES AND UNIVERSITIES (Proposed Regulation §53.4968-1, June 28, 2019)

Under the 2017 Tax Cuts and Jobs Act, private colleges and universities face 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 IRS estimates that 40 or fewer institutions will be subject to the tax. The expected revenue gain from this new tax is \$1.8 billion over ten years.

The Act directed 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. It also ordered regulations explaining 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.

In the summer of 2018, in *Notice 2018-55*, the IRS provided interim guidance. Among other things, the Notice provides that in the case of property held on December 31, 2017, and continuously thereafter to the date of its disposition, the basis of such property for purposes of determining gain (but not loss) shall be deemed to be not less than the fair market value of such property on December 31, 2017.

On June 28, 2019, Treasury issued proposed regulations. Interestingly, the preamble to the proposed regulations cite two studies estimating that between 23 and 27 colleges and universities are expected to pay the excise tax. The preamble also observes that those studies do not account for some of the qualifications and exceptions made in the proposed regulations, suggesting that perhaps fewer institutions will ultimately pay the tax.

The proposed regulations provide that an asset is used directly in carrying out an institution's exempt purpose only if the asset is actually used by the institution in carrying out its exempt purpose. The proposed regulations list administrative assets, real estate, and physical property used by the institution directly in its exempt activities as examples of such "exempt-purpose assets." A "reasonable cash balance necessary to cover current administrative expenses and other normal and current disbursements directly connected with the educational institution's exempt activities" also counts as an exempt-purpose asset. For this purpose, a reasonable cash balance is defined as 1.5 percent of the fair market value of the assets not actually used by an institution in carrying out its exempt purpose. The proposed regulations list assets held for the production of income or for investment ("stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate") as assets not used in carrying out an institutions' exempt purpose, even if the income from such assets is used to carry out the exempt purpose. Property used for managing endowment funds of the institution are also not assets used in carrying out an exempt purpose.

Consistent with the hint in the statute, the proposed regulations provide that the computation of net investment income uses the same rules applicable to private foundations for such purpose. They also retain the basis rule from *Notice 2018-55* described above.

The proposed regulations also provide a number of definitions absent from the legislation. For example, the proposed regulations clarify that the term "student" means a person enrolled in a degree, certification, or other program (including a study abroad program) "leading to a recognized educational credential ... and not enrolled in an elementary or secondary school." The proposed regulations clarify that while the term "student" does not include individuals merely accepted for enrollment, it does include those carrying less than half of the normal full-time credit load. The proposed regulations provide that in determining the fair market value of assets per student, an institution must use the total number of all students, not just those paying tuition.

The proposed regulations also provide that whether a student is "tuition-paying" is determined after taking into account any scholarships provided directly by the educational institution and any work study programs operated directly by the educational institution. But scholarship

payments provided by third parties are considered payments of tuition on behalf of the student, even if administered by the institution.

XIV. PORTION OF 23ANDME TESTING MAY BE DEDUCTIBLE AS A MEDICAL EXPENSE (*Private Letter Ruling 201933005*, August 16, 2019)

23andMe sells genetic tests that provide customers with information about ancestry, wellness, and genetic traits like food-taste preferences. In addition, the company provides health reports with information on whether customers have gene variants that increase their risk for developing certain diseases. As of this writing, customers have two purchase options: an "ancestry service" kit for \$99 and a "health and ancestry service" kit for \$199. While the report from the ancestry kit is limited to information about a customer's maternal and paternal ancestry, the health and ancestry kit also includes information about whether the customer carries certain genes or genetic predispositions to conditions like cystic fibrosis, sickle cell anemia, and hereditary hearing loss. Customers provide 23andMe with a DNA sample collected through a home-testing kit.

In this private ruling, the Service concluded that the price of the ancestry kit is not deductible as a medical expense. But "if the taxpayer also purchases the health services, the price of the DNA collection kit must be allocated between the ancestry services and the health services using a percentage (cost of health services / total cost of ancestry plus health services). For this purpose, explained the Service, "the taxpayer may use a reasonable method to value and allocate the cost of the health services between services that are medical care (such as the testing at the laboratory) and non-medical services or items (such as the reports that provide general information on a test result)." 23andMe reports that the ruling means a customer can deduct up to \$117.74 of the \$199 cost of the health and ancestry service kit.

Two observations about the ruling: First, to the extent the cost qualifies as a medical expense, that means a taxpayer may use a healthcare flexible spending account or health savings account to cover that portion of the cost. Second, one wonders whether this ruling might open the door to taxpayers claiming medical expense deductions for other mixed-use costs, like Apple Watches used in part to track diet and exercise regimens.

XV. IRS DECONSTRUCTS DONATION OF RESIDENCE AND PERSONALTY TO DECONSTRUCTION CHARITY (*Mann v. United States*, United States District Court, District of Maryland, January 31, 2019)

In 2011, Lawrence and Linda, a married couple, bought a home in Bethesda, Maryland. Shortly after taking possession, the couple decided to demolish it in order to construct a new residence. They reached out to Second Chance, a charitable organization that salvages building materials, fixtures, and furniture from properties to be demolished. The charity hires "disadvantaged individuals in need of workforce training" to help them build specific work skills. The charity sells some of the salvaged items at its own store and tries to recycle the rest. The charity doesn't do the actual demolition, but its work will sometimes destroy certain parts

of the property. To help with its costs, Second Chance asks property donors to make a concomitant cash contribution. In this case, a sales manager from Second Chance told the couple they could deduct the value of all material that "crosses the threshold" of Second Chance's warehouse. He told the couple they could expect a deduction of at least \$150,000 plus the \$20,000 requested cash donation. The combined tax benefit of the deductions, he told them, would be roughly between \$25,000 and \$30,000. The couple agreed to this arrangement, with the understanding that they could make two contributions of \$10,000, one in late 2011 and another in early 2012. The couple then obtained an appraisal of the property that showed the value of the house at \$675,000. They also secured an appraisal of the furniture inside the home, which came to just over \$24,200. The deconstruction work was completed in two phases, one in the winter of 2011-12 and the other in the summer of 2012.

On their 2011 joint tax return, the couple claimed charitable contribution deductions of \$675,000 for the house, \$24,200 for the furniture, and \$10,000 for the cash donation to Second Chance. The IRS disallowed all of these deductions. The couple paid the deficiency and then brought this refund action. As the case was pending, the couple filed an amended return for 2011, this one claiming a deduction of \$313,353 for the house (instead of \$675,000) based on another appraisal that valued the home not at its highest and best use but at its value as property to be deconstructed.

The court held the couple could not deduct the value of the house. The couple never donated the home to Second Chance. While it is possible to convey an interest in improvements apart from an interest in the underlying land under applicable state law, there was no deed conveying the house itself to the charity. Thus the house was never validly severed from the property, and their donation was thus one of a partial interest in the real property (a license to use the residence for deconstruction purposes). While there are limited exceptions (none of which apply here), a taxpayer cannot claim a charitable contribution deduction for the donation of a partial interest in property. The court went on to observe that even if there had been a valid severance by deed, the appraisals were not adequate substantiation of the donation. According to the court, "the proper way to calculate a tax deduction from this donation is based on the resale value of the specific building materials ... that 'cross[] the threshold' of Second Chance's warehouse."

The court likewise held the couple could not deduct the value of the furniture. The couple did not contest this part of the deficiency assessment. Nonetheless, the court held that the Service was right to disallow the deduction here too, for the appraisal supporting the claimed amount was deficient in many respects (it itemized only a handful of the 40 items of furniture claimed and used inconsistent and arbitrary depreciation methods).

But the court did hold that the couple could deduct the cash donation. The Service said the cash donation was part of a *quid pro quo* arrangement, but the court observed that the couple received no specific benefit in return for the required cash donation. They made the cash donation "not to secure some tangible goods or service in return, but to secure the ability to make a donation to a charitable cause and to obtain a tax deduction, which is not a specific

benefit from Second Chance." The cash was used to pay for services that benefitted the charity, not the couple, by letting the charity administer the gift and provide job training skills as part of its charitable purpose.

XVI. TRUSTS AND ESTATES MAY STILL DEDUCT UNIQUE ADMINISTRATION EXPENSES (Notice 2018-61, July 13, 2018)

Prior law allowed individuals, estates, and trusts 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), added by the 2017 Tax Cuts and Jobs Act, suspends any deduction for miscellaneous itemized deductions for 2018 through 2025. 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 feared 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.

XVII. DEVELOPMENTS INVOLVING THE PARSONAGE EXCLUSION

First enacted in 1954, §107 reads as follows:

In the case of a minister of the gospel, gross income does not include—

- (1) the rental value of a home furnished to him as part of his compensation; or
- (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not

exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.

Two courts in 2019 had occasion to parse the parsonage exclusion.

A. For One Thing, It's Constitutional (*Gaylor v. Mnuchin,* Seventh Circuit, March 15, 2019)

The issue presented in this case is whether §107(2) violates the Establishment Clause of the First Amendment, for it awards the exclusion for rental allowances to a "minister of the gospel" and to no other taxpayers. An amicus brief filed in the appeal estimates that "of the United States' 384,000 congregations, 200,000 to 300,000 provide a housing allowance to their ministers under §107(2)."

The challenge was brought by the Freedom From Religion Foundation (FFRF). To secure standing, FFRF paid its officers a housing allowance as part of their salaries. The officers then sued the Treasury Department, claiming §107(2) violates the Establishment Clause. But in a 2014 case, the Seventh Circuit held they did not have standing because they never claimed the exclusion. They were thus never denied the benefit of §107(2). So the officers filed amended returns claiming refunds for the housing allowances. Hilariously, the Service issued refunds to them but took no further action on their claims. So the officers had to wait until the Service ran out of time to respond before it could launch the current lawsuit. After filing its claim, three ministers and four churches were allowed into the case as intervenors.

The District Court held that the officers and FFRF had standing, and further held that §107(2) violates the Establishment Clause. The lower court referred to the three-part test from the Supreme Court's decision in *Lemon v. Kurtzman*, 403 U.S. 602 (1971), the so-called "*Lemon Test*." Under this test:

"First, the statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion; finally, the statute must not foster an excessive government entanglement with religion."

The lower court ruled that §107(2) violates the second prong of the *Lemon* Test because the purpose of the exclusion was to "provide aid to a group of religious persons." Both Treasury and the intervenors appealed to the Seventh Circuit.

The three-judge panel from the Seventh Circuit unanimously reversed. It agreed that the officers and FFRF had standing (but no one was raising the issue on appeal anyway). Turning to the merits, the appellate panel concluded that §107(2) survived scrutiny under both the *Lemon* Test and the so-called "historical significance" test from the Supreme Court's more recent decision in *Town of Greece v. Galloway*, 572 U.S. 565 (2014).

First, said the Seventh Circuit, §107(2) meets the *Lemon* Test. The exclusion has three secular purposes: "to eliminate discrimination against ministers, to eliminate discrimination between ministers, and to avoid excessive entanglement with religion." The court observed that §107 was a legislative response to an earlier ruling that parsonages were not within the traditional "convenience of the employer" doctrine applicable to taxpayers receiving a benefit that was also of benefit to their employers. The court noted that the doctrine underlies a number of statutory exclusions, like the §119 exclusion for meals and lodging furnished on the employer's premises, the §134 exclusion for housing given to current or former members of the military, and the §911 exclusion for housing allowances provided to some taxpayers working abroad. "Reading §107(2) in isolation from the other convenience-of-the-employer provisions, and then highlighting the term 'minister,' could make the challenged statute appear to provide a government benefit exclusively to the religious. But reading it in context, as we must, we see §107(2) is simply one of many *per se* rules that provide a tax exemption to employees with work-related housing requirements."

FFRF argued that §107(2) is over-inclusive in that it excludes allowances paid to any minister and not just those using the home for religious purposes. This was convincing to the lower court but not to the Seventh Circuit. It noted that §911 is similarly over-inclusive in that any person residing abroad may exclude or deduct housing expenses, no matter whether this is required by the employer and no matter whether the taxpayer uses the home in conducting business abroad. Besides, the court reasoned, over-inclusiveness alone does not render §107(2) without a secular purpose.

The court also determined that §107(2) eliminates discrimination between ministers, as it allowed smaller congregations that cannot afford to award in-kind housing the chance to pay a cash stipend for housing instead. FFRF pointed to testimony from one of the bill's sponsors indicating this rule was intended to promote religion, but the court said "the motivation of one representative in a House of 435 does not definitively reveal the impetus behind the bill's passage."

The court also bought the third asserted secular purpose: that the rule avoids excessive entanglement with religion. The thinking here is that §107(2) saves the Service from having to police ministers and churches using the more detailed requirements of §119. Section 107 requires one pretty non-intrusive question: whether the taxpayer is a minister. Section 119, by contrast, invites much more entanglement, as the Service would have to determine the "business" of the church, the extent of its "premises," what activities qualify as "worship," and more.

The court also held that §107(2) neither advances nor inhibits religion (the second prong of the *Lemon* Test). FFRF argued that an exemption is like a tax subsidy, but the court rejected this position. "The grant of a tax exemption is not sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state."

The court also concluded that §107(2) does not creative excessive entanglement between church and state (the third prong of the *Lemon* Test). As explained above, the court found §107(2) to create far less entanglement than what would be the case if ministers had to use the §119 exclusion available to employees receiving lodging on the employer's business premises.

Finally, the Seventh Circuit found §107(2) passes the "historical significance" test. This is the test that upholds public monuments inscribed with the Ten Commandments situated on public property, prohibits government from interfering with the decision of a congregation to terminate a minister's employment, and upholds a legislative prayer, all because of long-established customs and history. The court cited "a lengthy tradition of tax exemptions for religion, particularly for church-owned properties." The lower court reasoned that this tradition applied to property taxes, while §107(2) relates to income taxes, but the appellate court found that "too fine a distinction."

In June, 2019, the FFRF decided not to seek review by the full Seventh Circuit or the United States Supreme Court.

B. But You Have to Follow the Formalities to Get It (*Brown v. Commissioner*, T.C. Memo. 2019-69, June 10, 2019)

Among other things, Regulation §1.107-1(b) provides that a "rental allowance" for purposes of §107(2):

means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken ... in advance of such payment by the employing church... . The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action.

In this case, the taxpayers are a married couple. One spouse, Mikel, is the founder of the Christian Joy Center, an independent church; the other, Debra, is the church administrator. During the year at issue in the case, Mikel and Debra received monthly payments of about \$3,500, though the exact amounts were not made clear. The church also paid the taxpayers' utility bills and other random, personal expenses.

The church collects offerings from its members in envelopes. Members could designate on the envelopes how the donated funds inside could be spent. When an envelope designated a gift for the Mikel, the church paid the gift to him. There was a clear paper trial with respect to offerings made by check or credit card, but the paperwork is sloppier on cash contributions.

An examination of the taxpayers' deposit records concluded the taxpayers underreported about \$470,000 in income over the three years at issue. The taxpayers argued these amounts were excludable either as parsonage allowances or as gifts. But the Tax Court held that the

amounts were never "designated" as rental allowances distinct from salary or other compensation, as required by the regulation. Even though most of the monthly deposits from the church were marked as parsonage allowances, the taxpayers did not show that they used the funds for housing alone, nor that the allowances did not exceed the sum of their mortgage payments plus the cost of utilities.

In addition, the court could not find any evidence to support that the "love offerings" in the envelopes were "gifts" from the church members:

Reverend Brown may not have explicitly agreed to provide future services in exchange for these contributions, but we find that they were made by congregants who meant to keep Reverend Brown preaching where he is. He provides the "fruit", or "intangible religious benefits," and the congregants' "seeds", or contributions, are in some secular sense in exchange for them.

The court held that these payments were gross income to the taxpayers. The court then went on to address other aspects of the taxpayers' returns not relevant to the §107 exclusion.

XVIII. GUIDANCE ON NEW RULE PRECLUDING DEDUCTION FOR SETTLEMENTS SUBJECT TO NONDISCLOSURE AGREEMENTS IN CONNECTION WITH SEXUAL HARASSMENT OR SEXUAL ABUSE

Added by the 2017 Tax Cuts and Jobs Act, §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, $\S162(q)(2)$ 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, $\S162(q)(2)$ 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 late February of 2019, the IRS resolved the uncertainty by adding this text to a webpage entitled "Section 162(q) FAQ" (available at https://www.irs.gov/newsroom/section-162q-faq):

Question:

Does section 162(q) preclude me from deducting my attorney's fees related to the settlement of my sexual harassment claim if the settlement is subject to a nondisclosure agreement?

Answer:

No, recipients of settlements or payments related to sexual harassment or sexual abuse, whose settlement or payment is subject to a nondisclosure agreement, are not precluded by section 162(q) from deducting attorney's fees related to the settlement or payment, if otherwise deductible. See Publication 525, Taxable and Nontaxable Income, for additional information on when all or a portion of attorney's fees may be deductible.

XIX. HOW DID A \$33 MILLION DONATION GET DISALLOWED? IT'S ALL ABOUT THAT BASIS (Reri Holdings I, LLC v. Commissioner, D.C. Circuit, May 24, 2019).

The taxpayer, a limited liability company, purchased a remainder interest in real property for just under \$3 million in 2002. The next year, it donated the remainder interest to the University of Michigan. The LLC's tax return claimed a \$33 million deduction for the donation. Alas, the Form 8283 appraisal summary attached to the 2003 return showed no amount in the space provided for the "Donor's cost or other adjusted basis." The Service denied the deduction for lack of adequate substantiation.

The Tax Court held that the Service was right to disallow the deduction. The taxpayer claimed that it had substantially complied with the substantiation requirements, but the court was unmoved. Had the taxpayer disclosed the \$3 million basis in the property, reasoned the court, the Service would have been alerted to a potential overvaluation of the property. Leaving off the basis information prevented the Form 8283 from fulfilling its intended purpose, so there was no grounds for claiming substantial compliance.

But it gets worse. The court also upheld application of a gross valuation misstatement penalty, finding that the value of the donated remainder was about \$3.4 million instead of the claimed \$33 million. The taxpayer argued for a reasonable cause exception to the penalty but the court found the taxpayer did not make a good faith investigation into the property's value. "The taxpayer must do more than simply accept the result of a qualified appraisal."

On appeal, the United States Court of Appeals for the District of Columbia Circuit affirmed. The appellate court declined the invitation to determine whether substantial compliance is sufficient to meet the substantiation requirements because it concluded that the failure to disclose the basis in the donated property did not substantially comply with the substantiation requirements. The taxpayer argued that listing the basis is not relevant where the deduction is equal to the property's fair market value. But the D.C. Circuit observed that the taxpayer "fails to recognize that the purpose of the substantiation requirements is not merely to collect the

information necessary to compute the value of donated property. The requirements have the broader purposes of assisting the IRS in detecting and deterring inflated valuations. Because the cost or other basis in property typically corresponds with its [value] at the time the taxpayer acquired it, an unusually large difference between the claimed deduction and the basis alerts the IRS to a potential over-valuation, particularly if the acquisition date, which must also be reported, is not much earlier than the date of the donation."

The appellate court also upheld the gross valuation misstatement penalty. The taxpayer argued that the valuation misstatement related to the failure to state the donated property's basis, but the court reasoned that it was also attributable to the taxpayer's huge miss on the fair market value of the donated property. The court rejected the taxpayer's argument that its valuation was not so far off, finding no clear error in the Tax Court's determination of the property's value.

XX. COSTS INCURRED WHILE EVANGELIZING ARE NOT DEDUCTIBLE AS CHARITABLE CONTRIBUTIONS (Oliveri v. Commissioner, T.C. Memo. 2019-57, May 28, 2019)

The taxpayer retired from the United States Air Force in 1986 after 26 years of service as a pilot. He became very active in the Catholic Church after retirement, even becoming certified as a teacher and trainer following a 16-week training program at a Catholic university. As the Tax Court explains:

Petitioner seeks to spread the teachings of the Catholic Church through random interactions with members of the general public. He considers all of his contact with members of the public to be opportunities for evangelism. He wears a large and visible crucifix at all times which identifies his religious affiliation and commitment to evangelism. Petitioner evangelizes people he happens to see when he engages in otherwise personal activities, such as when he eats in restaurants, travels, and pilots private planes. He usually does not know in advance whom he will evangelize. Petitioner evangelizes and discusses his faith with friends, members of his extended family, and members of the religious organization that he founded, ... and the Catholic Church.

The taxpayer deducted a great many expenses as charitable contributions for the taxable year at issue (2012). These included \$15,082 incurred in connection with his rental of private airplanes both for travel purposes and for pilot training (which the taxpayer labeled as "Evangelization: Christian Outreach"), \$1,292 for automobile traveling expenses (mileage, tolls, parking), which the taxpayer labeled as "Pastoral Ministry: Transportation," and \$5,228 for meals, coffee, and snacks, which the taxpayer labeled as "Evangelization: Counseling." Also deducted were \$7,151 in travel expenses for six personal trips that the taxpayer labeled as "Evangelization: Temporary Assignments." The taxpayer even deducted \$7,910 spent on buying clothes, groceries, lodging, traveling, and other gifts for third parties. (These costs were labeled as "Evangelization: Charitable Grants.") Then there was the \$3,567 spent for petitioner's home

telephone, a separate line for a fax machine, and a cell phone, all of which were labeled as "Evangelization: Communications."

The Service argued that most of these expenses were at least in part personal, that the taxpayer's unreimbursed expenses were not contributions "to or for the use of" the church due to the absence of coordination by or supervision from the church, and that the expenses of \$250 or more are not deductible because the taxpayer did not receive a contemporaneous written acknowledgment from the church. The Tax Court sided with the Service on all of these points. The court held that most of the claimed expenses were incurred either in whole or in part for personal purposes and thus do not qualify for a charitable contribution deduction. Moreover, most of the taxpayer's evangelism activities were "random and uncoordinated by ... the Catholic Church...." The court determined that the taxpayer evangelized during the course of his usual personal activities, and the taxpayer could not coordinate his expenses with the church such that the costs were "to or for the use of" the church.

The taxpayer argued he did not need a contemporaneous written acknowledgment because that requirement applies to "contributions" and not to unreimbursed expenses. He pointed to the rule that acknowledgments are required for "contributions" over \$250, not for "out-of-pocket' expenditures." But the court rejected this argument, reasoning that since only "contributions" are deductible under §170, unreimbursed, "out-of-pocket" expenses must be considered contributions to be deductible in the first place.

As Ed Zollars observes, "Nothing in the case suggests that the taxpayer was not sincere in his devotion to evangelizing his faith, nor that he didn't actively look for opportunities to communicate that faith when conducting various activities. But the tax law requires complying with specific rules to obtain any tax deduction for payments or expenses related to that activity, generally needing to have a connection with an organization that meets the requirements to be recognized as a tax exempt organization...."

XXI. GAMBLING LOSSES RELATED TO PRESCRIBED MEDICATION NOT DEDUCTIBLE AS CASUALTY LOSSES (*Mancini v. Commissioner*, T.C. Memo. 2019-16, March 4, 2019).

In 2006, the taxpayer started taking a generic form of Mirapex as part of his treatment for Parkinson's disease. The drug proved effective, but side-effects started arising in 2008:

He vacuumed a lot and became compulsive about his cleanliness. He spent a week researching and obsessing over which mattress to buy. He started falling asleep suddenly while driving. He had suicidal thoughts. And he started gambling — a lot.

At first it was just lottery tickets. Then he started going to casinos — especially the Venetian in Las Vegas and Morongo near Palm Springs. Then he moved to online gambling. That's where he says he suffered his biggest losses, though he didn't keep logs of his gambling activity. ...

Over the next two years gambling wiped out all of his bank accounts and all but \$10,000 of his retirement savings. In 2009 he also started selling his real estate for less than fair market value. He first sold a house he owned in Manhattan Beach to its tenants for a quick \$995,000, when he believed the true value was closer to \$1.2 million. ... He also sold property in Massachusetts that he thought was worth \$300,000 for only \$90,000. He explained that, with this sale, he felt indebted to the buyer who had cared for his mother. He used the proceeds from both of these sales to pay gambling debts.

When he went off the drug in 2010, the compulsive behaviors stopped. On his 2010 tax return, the taxpayer reported \$45,000 in gambling winnings, \$45,000 in gambling losses, and \$603,000 in casualty losses described as "Investment Portfolio and Home." He then filed amended returns for 2008 and 2009 that showed casualty losses of \$1,000,000 and \$1,800,000, respectively. The Service disallowed all of these casualty loss deductions, which brought the taxpayer before the Tax Court.

The Tax Court held that while it was more likely than not that the taxpayer's compulsive gambling was a side effect of his prescribed medication, the resulting losses were not "casualty losses." The court cites a long list of cases standing for the proposition that a casualty loss requires physical damage to the taxpayer's property. The taxpayer's alleged losses here were not from physical damage to the taxpayer's property.

The taxpayer pointed to an IRS Publication (547) that says a taxpayer can deduct as a casualty "the type of loss on deposits [that occurs] when a bank, credit union, or other financial institution becomes insolvent or bankrupt." That suggests casualty losses are not limited to cases involving physical damage to property. "Fortunately for the Commissioner," said the court, "his own publications aren't the law. ... But even if [they were], that publication says only that taxpayers can claim as a casualty the 'type of loss" that occurs when a bank becomes insolvent or goes bankrupt—it doesn't authorize casualty-loss deductions for decreases in bank accounts generally. We're therefore not inclined to let Publication 547 upset decades of case law."

For completeness, the court went on to observe that the taxpayer's condition was not "sudden," as it lasted for three years. Even if there was a "casualty" at first, by the second and third year the condition was no longer "sudden." What's more, the taxpayer lacked evidence to support the dollar figures claimed, so there is a substantiation issue on top of the problems with qualifying as a casualty loss.

XXII. PAYMENTS FOR AUTHOR'S "BRAND" ARE SUBJECT TO SELF-EMPLOYMENT TAX (Slaughter v. Commissioner, T.C. Memo. 2019-65, June 4, 2019)

"Karin Slaughter is one of the world's most popular and acclaimed storytellers." So begins the "About Karin" page on karinslaughter.com. It continues: "Published in 37 languages, with more

than 35 million copies sold across the globe, her eighteen (sic) novels include the Grant County and Will Trent books, as well as the Edgar-nominated *Cop Town* and the instant *New York Times* bestselling novels *Pretty Girls* and *The Good Daughter.*"

This case involves the substantial royalty income Slaughter received pursuant to several publishing contracts in 2010 and 2011. The Tax Court observed that beyond writing books, Slaughter spent time and money building her personal brand as an author. In exchange for advances and royalties, the publishers:

receive more than just the right to print, publish, distribute, sell, and license the works and manuscripts written, or to be written, by petitioner. They also secure the right to use her name and likeness in advertising, promotion, and publicity for the contracted works. Petitioner is required to provide photos and be available for promotional activities. The contracts include noncompete clauses which vary in scope, from requiring that the specified manuscript be completed before others, to prohibiting petitioner's entry into another contract until her writing obligations are met. Publishers also secure the right to advertise other works in petitioner's books, qualified by the requirement that petitioner consent to the specific advertisements. Several of the contracts allow for, but do not require, a share of advertising proceeds to be paid to petitioner as a condition of her consent. Finally, the contracts include an exclusive option for the respective publisher to negotiate the contract for petitioner's next works.

As is customary in the book publishing world, the contracts did not allocate the advances or royalties between writing the works, promoting the works, the noncompete clauses, or the other rights.

Slaughter's tax preparer determined that some of her royalties and advances should be treated as payment for the use of her brand, an intangible asset, and not as payment in connection with being an author. Accordingly, Slaughter did not pay self-employment taxes on the portions allocated to her brand. The Service assessed a deficiency on the grounds that all of the payments received during the years at issue were connected to her work as an author.

The Tax Court agreed with the Service. It found that Slaughter's brand is part of her business, so payments related to her brand are necessarily payments in connection with her business and thus subject to self-employment tax. The court observed that Slaughter deducted the cost of renting a New York City apartment as a business expense when the apartment's main purpose was to enable her to attend meetings with agents, publishers, and booksellers. Indeed, "the fundamental benefit of having a presence in New York City was to develop her brand, not to write." Treating this as a business expense (not an investment expense) suggests the author's brand is very much a part of her business.

XXIII. NOT ALL UNITED STATES CITIZENS ARE UNITED STATES CITIZENS FOR TRANSFER TAX PURPOSES (*Private Letter Ruling 201924009*, June 14, 2019)

The federal wealth transfer taxes generally apply to United States citizens and residents. A separate, narrower transfer tax regime applies to individuals who are neither citizens nor residents of the United States. For this purpose, an individual's residency is not based on mechanical tests like possession of a green card or a certain number of days of physical presence within the United States, but instead on the squishier criterion of the individual's "domicile."

Though it gets little attention, §2209, an estate tax provision enacted in 1960, employs a special rule for United States citizens that are residents of a United States possession. The statute states in its entirety that:

A decedent who was a citizen of the United States and a resident of a possession thereof at the time of his death shall, for purposes of the tax imposed by this chapter, be considered a "nonresident not a citizen of the United States" within the meaning of that term wherever used in this title, but only if such person acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

The decedent at the heart of this ruling was born in what the redacted ruling calls "Country A," which is neither the United States nor one of its possessions. At his birth, neither of the decedent's parents were citizens, nationals, or residents of the United States nor any of its possessions or territories, and neither parent was born in the United States or one of its possessions.

Using a student visa, the decedent relocated to what the redacted ruling calls "Possession," aptly enough a possession of the United States. After completing college, the decedent commenced employment in Possession under a work visa. The decedent resided in Possession at all times since college.

A few years after starting work, the decedent became a naturalized citizen of the United States. The decedent, then, did not acquire citizenship on account of his birth but based on his continuous residency in Possession. So the Service ruled that the decedent met the requirements of §2209 and therefore was a nonresident, noncitizen at the time of his death.

XXIV. "THE COOLEST HOBBY LOSS CASE EVER" (*Kurdziel v. Commissioner*, T.C. Memo. 2019-20, March 21, 2019).

I'mma let Judge Holmes frame the issue for you: "Edward G. Kurdziel is the only man in America licensed to fly a Fairey Firefly. He is also the only man in America who has a Firefly to fly. But restoring this old WWII fighter and submarine hunter took bales of money, which he's never

gotten back. Kurdziel says the restoration was a business and claimed big deductions for it on his returns for 2007 through 2010. The Commissioner says it was all just a very expensive hobby."

The taxpayer, a Delta pilot with "45 years of flying experience under his wings," bought a twoseater Fairey Firefly warplane in 1994 for about \$200,000. He started to restore the plane with plans to sell rides on it. Spending some 45,000 hours over eight years, the taxpayer got the plane into a sufficient shape to get an air worthiness certificate from the Federal Aviation Administration. In 2003, the taxpayer transferred the plane to a trust for state income tax purposes. Hoping to make some money flying the plane at military air shows, the taxpayer became a government contractor in 2004. Starting the next year, the taxpayer claimed his income and expenses from the airplane on a Schedule C, taking the position the airplane activity was a business. This was helpful: "The great gobs of money that the restoration had required led Kurdziel to claim an adjusted basis in the Firefly of just over \$1.6 million on his 2005 return, which generated a nearly \$82,000 depreciation deduction for that year alone. In total Kurdziel reported \$129,230 in total expenses related to the Firefly, and \$115,280 in business loss--an amount which reduced Kurdziel's taxable income from other sources by more than half. Similar Schedules C were produced in subsequent tax years on which Kurdziel claimed over \$80,000 in depreciation deductions and six-figure net losses that greatly offset his income."

The Service disallowed the net losses as losses from a hobby activity. Applying the multi-factor test for determining whether a taxpayer operates an activity with a profit motive, Judge Holmes held that the activity was a hobby. The taxpayer had no business plan and kept no separate records. And while the taxpayer "is extremely experienced with airplanes and their restoration, we think this practical experience is canceled out by his failure to show that he did a basic investigation into the business aspects and economics of vintage airplane restoration." Further, the losses from the activity only increased from year to year. "Kurdziel completed the Firefly's restoration in 2002 and won his most prestigious awards that same year. If Kurdziel was interested in making a profit (and cutting his losses), he would have sold, or at least attempted a sale much sooner--especially after he learned that monetizing rides was impossible." But what weighs most heavily against the taxpayer is that he received retirement pay from the Navy and a salary of \$180,000 from Delta throughout the years at issue. The court concluded he used the airplane activity "not as a source of income, but rather as a way to significantly reduce his taxable income from other sources."

The only factor favoring the taxpayer was that he reasonably expected the value of the plane to increase over his holding period, which appears to in fact be the case based on a 2014 appraisal of the plane claiming it to be worth \$3.5 – 8 million even though it crashed at an air show in 2012. But even though he expected the plan to appreciate, "what ultimately matters is whether he had a good-faith plan to realize a profit from its sale. We aren't convinced that he did."

XXV. A LITTLE NAVEL-GAZING ON THE TAX TREATMENT OF REFUNDED DONATIONS

In 2018, Hugh Culverhouse, Jr., pledged \$26.5 million to the University of Alabama. Touched, the university named its law school after him. On June 7, 2019, however, the university's board of trustees voted to return all of the contributions Culverhouse had given to date and to remove his name from the law school. This extraordinary action garnered national attention. The parties disagree as to why the university decided to refund the donation—Culverhouse says it was in retaliation for his outspoken opposition to a new Alabama statute outlawing nearly all abortions in the state, but the university declared it could no longer cope with Culverhouse's micro-managing of the law school and his insistence on being involved in admissions and staffing decisions. A June 8, 2019, article in the *New York Times* quotes Culverhouse: "I think what provoked them the most was when they asked me if I wanted to see a football game and I said no; I don't like to see young men hurting themselves."

Fortunately for our purposes, the federal income tax consequences of the donation's return do not depend on whose version of the story is correct. Assume first that Culverhouse's donations in 2018 were entirely in the form of cash. If Culverhouse deducted the cash contributions he made in 2018 on his federal income tax return, the tax benefit rule requires him to include the refunded amount in gross income on his 2019 federal income tax return. That much is easy.

It gets more complicated if we assume some portion of the donation came in the form of appreciated property, and if we further assume the university sold the appreciate appreciated asset(s) after the donation. If the university refunded the cash proceeds to Culverhouse, does he have to recognize gain? The answer, it seems, is yes. The tax benefit rule applies regardless of whether the taxpayer receives the donated property or the cash proceeds from the sale of the donated property.

What is even more interesting, though, is the character of the gain Culverhouse would recognize. To illustrate, suppose Culverhouse donated a long-term capital asset with a zero basis and a \$10 million value in 2018. The donation would give rise to a \$10 million that would save \$3.7 million in tax, assuming Culverhouse is already in the highest federal income tax bracket. If the university sold the asset and then refunded \$10 million cash in 2019, inclusion of \$10 million in long-term capital gain would generate federal income tax of only \$2.38 million, leaving Culverhouse ahead by \$1.32 million (not even factoring in the time value of money advantage from getting the tax benefit of the deduction a year before the tax burden of inclusion).

In *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), the Supreme Court held that a deduction arising from the restoration of an amount associated with a prior inclusion in gross income has the same flavor as the original income inclusion. In *Arrowsmith*, the taxpayers where shareholders of a corporation that liquidated in 1937. They properly reported their gains from the liquidation as long-term capital gains. Seven years later, the shareholders were ordered to pay a judgment arising from the corporation's activities. The shareholder argued that these

payments should be deductible as ordinary expenses, but the Court held that fairness required them to report the payments as long-term capital losses.

Arrowsmith is a case where the taxpayer has gross income in one year and then a restoration of some benefit from that income in a later year. Our Culverhouse hypothetical is the reverse—a deduction in 2018 and then a recovery of some of that cost in 2019. But the concern is the same, and the rationale of Arrowsmith—that the flavor of a subsequent transaction should match that of the prior transaction to which it relates—applies with the same force. If Culverhouse gets cash, he should recognize ordinary income even if the donated asset was a capital asset.

XXVI. PASS THE SUGAR – PREGAME MEALS ARE FULLY DEDUCTIBLE (IRS Action on Decision 2019-01, February 21, 2019)

The taxpayers, owners of the NHL's Boston Bruins, provided pregame meals to players and personnel during away games throughout the taxable years at issue (2009 and 2010). The taxpayers deducted the full cost of the meals, but the Service argued that the §274(n)(1) applies to limit the deduction to 50% of the cost. In the 2017 case of *Jacobs v. Commissioner*, the Tax Court held that the provision of meals before away games is a *de minimis* fringe and thus not subject to the 50% limitation.

Regulations explain that employee meals provided in a nondiscriminatory manner qualify as a de minimis fringe where: (1) the eating facility is owned or leased by the employer; (2) the facility is operated by the employer; (3) the facility is located on or near the business premises of the employer; (4) the meals furnished at the facility are provided during, or immediately before or after, the employee's workday; and (5) the annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility (the revenue/operating cost test). Here the pregame meals met these conditions, as the taxpayers contracted out for the provision of meals at hotels and arenas. Though they did not own the hotels or arenas, the court observed that under the regulations it is sufficient if the taxpayers "contract with another to operate an eating facility for its employees." The meals are provided to help players perform well, so they are given for a substantial non-compensatory business reason.

The Service announced that it is acquiesces in result only. This means it disagrees with the rationale of the Tax Court but will not appeal this particular case. Given the 2017 Tax Cuts and Jobs Act phases out this deduction (providing for only a 50% allowance from 2018 – 2025, followed by 0% for amounts paid in 2026 and beyond), the long-term significance of the acquiescence is likely minimal. But hey, let's give hockey some love.