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QUARTERLY TAX UPDATE

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A sampling of recent tax developments, provided by an advisor, for advisors.

The next phase of tax reform has been in full swing this summer, with the Treasury Department's attempt to interpret, or at least make sense of, the Tax Cuts and Jobs Act passed in 2017. Below you will see summaries of proposed regulations and other IRS pronouncements issued in the past quarter, focusing on the aspects that are of most interest to estate planners. There has been relatively little activity in the sense of conventional estate and gift taxation cases and rulings, but there is still plenty to think about for estate planners engaged in broad based tax planning for clients. Please read on to get some news regarding:

- Follow up tax legislation passed out of the House of Representatives.
- Regulations covering the 20% income tax deduction against business income.
- IRS views on state and local tax deductions, income taxation of trusts and estates, and whether last night's steak dinner was deductible.
- Judges issuing opinions on matters involving family trust liability for a company's underfunded pension plan, a split dollar insurance plan for the benefit of a corporate shareholder, denial of charitable deductions for pre-arranged stock sales, and another conservation easement case.

LEGISLATION AND TREASURY REGULATIONS

Here We Go Again. Three related bills were introduced this summer in the House Ways and Means Committee, approved out of committee to the full House, and passed the full House largely on a party line vote. The package was dubbed "Tax Reform 2.0".

- H.R. 6760, Protecting Family and Small Business Tax Cuts Act passed on September 28, with provisions to make permanent the many individual and small business tax provisions (such as the new tax rates, the cap on state and local tax deductions, and the Section 199A deduction) that under the Tax Cuts and Jobs Act of 2017 are set to expire in the year 2026. The increase in the estate, gift and GST exemptions is included in the bill.

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- H.R. 6757, the Family Savings Act, and H.R. 6756, the American Innovation Act, both passed on September 27, and include various items affecting retirement accounts (including a repeal of the maximum age beyond which contributions currently cannot be made to IRAs) and enhanced deductions for business startup expenses. An earlier proposal to eliminate stretch IRA planning for long term post-death distributions, was not included.
- There is no indication the Senate will even take up the measures before the end of the congressional term in December, leaving the fate of legislation up to the results of the midterm elections.

Proposed Regulations under Section 199A. The complicated provisions of Code Section 199A set forth the 20% deduction against qualified business income (QBI). With the deduction, the marginal tax bracket for high income clients with business income can be lowered from 37% to 29.6%.

Treasury has now followed up TCJA with detailed proposed regulations on the business deduction. Reg-107892-18, 2018-35 IRB 353 (8/16/2018). The regulations broadly address:

- definitional aspects of the QBI deduction;
- how to compute the deduction for taxpayers both below and above the "threshold amount" ($157,500 taxable income for singles, $315,000 for marrieds);
- when separate trades or businesses can be aggregated for determining QBI;
- determining if a business is a "specified service" business, which does not entitle an owner to the 20% deduction when income exceeds the threshold amount;
- rules for how to apply the QBI deduction to trusts and estates with business income.

We focus here on the effects of the regulations on trusts and estates. It will not be uncommon for a trust or estate to have QBI, since there is no requirement for participation in the business activity, or to have control of the entity conducting the business. Any trust or estate receiving a Form K-1 from a pass-through entity, with line 1 allocable income or loss, will have to consider the QBI deduction rules, and whether the deduction is available to the trust or estate to recognize on its Form 1041 income tax return. First, Prop. Reg. Section 199A-6 provides that grantor trusts are not subject to the Section 199A rules. For grantor trusts, the grantor will report all attributes of the QBI deduction on the grantor's personal tax return. An ESBT will be entitled to the QBI deduction on its share of S corporation income.

The threshold amount of $157,500 applies to estates and trusts for purposes of whether the specified service income rules apply, and whether to exclude the trust or estate from the wage and property basis limitations. If the nongrantor trust or estate has taxable income under that limitation, then the trust or estate will be able to claim the deduction if the source of the income is from a service business in the fields of consulting, investment services, financial services, and other professional services.

Trusts and estates have a hybrid presence under the Section 199A regulations, so whether the trust or estate, or the beneficiaries, take the deduction depends on distributions of distributable net income (DNI). Beneficiaries of trusts and estates that receive income distributions will also receive an allocable share of the

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Section 199A attributes (wages, basis of assets, PTP and REIT dividends, etc.), based on the beneficiary's share of the DNI distributed. If DNI is not distributed, the QBI deduction is calculated at the estate or trust level.

The regulation package includes an anti-abuse rule to combat planning to increase the available deduction that has been floated in popular commentary since the passage of TCJA. New proposed regulation 1.643(f)-1 provides that if two or more nongrantor trusts are created by the same grantor or grantors, with substantially the same beneficiaries, and there is a principal purpose of avoiding federal income tax in creating the trusts, the IRS can aggregate and treat the trusts as one. For example if one trust would have specified service business income of $500,000, and as an alternative four separate trusts with identical provisions are created, each with $125,000 of specified service business income (thus each under the $157,500 threshold), the IRS could contest the allowance of the 20% deduction and aggregate the trusts.

A significant unresolved issue is whether the Section 643(f) anti-abuse rule targeting multiple trusts applies to pre-existing trusts. While Section 643(f) has been around for several decades, directing Treasury to issue regulations on the issue, this was never done until this year. A legal question exists as to whether the IRS can treat the regulations issued in 2018 as being retroactive to trusts created prior to the effective date.

Proposed Regulations for Charitable Contributions in lieu of State Tax Payments. Following up on prior IRS Notice 2018-54, 2018-24 IRB 1 (5/23/2018), the IRS has issued proposed regulations on the subject of taxpayers claiming charitable deductions for contributions to organizations in connection with reduction of state tax liabilities. Reg-112176-18, 2018-37 IRB 430 (8/27/2018). The Tax Cuts and Jobs Act included a new limitation on deducting state and local taxes, capped at $10,000 per year. In reaction, some states with high state and local tax bases have been working on changing their local laws to benefit their resident taxpayers relative to the new federal deduction cap. An example of such state level legislation is to provide that in exchange for a taxpayer making a donation to a charitable organization that disburses funds for government-related purposes, the state will allow the taxpayer up to a dollar-for-dollar reduction in state income taxes otherwise due.

The regulations under Code Section 170 have a lengthy preamble, with Treasury describing its approach in, and legal basis for, concluding that such programs provide the taxpayer a *quid pro quo* benefit. With such benefit, the payments by the taxpayer to the charitable entity are not charitable in nature for purposes of an income tax deduction under Code Section 170. The general approach is that the charitable deduction will be reduced by the amount of state or local tax credit received due to making the contribution. The regulations do not take this approach on state and local tax income tax *deductions* granted for making the contribution. For trusts and estates, the Code Section 642(c) deduction for charitable contributions is impacted by the regulations, applying the same *quid pro quo* rules for state or local income tax *credits* granted to trusts and estates.

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COURT CASES

Machacek v. Commissioner, No. 17-1131 (6th Cir. 10/12/2018), *reversing* T.C. Memo. 2016-55 (3/28/2016). The Sixth Circuit Court of Appeals has reversed the Tax Court and found in favor of a taxpayer in a split dollar insurance case. The case involved a collision between the rules for economic benefit split dollar for an employee, and split dollar plans for the benefit of a shareholder, because in this case, the taxpayer was both an employee and the shareholder of an S corporation.

The taxpayer and his spouse held all the stock of Machacek, Inc., an S corporation. The taxpayer was also an employee receiving compensation. The corporation had adopted what was known as a "Sterling Benefit Plan", a welfare benefit plan for employees. The case addressed issues involving the Benefit Plan as constituting nonqualified deferred compensation to the taxpayer, but the subject of the appeal to the Sixth Circuit was a plan that included a corporate-owned life insurance policy on the taxpayer's life with an annual premium payment of $100,000.

The corporation deducted the insurance premium payment on the S corporation tax return, and the taxpayer did not include the value of any economic benefit received. The IRS assessed tax, and the Tax Court agreed, that the insurance premium was not deductible to the corporation, and the taxpayer was required to include in personal income the value of the economic benefit received under the compensatory split dollar plan. The taxpayer did not contest the disallowance of the corporate deduction for the premium paid. The remaining issue then was the treatment of the economic benefit of the split dollar plan, related to the increase in the cash value of the insurance policy.

The Sixth Circuit took a different approach to the interplay between the split dollar regulations under Regulation Section 1.61-22, and regulations affecting the distributions from corporation. Specifically, the Tax Court did not address Regulation Section 1.301-1(q), which specifically states that in the case of an economic benefit split dollar plan with a shareholder, the benefit is treated as a distribution of property by the corporation to the shareholder. The Tax Court had analyzed the case as one involving economic benefit provided to an employee, ruling the economic benefit was taxable compensation.

The Sixth Circuit concluded that the regulation under Section 301, dictating treatment split dollar benefits as a distribution of property to a shareholder, should dictate the outcome of the split dollar plan. Since Machacek, Inc. was an S corporation, the result was a distribution to an S corporation shareholder, and the taxation therefore would be governed by the Subchapter S rules for shareholder distributions.

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PBGC v. Findlay Industries, Inc., No. 17-3520 (6th Cir. 9/4/2018). While not directly a tax case, the Sixth Circuit was presented a case on appeal of some interest to estate planners, involving the liability of a family trust for unfunded pension plans of a corporation leasing property owned by the trust. Findlay Industries shut down operations in 2009 without meeting its obligations under a pension plan established for employees.

The founder and owner of Findlay Industries, Philip Gardner, had received a transfer of real estate properties from the corporation in 1986. Soon thereafter, Gardner transferred ownership of the properties to an irrevocable trust (the Gardner Trust) for the benefit of his family members. His sons were the trustees. They also managed the operations of the corporation and owned a majority of the shares in the last few years of the corporation's existence.

The Gardner Trust leased the real estate back to the corporation for use in its operations. When the Pension Benefit Guaranty Corporation stepped in to administer the underfunded pension plan, the question became whether any third parties could be held liable for the corporation's obligations. At the District Court level, the court had denied the PBGC argument that the Gardner Trust was, for ERISA purposes, engaged in a trade or business and thus was a business under common control with the defunct corporation. If so, this would cause liability to the Gardner Trust for the pension obligations.

The Sixth Circuit reversed the District Court and reasoned that for ERISA purposes, the Gardner Trust was a trade or business that leased property to the corporation. Under the facts of the case involving the same persons being shareholders and directors of the corporation/lessee, and trustees of the lessor, the Trust was under common control with Findlay Industries and held liable for the underfunded pension obligations.

Harbor Lofts Associates v. Commissioner, 151 T.C. No. 3 (8/27/2018). In an income tax charitable deduction case involving a façade easement, the Tax Court held that a long term lease on a property does not satisfy the ownership rights that must exist under Code section 170 to receive the tax deduction. Harbor Lofts entered into a 61 year lease on buildings, and held many of the rights and obligations of ownership under the lease terms. This included the right to alter the building.

The lessor and Harbor Lofts jointly granted a façade easement to a nonprofit charity that preserves historic properties. On its partnership tax return, Harbor Lofts recognized a charitable deduction of $4.5 million relative to the easement value. The deduction was disallowed by the IRS.

The Tax Court reviewed Massachusetts law and concluded that the lessor was the fee owner of the real estate, and Harbor Lofts held contractual rights under the lease, not an interest in property. Thus, Harbor Lofts could not convey property rights in the transfer of the leasehold interest. The donation of an easement does not qualify for a charitable deduction unless it is a perpetual restriction on the property, and the contractual rights, as personal property, did not qualify under Code Section 170(h)(2)(C). Even though the lessee joined

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with the property owner in transferring the façade rights to the property, the lessee did not itself hold the needed property rights to obtain a charitable deduction.

Chrem v. Commissioner, T.C. Memo. 2018-164 (9/26/2018). The Tax Court considered motions for summary judgment in a case involving the donation of foreign stock to a public charity, whereby the charity then would sell the stock to another related corporation. The issue was whether the taxpayer had assigned the rights to the income to be realized on a proposed sale to the charity prior to the sale, rather than making a legitimate charitable contribution of the stock.

The taxpayer owned a majority stock interest in Comtrad, a closely held Hong Kong corporation. A U.S. corporation, SDI Technologies, was the principal customer of Comtrad. SDI was owned by an ESOP, and the taxpayer was a participant in the ESOP. The same group of individuals were the majority of the directors for both corporations.

SDI proposed to purchase the stock of Comtrad in 2012 for non-tax strategic business purposes. Under the proposal, SDI would purchase 6,100 of the stock shares in Comtrad for $27 million in cash and notes. For a remaining 900 shares in Comtrad, the petitioners agreed to donate the stock to a charity. SDI would purchase the stock from the charity for the same per share price. Comtrad and its shareholders could not force the charity to sell the stock to SDI, but agreed to use corporate governance procedures such as reverse stock splits or other actions to dilute the charity's ownership if it did not follow through with a sale. The proposal specified that if the charity had not sold the stock to SDI within 60 days of donation, the first sale transaction would be unwound and the 6,100 shares of Comtrad would be returned from SDI to the sellers.

A fairness opinion obtained by the ESOP trustees as to the value of the stock described that SDI would acquire ownership of all 7,000 shares in two stages. On December 12, SDI closed the purchase of the 6,100 shares. The parties disputed whether the donation of the 900 shares to the charity occurred on December 5 or December 10. The Tax Court denied the taxpayer's motion for summary judgment, finding under the assignment of income doctrine that there remain questions of fact to be resolved at trial as to whether the charity had agreed and had a binding obligation, to sell the stock to SDI, or alternatively whether the sale was virtually certain to occur due to common management and control of both corporations.

The Tax Court also left for trial a question of whether the taxpayer had satisfied the requirements under the regulations to Code Section 170 for obtaining a qualified appraisal of the donated stock. The taxpayers are arguing that the valuation report obtained by the ESOP trustees constitutes substantial compliance with the qualified appraisal rules.

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NOTICES, ANNOUNCEMENTS AND DETERMINATIONS

Charitable Contributions in lieu of State Tax Payments. In Notice 2018-54, 2018-24 IRB 1 (5/23/2018), the IRS had issued fair warning of its views on the ability to deduct charitable contributions that are directly connected to state and local tax obligations that are capped under TCJA. The Notice itself was vague and without much detail. It did state that the IRS intends to issue regulations "addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against state and local taxes." The IRS stated that the regulations will "make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers." See the above summary of the proposed regulations on how the IRS fulfilled that prediction.

Itemized Deductions by Estates and Trusts. In Notice 2018-61, 2018-31 IRB 278 (7/13/2018), the IRS announced that its intends to issue regulations addressing the ability of estates and nongrantor trusts to deduct expenses that, for individuals, are treated as miscellaneous itemized deductions. In TCJA, Congress eliminated all miscellaneous itemized deductions that had previously been deductible to the extent they exceeded 2% of adjusted gross income. Concerns had developed that perhaps new Code Section 67(g) also eliminated these deductions from being available against estate and trust income.

In the Notice, the IRS describes that Code Section 67(e)(1) provides that the AGI of an estate or trust is computed in the same manner as that of an individual, except that the deductions for costs that (i) are paid or incurred in connection with the administration of the estate or trust and (ii) that would not have been incurred if the property were not held in an estate or trust, are treated as allowable in arriving at estate or trust AGI. Costs that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held by the estate or trust, are allowable. Presumably this will include legal fees for trust and estate administration, fiduciary accountings, court costs, court-required appraisals, and similar items.

The IRS concludes that the Code Section 67(g) elimination of miscellaneous itemized deductions for individuals does not affect Code Section 67(e)(1) deductions for estates and trusts. Note that the existing regulations to Code Section 67 provide detail on how to determine the deductible portion of wrap trustee fees that cover investment advisory services, since the investment advisory portion of the trustee fee will be nondeductible. Finally, in the Notice the IRS requests comments be submitted in how to approach the deductibility of Code Section 642(h) excess deductions in the year of termination of an estate or trust, which may be Section 67(e) deductions at the estate or trust level, but in the past have been miscellaneous itemized deductions for individuals (now disallowed).

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Amended Joint Tax Return After Death. In the form of an email response, the IRS issued Chief Counsel Advisory 201830012 (7/27/2018) addressing the effect of a surviving spouse filing amended joint income tax returns after the death of the other spouse. In the controversy, an executor is seeking to disaffirm the amended tax returns (presumably the executor is not the surviving spouse in the fact pattern). The CCA concludes that under Code Section 2(a), the living spouse is not a surviving spouse for purposes of the rules under Code Section 6013(a) for disaffirming an amended return, because the first spouse to die was still alive in the preceding two tax years in question. So the surviving spouse is not considered a surviving spouse for those tax years.

Required Minimum Distributions. An Executive Order issued by the President on August 31 directed that Treasury is to study the current required minimum distribution tables for IRAs and qualified plans. The purpose of the review will be to determine if tables must be updated to reflect current mortality data, presumably leading to a lowering of annual RMD rates for longer life expectancies. Treasury is also asked to determine if the review of the tables should be conducted annually.

Section 529 Plans. The IRS has issued Notice 2018-58, 2018-33 IRB 305 (6/22/2015), with intent to issue regulations to clarify new Section 529(c)(7) under TCJA, the rules for treating certain elementary or secondary school expenses as qualified higher education expenses (QHEEs). Under the new rule, QHEEs include tuition charged for enrollment or attendance at an elementary or secondary public, private or religious school. Section 529(e)(3)(A) was amended in TCJA to limit the total amount of such tuition distributions from all accounts for a beneficiary to $10,000 per year. The Notice states that the IRS intends for the regulations to be issued to provide that the term “elementary or secondary” means kindergarten through 12th grade as determined under state law, and consistent with the rules for Coverdell ESAs.

And Finally, Meals. The IRS issued Notice 2018-76, 2018-42 IRB 1, addressing what was not anticipated to be such a big issue under TCJA, that being what sorts of business meals, if any, or still deductible after tax reform. The item effects anyone conducting business activities. TCJA revised Code Section 274(a)(1) and eliminated deductions for business expenses incurred in connection with entertainment. While language in the committee reports to TCJA suggested that the costs of business meals that were not incurred in connection with entertainment still could be deductible, the answer had become less certain due to the structure of the statutory wording.

The Notice details the preliminary conclusion of the IRS, to be fleshed out further in later regulations, regarding the continued deductibility of certain kinds of business meals. The IRS concludes that in general, business meals continue to be deductible, subject to the 50% of cost limitation under Section 274(n)(1). Until regulations are issued, taxpayers can rely on a rule that 50% of the cost of a meal may be deducted if:

1. The expense is ordinary and necessary in conducting business.
2. The expense is not lavish or extravagant.
3. The taxpayer or employee is present at the meal.
4. The meal is provided to a current or potential customer, client, consultant or similar business contact.

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5. If the meal is provided at an entertainment event, the food and beverage cost is purchased separately, or stated separately on an invoice or receipt.

There will surely be updates and revisions to these prospective rules when the regulations are issued.

IRS LETTER RULINGS

Erroneous GST Exemption Allocation. In Letter Ruling 201836007 (9/7/2018), the IRS granted a taxpayer request that an allocation of GST exemption to three trusts was void. The taxpayer had created and funded the irrevocable trusts for the taxpayer's children. A child was the primary beneficiary of each trust. The primary beneficiary was granted a testamentary general power of appointment. On federal gift tax returns filed for the years of gifts to the trusts, the taxpayer erroneously allocated GST exemption to the trusts. The ruling request sought to treat the allocations as void because there was no GST potential with respect to the transfers. The IRS agreed that at the child's death, the child would become the transferor of the trust property due to the presence of the general power of appointment. Under Regulation Section 26.2632-1(b)(4)(i), the IRS granted the request.

No Tax on Division of Marital Trust. In Letter Ruling 201834011 (8/24/2018), the IRS addressed a question of whether a taxable event would occur upon the split of a QTIP marital trust for a surviving spouse into separate marital trusts for the spouse's benefit. The proposed split was on a non-pro rata basis, meaning the assets in the original marital trust would not be equally allocated to the continuing multiple trusts. A local court issued an order approving a nonjudicial settlement agreement for the division. The goal of the plan was for the surviving spouse to subsequently renounce her income interest in one of the trusts by nonqualified disclaimer, causing those trust assets to transfer into a continuing trust for the benefit of charity.

The IRS granted a ruling that even though the assets of the QTIP trust were not going to be divided evenly among the continuing marital trusts, there would be no deemed sale or exchange of trust interests causing an income tax event, since each continuing trust contained identical beneficial interests, citing Revenue Ruling 56-437, 1956-2 C.B. 507 (involving a partition of jointly held property where no new interests were acquired by any party).

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