TAX NEWS & COMMENT

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IRS & NYS DTF MATTERS

Recent Developments & 2016 Regs. & Rulings of Note

I. IRS Matters

A. New §2704(b) Proposed Regs

In August, Treasury released proposed regulations under Section 2704 to limit the use of valuation discounts in transfers of family-controlled entities. While the proposed regulations address perceived abuses, their scope is broad, and they will apply as well to transactions not involving tax avoidance.

[Under current law, Section 2704(a) generally denies discounts upon "lapse" of voting or liquidation rights when interests are transferred to family members. However, discounts are not denied if those rights become

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FROM FEDERAL COURTS NYS COURTS & TAX TRIBUNALS

Recent Developments & 2016 Decisions of Note

I. Federal Courts

Conservation Easements

The Tax Court in *Palmer Ranch Holdings, Ltd. v. Com'r*, T.C. Memo 2016-190, upheld a $20 million deduction for a conservation easement in undeveloped wetlands in Sarasota which had been approved for environmental conservation by a local government board. The Court rejected the IRS argument that a zoning order that had rejected a bid by Pulte to build homes was dispositive, noting that the vote was 3-2 and had been made two years earlier. On appeal, the Eleventh Circuit found the Tax Court had erred, but only in reducing the de-

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FROM WASHINGTON & ALBANY

NOVEMBER ELECTION YIELDS FEW ANSWERS

I. From Washington

Tax Analysis

After enduring a difficult winter in Washington, President Trump will have little time to enjoy the cherry blossoms. He must now turn his attention to achieving the daunting task of overhauling an antiquated federal tax system that is out of sync with major world economies. This forces American businesses to make the Hobson's choice of paying virtually the highest corporate tax rate in the world (exceeded only by the UAE) or to relocate offshore and remain competitive by not repatriating income that could otherwise drive U.S. growth.

Passage of the Administration's

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Taxation of Alimony After Repeal of Deduction

I. Agreements Executed Before January 1, 2018 Exempted

Tax Planning

The 2017 Tax Act repealed the deduction for alimony payments made under divorce or separation agreements executed after December 31, 2017. However, the repeal is expressly inapplicable to agreements executed before January 1, 2018.

IRC Section 71, which remains applicable to divorce or separation agreements executed before January 1, 2018, makes alimony payments deductible to the payor spouse. IRC Sec-

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Requesting a Private Letter Ruling

I. Introduction

A private letter ruling (PLR or "letter ruling") is a written determination issued to a taxpayer by the IRS in response to the taxpayer's written inquiry, filed prior to the filing of returns about its status for tax purposes or the tax effects of its acts or transactions. A letter ruling interprets the tax laws and applies them to the taxpayer's specific set of facts. A letter ruling is issued when appropriate in the interest of sound tax administration. The IRS generally issues a letter ruling on a proposed transaction or on a completed transaction if the letter ruling request is submitted before the re-

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JUNE COMMENT

A Journey Through IRC Sec. 199A: Wasn't the Code to be Simplified?

I. Introduction

Final regulations were issued in January under Section 199A, which permits a deduction of up to 20 percent to owners of pass through entities, and beneficiaries of trusts and estates. It seeks to level the playing field between those individuals and corporations, taxed at 21 percent, and owners of entities taxed at much higher rates.

Will Congress Repeal Section 1031 in 2017? (Page 19)

The benefit of the deduction is gradually reduced, in phases, as taxable income increases. The first phase imposes no limitations on the deduc-

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FROM WASHINGTON & ALBANY, CONT.

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tax plan hangs in the balance of Mr. Trump convincing a half dozen Republican Senators — one liberal, one libertarian, and the rest moderate — to vote for passage. They include Collins (ME), McCain (AZ), Portman (OH), Murkowski (AK), Paul (KY), Blunt (MO), and Rounds (SD). Although Treasury Secretary Mnuchin believes a tax reform bill will be on the floor of the Senate by the August recess, Senate Majority Leader McConnell (KY) believes the August date is optimistic since tax reform is "complicated." Democratic opposition to any Republican bill appears resolute and unified.

The Senate is now composed of 48 Democrats and 52 Republicans. Though controlling neither chamber of Congress, Senate Democrats still possess the powerful filibuster, as Republicans do not have the necessary 60 votes to invoke cloture and end debate. Republicans could invoke the Budget "reconciliation" rule under which debate on budget proposals is limited to 20 hours. Although this would preclude filibuster and result in passage of legislation with a simple majority, any legislation passed through budget reconciliation must "sunset" (expire) after 10 years if it has a negative impact on revenue.

In the event a vote on tax legislation does not occur until after the 2018 elections, the complexion of the Senate will not likely change enough to make passage either much more or much less difficult: Democrats need a net gain of three seats to win control of the Senate. Republicans need a net gain of eight seats to avoid filibuster. However, Democrats have 25 seats up for reelection, as opposed to the Republicans' eight.

President Trump stated in late February that healthcare legislation must precede tax reform. Others agree that since his tax plan is dependent on the revenue savings in the health act, a delay in passage of the health act might imperil early passage of tax legislation. If the American Health Care Act gets delayed or derailed in Congress, tax reform could be stalled until 2018 or even later. This would undoubtedly unnerve the markets, which appear to have priced in meaningful tax reform in the near future.

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David graduated from Columbia Law School and received an LL.M. in Tax from NYU. Formerly associated with Pryor Cashman, David is an approved sponsor with the NYS Board of Public Accountants, and lectures frequently on taxation and estate planning. He wrote "*Like Kind Exchanges of Real Estate Under IRC §1031*," an authoritative treatise on the subject. Areas of practice include:

TAX PLANNING & TAX LITIGATION
- ¶ Federal & NYS Income Tax Planning
- ¶ Federal & NYS Tax Litigation
- ¶ U.S. Tax Court & District Ct Litigation
- ¶ NYS Tax Appeals Tribunal Litigation
- ¶ Criminal, Sales & Employment Tax
- ¶ Estate Taxes & Audits

WILLS, TRUSTS & PROBATE
- ¶ Wills, Inter Vivos, & Testmentry Trusts
- ¶ Probate and Administration of Estates
- ¶ Powers of Attorny; Health Care Proxies
- ¶ Contested Estates; Trust Accountings
- ¶ Grantor & Nongrantor Trusts
- ¶ Trust Amendment & Decanting
- ¶ Gift & Estate Tax Returns & Audits
- ¶ Trust & Fiduciary Litigation

CIVIL & COMMERCIAL LITIGATION
- ¶ NYS Trial & Appellate Litigation
- ¶ Business & Commercial Litigation
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- ¶ Article 78 Proceedings; Injunctions
- ¶ NYS & NYC Admin. Proceedings

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- ¶ Opinion Letters & Ruling Requests
- ¶ International Taxation; FBAR Matters
- ¶ Corporate & Partnership Tax Planng
- ¶ Buy-Sell Agrmts; Business Succession
- ¶ Incentive Stock Options

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ESTATE PLANNING & ASSET PROTECTION
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- ¶ Sales to Grantor Trusts; GRATs, QPRTs
- ¶ Gifts & Sales of LLC and FLP Interests
- ¶ Prenuptial Agreements; Divorce Planning
- ¶ Post-Mortem Tax Planning
- ¶ Social Security & Retirement Planning

TAX'N OF REAL ESTATE & TAX COMPLIANCE
- ¶ Section 1031 Like Kind Exchanges
- ¶ Delaware Statutory Trusts; TICs
- ¶ IRS Private Letter Rulings

APPELLATE PRACTICE
- ¶ New York State Tax Appeals
- ¶ New York State Civil Appeals
- ¶ Appellate Briefs in Tax & Civil Matters

SPEAKING ENGAGEMENTS:

Mr. Silverman is licensed by New York State to provide CPE credits to CPAs, and may provide CLE credits to attorneys if sponsored by a credit-providing institution. If you would like to invite David to speak at a professional event, please call the office.

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Directions to Connecticut Office:

Hutchinson Parkway to I-684 North (Brewster). Take I-684 North for 30 miles to I-84 East, (Danbury). Proceed 2 miles to Exit 1, Saw Mill Road. Make right on Saw Mill Road from exit ramp, then go up short hill and turn left at light into Rivington development. You will be on Reserve Road. Continue for .2 miles, (go straight through traffic circle) and turn left on Winding Ridge Way. (65-75 minutes from Lake Success; 63 miles.)

I. Personal Income Tax Proposals

President Trump initially proposed reducing the number of income brackets to four, but appears to now agree with the Congressional Republican proposal to have three brackets (instead of the current seven) of 12 percent, 25 percent and 33 percent. Married persons with incomes up to $70,000 would be within the 12 percent bracket; and those

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FROM WASHINGTON & ALBANY , CONT.

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with incomes of up to $225,000, the 25 percent bracket. The average reduction in taxes for couples with two children earning $100,000 would be more than symbolic but less than significant.

[This continues the historical general trend downward. Under Roosevelt, the highest personal rate was 94 percent, under Eisenhower and Kennedy, 91 percent, Johnson and Nixon, 70 percent, Reagan 28 percent, Clinton and Obama 39.6 percent.]

Although the House GOP proposed taxing half of capital gains at ordinary income rates and excluding the other half, it appears more likely that there will be no change to the present favorable taxation of capital gains and dividend income. The Medicare surtax of 3.8 percent on net investment income would be repealed. Both the House GOP plan and the Administration advocate elimination of the AMT. Dividends would continue to receive favorable tax treatment.

Under the Administration's proposal, personal exemptions would be eliminated, but the standard deduction would be increased to $15,000 per taxpayer, regardless of marital status. About half of those who currently itemize would no longer do so. Itemized deductions would be subject to a $200,000 limit for married taxpayers, and $100,000 for individuals. Head-of-household filing status would be eliminated.

Mr. Trump favors simplification of present law child subsidies. He proposes a nonrefundable above-the-line deduction for employer-related child care expenses for children under age 13. The upper limit would be determined by costs within the individual state. The deduction would be available to families with incomes of up to $250,000. Phase-out would also have high limits. An earned income tax credit would be available to low income taxpayers.

Parents could also maintain a dependent care savings account that would be funded with a fully deductible $2,000 per child annual contribution. Growth would be tax-free as would withdrawals for qualified purposes, such as traditional child care, after-school programs or tuition.

Amounts expended for dependent elder care living in the home would also be an above-the-line deduction, capped at $5,000.

The Administration has not indicated how it intends to pay for the revenue losses occasioned by the individual and corporate tax relief proposed. In fact, even the most generous methods of estimating revenue losses reveal the cost of Mr. Trump's proposals could be problematic for a Republican Congress averse to incurring further federal deficits.

Both the Administration and House Republicans appear to favor continuing to allow deductions for mortgage interest and charitable contributions.

II. Transfer Taxes

Elimination of transfer taxes in their entirety seems unlikely, at least with respect to the gift tax. The estate tax and the GST tax now reach few estates, and may be targeted for repeal. Mr. Trump has proposed a capital gains tax at death with no basis step up with a large $10 million exemption in place of an estate tax. This proposal will likely engender opposition from both sides of the aisle, since determining historical basis would create an administrative nightmare. Similar efforts to eliminate the basis step up at death have failed for this reason.

Since repeal of the estate tax would likely require budget reconciliation, elimination would "sunset" in 10 years, as did EGTRRA. This means even a repeal would be only temporary, although bringing back an estate tax once repeal actually occurs might be difficult for a future president.

The gift tax will not likely be repealed as income shifting may still be a concern, especially if the estate tax is repealed. All of this means that transfer tax planning remains important, but less so. Even if Washington repeals the estate tax, it is unlikely that New York will follow suit. (see NYS DTF matters, p. 10).

III. Corporate and Business Tax Reform

More significant than the individual tax regime changes that Mr. Trump proposes are the sweeping corporate tax changes he envisions.

Under the U.S. international taxation, corporate earnings remain untaxed unless and until those earnings are repatriated. An estimated $2.6 trillion of earnings remained unrepatriated as of the beginning of 2016. The Administration's proposal would reduce the corporate tax rate from 35 percent to 15 percent, while repealing the AMT. Owners of sole proprietorships, S Corporations, partnerships, and limited liability companies would also be entitled to the 15 rate of taxation. A permanent "deemed" repatriation on unrepatriated profits would result in a single 10 percent tax being imposed on those earnings when the plan is enacted. Going forward, the Trump plan would permit deferred income to be taxed as dividend income to shareholders.

[Note: Since taxation of partnerships (as well as LLCs and S Corporations) is now determined at the partner rather than entity level, some type of mechanism would be required to permit the partner to benefit from the lower rate on "flow through" partnership income. For example, since the character of partnership income is determined at the partnership level, capital gain characterization is determined at the partnership level, but reported at the partnership level applying the partner's tax rate. Under the Trump plan, taxation of partnerships would assume some "entity" characteristics now associated with C Corporations or trusts, where the income is actually determined at the entity level. This would mark a sea change in the tax law.]

Businesses would no longer be required to amortize domestic investment in plants and equipment, but would be allowed to expense these costs. However, if the election to expense were made, the deduction for interest expense would be forfeited. The plan might also allow expensing for research, salaries and intellectual property.

IV. Border-Adjustment Tax

President Trump holds as a priority the imposition of a "border-adjustment tax," which is a territorial tax system adopted by most European countries. Under a border-adjustment tax — which in effect taxes consump-

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tion — companies incur no tax on income derived through exports; but tax is indirectly imposed on imports by disallowing a business deduction for the cost of imports. Under the territorial system, earnings could be repatriated without being subject to tax.

Salaries paid to domestic workers by exporting companies would be deductible, while salaries paid to foreign workers by importing countries would be nondeductible. Companies dependent on imports, such as Best Buy, Walmart, and Nike have expressed concern that the tax will increase the cost of consumer products, while companies that focus on exports of U.S. made goods and services, such as Boeing, General Electric, and Pfizer, believe that the new tax would stimulate growth.

[This proposal might be objected to by Europe as violating international trade agreements by imposing a tariff on imports and subsidizing exports. President Trump has called for renegotiating trade agreements.]

Advocates of the tax posit that the border adjustment would result in the dollar gaining value, thereby increasing the purchasing power of the dollar, and reducing the cost of imports. When the dust settles, they argue, the cost of imports would remain unchanged. However, if the dollar does rise precipitously, this will make the cost of exporters' products more expensive, and will reduce those companies' profits.

Mr. Trump believes that the current tax regime places U.S. workers and businesses at a distinct economic disadvantage via à vis other countries that now maintain a border-adjustment tax system. He argues that enactment of the tax would remove incentives to locate businesses outside of the United States. Combined with full expensing for investment in new plants and equipment, increased production of goods and services for both domestic and foreign consumption would occur.

Advocates and critics dispute the likelihood and magnitude of short-term economic disruption that imposition of the new tax would occasion. If Mr. Trump is successful in shepherding passage through Congress, this would presage the most significant change in federal taxation since 1986, and possibly since the enactment of the present Internal Revenue Code in 1956.

V. Repeal of Affordable Care Act

President Trump advocates repeal of all taxes associated with the Affordable Care Act. Repeal or modification of the Affordable Care Act would increase pressure on Congress to offset lost revenues. The Congressional Budget Office (CBO) estimates that repeal of the 3.8 percent net investment tax would result in a $223 billion increase in the federal deficit over the next ten years. Repeal of the 0.9 percent Medicare tax would increase the deficit over that time period by an estimated $123 billion; repeal of the annual tax on health care providers, $156 billion. On the other hand, the CBO estimates that eliminating individual and employer mandates would result in a net decrease in the federal deficit of $130 billion over ten years.

VI. Tax Expenditures

Congress as well as President Trump propose to offset lost revenue occasioned by a reduction in taxes through the reduction or elimination of various "tax expenditures." Tax expenditures are revenue losses attributable to exclusions, exemptions or deductions that provide a deferral or a reduced tax rate. Tax reform envisioned by President Trump would, without the corresponding elimination of various tax expenditures, cause the federal deficit to escalate. Under budget reconciliation, proposed tax cuts need only be offset by revenue increases, of which elimination of tax expenditures would play an important role.

The largest corporate tax expenditures are indicated below in billions of dollars over five years, and rounded. Tax expenditures which President Trump has either stated that he is in favor of eliminating, or tax expenditures that appear at risk of being eliminated or reduced are bolded in red. They include:

(i) **Deferral of income of controlled foreign corporations (563);**

(ii) **Deferral of income attributable to domestic production activities (62) (unclear);**

(iii) **Deferral of gain on like-kind exchanges (58);**

(iv) **Exclusion of interest on state and government bonds (51) (unclear);**

(v) **Credit for low-income housing (41); and**

(vi) **Deferral of gain on installment sales (34).**

The largest individual tax expenditures are indicated below in billions of dollars over five years, and rounded. Tax expenditures which President Trump has either stated that he is in favor of eliminating, or tax expenditures that appear at risk of being eliminated or reduced are bolded in red. They include:

(i) **Exclusion of employer contributions for health care (770) (unclear);**

(ii) **Deduction for State and Local taxes (unlikely but possible) (342);**

(iii) **Health care exchange subsidies (322)**

(iv) **Exclusion of capital gains at death (191) (may be conditioned on repeal of estate tax)**

(v) **Deductions for charitable contributions to educational institutions (33); and**

(vi) **Deferral of gain on like-kind exchanges (30).**

VII. Conclusion

Following tax cuts for businesses, Mr. Trump proposes a massive $1 trillion effort to rebuild the nation's infrastructure, and also increase defense spending dramatically. These will require the elimination or curtailment of many tax expenditures or entitlements, which may be quite unpopular.

President Trump believes that by slashing taxes on businesses, eliminating many government regulations, encouraging domestic production of goods and services, renegotiating unfavorable international agreements and treaties, and shifting much of the health care burden to the States, economic growth will more than offset the loss in tax revenues.

Wall Street seems to agree.

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FROM THE COURTS, CONT.

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duction to $20 million. On remand, the Tax Court reinstated the $25.2 million deduction reported by the taxpayer.

Taxpayers also struggled in other cases involving conservation easements. In *Gemperle v. Com'r,* T.C. Memo 2016-1, Judge Halpern citing IRC §179(h)(4)(B)(iii)(I) in deciding that the taxpayer's failure to attach an appraisal barred any deduction. The Court also upheld a gross valuation penalty since the taxpayer's deduction exceeded by more than 200 percent the valuation attributed to the easement by the only expert testifying at trial, that of the IRS.

In *Partita Partners, LLC v. U.S.*, No. 15-cv-2561 (S.D.N.Y. 2016) the Southern District granted summary judgment to the IRS which disallowed a $4.19 million deduction for a conservation easement relating to a historic façade. The Court found that the easement exception in this case, which permitted additional floors to be build, conflicted with the requirement that the historical façade preserve the "entire exterior of the building."

Courts' hostility to allowing deductions for conservation easements was again reflected in *Mecox Partners LP v. U.S.*, No. 11-cv-8157, where the Southern District, per Judge Ramos, upheld a motion for summary judgment made by the government, finding that the failure of the taxpayer to file a deed recording the easement pursuant to NY ECL § 49-0305 had resulted in there being no "qualified conservation contribution."

Trust Deduction Depends Upon Strict Adherence to Terms of Governing Instrument

IRC Section 642(c)(1) authorizes a trust to deduct charitable distributions made pursuant to the terms of the governing instrument. In *Hubbell Trust v. Com'r,* T.C. Summ. Op. 2016-67, despite an order from the probate court authorizing the trust to make the distribution, the Tax Court found that since the trust had not yet terminated, the trustees were without power to make the distributions, and thus agreed with the IRS that the deduction should be disallowed.

No Good Deed of Executor Goes Unpunished

In *Singer v. Com'r*, T.C. Memo 2016-48, the executor found that the testamentary estate could not satisfy all claims against the estate, including unpaid federal income taxes of $4 million. An order was obtained from the surrogate's court restraining claims against some property in the estate. The executor also sought to void a transfer of real property which passed by operation of law. The IRS filed a proof of claim for $3 million and eventually settled for $1 million. The surrogate's court vacated the restraining order, and the executor made distributions to the decedent's spouse, to the IRS, and to the New York State Department of Taxation.

The IRS objected to the amounts paid to the spouse and to the Department of Taxation, arguing that the settlement covered only the income tax, that estate tax was still owed, and that the distributions rendered the estate "insolvent." The Tax Court disagreed, reasoning that under EPTL § 2-1.8(a), federal and state estate tax was apportioned equally among beneficiaries. Thus, the estate had a right to indemnification for the estate taxes and therefore was not insolvent.

The IRS and New York often find themselves in an adversarial position with respect to unpaid taxes. Here, the IRS claim against the executor appears unseemly, since the payment of taxes to New York reveals the antithesis of venality.

IRS Successfully Litigates Family Partnership Cases

Attempts to utilize family partnerships to avoid estate tax continues to vex the IRS and the Tax Court. In *Estate of Beyer v. Com'r*, T.C. Memo 2016-183, the partnership agreement was left blank in many places where one would expect to find information concerning contributions as well as the names of partners. Assets were transferred to the partnership shortly after its formation, and then sold to an irrevocable grantor trust in exchange for a promissory note. The Tax Court found that the assets in the trust were includible in the decedent's estate under IRC §2036(a)(1) since there had been no bona fide sale for adequate and full consideration. Citing *Stone v. Com'r*, T.C. Memo 2003-309, the Court held that the bona fide sale exception was inapplicable since there was no "legitimate and nontax purpose" for creating the family limited partnership.

In another case involving family partnerships, *Estate of Holliday v. Com'r*, T.C. Memo 2016-51, the Court rejected a claimed valuation discount of 34 percent for marketable securities transferred to a family partnership. Here the court found an implied agreement that the decedent would continue to benefit from assets transferred to the partnership. The Court found no legitimate nontax reason for the transfer. The Court also noted in its decision that the partnership had failed to maintain books and records.

Tax Court Allows Deduction Attributable to Madoff Losses

In *Estate of Heller v. Com'r*, 147 T.C. 11 (2016), the estate claimed a deduction under IRC §2054 for losses incurred through an LLC which owned assets in an account maintained by Bernard Madoff. The IRS disallowed the deduction claiming that the LLC rather than the estate suffered the loss. The Tax Court held for the estate and granted summary judgment. The Court found that the connection between the theft and the interest of the estate was direct and that the loss did indeed "arise from" theft, as required by Section 2054.

Tax Court Finds IRS May Assess Interest on Settlement Amount

In *Estate of La Sala v. Com'r*, T.C. Memo 2016-42, the IRS sought statutory interest of $137,752 on a deficiency stipulation agreed to by the parties in a Tax Court proceeding. In rejecting the taxpayer's argument that the stipulation was merely a notational amount, the Court found that the stipulation reflected an actual gift tax liability on which interest was due.

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Inattentive Executor Cannot Rely on Assurances From Neglectful Attorney

The Sixth Circuit Court of Appeals, in *Specht v. U.S.*, 2016 WL 5219881 upheld late filing penalties where an unsophisticated executor (a high school educated homemaker) who, despite receiving notices from the local probate court of missed deadlines — and assurances from her attorney (suffering from brain cancer who was subsequently forced to give up her license) that matters were being attended to — failed to timely file or pay estate tax of about $6 million on an estate exceeding $12 million.

The Court, while noting that the executor had received "staggeringly inadequate counsel" and had not intentionally sought delay, nevertheless upheld summary judgment to the IRS made by the District Court. The Court cited to the Supreme Court in *U.S. v. Boyle*, 469 U.S. 241 (1985), which held that reliance on an attorney cannot trump an unambiguous statute. The Sixth Circuit distinguished other cases where the executor was under a disability, thus implicitly if not explicitly suggesting that the result might be different if an executor (rather than the executor's attorney) were under a severe disability. (In such a case, the executor would not be violating the familiar maxim that filing a return is a non-delegable duty.)

Tax Court Rebuffs IRS Challenge Based in Part on Technical Grounds

The IRS challenged the taxpayer's appraisal for a charitable deduction relating to donated land in *Cave Buttes, LLC v. Com'r*, 147 T.C. ___ (9/20/2016), claiming that the taxpayer had not substantially complied with Form 8283 ("Noncash Charitable Contributions"). The Tax Court held for the taxpayer, finding that the appraisal was indeed a qualified appraisal, despite the fact that only one appraiser had signed the appraisal, rather than two, noting that Form 8283 provided only one signature line.

On a more substantive note, the Court rejected the IRS claim that the property was not sufficiently described, noting that a description including the address and particulars was sufficient to apprise the IRS of what was being contributed.

The Tax Court went further: In preparation for trial, the taxpayer had obtained another appraisal. Finding that the new appraisal was more accurate than the one originally obtained by the taxpayer, the Court allowed the original deduction, as well as an additional $667,000 deduction based on the appraisal obtained for trial.

The Tax Court may have been incensed with the officiousness of the IRS given the fact that the taxpayer had contributed land worth $2 million to local Flood Control District for $735,000, after the District expressed reluctance concerning the taxpayer's intention to develop land close to a dam. In accepting the appraisal of the taxpayer, the Court noted that the highest and best use of the property was residential, implicitly finding that the taxpayer had indeed acted benevolently in selling the property for less than half of its worth instead of developing it.

IRS Successful in Challenges to Charitable Donations

The Tax Court in *Beaubrun v. Com'r*, T.C. Memo 2015-217 agreed with the IRS and upheld a denial $10,026 in charitable deductions made to a church, finding that a cancelled check did not satisfy the requirement under IRC §170(f)(8)(C) for a contemporaneous written acknowledgment for donations more than $250, since a cancelled check could not show that no goods or services were received by the taxpayer.

Also, the written acknowledgement furnished by the church was not contemporaneous because it was provided more than four years after the donation was made. The Court sustained an accuracy-related penalty under Section 6662.

Similarly, in *French v. Com'r*, T.C. Memo 2016-39, the deduction of $350,971 for a conservation easement donated to a charity was disallowed in part because the taxpayer had not provided a contemporaneous written acknowledgment under IRC §170(f)(8).

Apparel Required For Work is Not a Business Expense

The Tax Court agreed with the IRS that an employee of Ralph Lauren could not deduct the cost of apparel required by the company while working. A negligence penalty imposed by the IRS was upheld. *Barnes v. Com'r*, T.C. Memo 2016-79.

7th Circuit Reverses Tax Court on Hobby Loss Finding

The Tax Court, in *Roberts v. Com'r*, 820 F.3d 247 (7th Cir. 2016) applied an expansive list of factors found in Regs. §1.183-2 in finding that an entrepreneur's foray into horse racing constituted a hobby rather than a business. The evidence though did reveal that taxpayer had indeed devoted substantial time and energies to the activity.

The Seventh Circuit, on appeal, reversed, finding that the nine factors articulated a test that was "open ended," and suggested that rather than "wading through" nine factors, it might be preferable to acknowledge that an activity known to attract persons pursuing a hobby rather than a business be presumed to be a hobby, and then permit the taxpayer to rebut the presumption. Reaching a conclusion opposite to that of the IRS and District Court, the Seventh Circuit reversed.

Applying New York Law 2nd Circuit Finds for Taxpayer

In *Alphonso v. Com'r*, T.C. Memo 2016-130, the taxpayer-tenant deducted as a casualty loss the amount paid by the taxpayer to a coop board for a special assessment imposed by reason of the collapse of a retaining wall in a building in upper Manhattan. The Tax Court held for the IRS, finding that a casualty loss could be claimed by the coop but not by a tenant. The Second Circuit reversed, finding that under New York law, the taxpayer did have a property interest consisting of the right to use the grounds. (The matter was remanded to the Tax Court for a determination of whether a casualty loss actually occurred, or whether the collapse of the wall was simply the result of gradual weakening

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and not a casualty.)

Whether Marriage is "Lawful" For Federal Tax Purposes Turns on State Law

In *U.S. v. Windsor*, 133 S.Ct. 2675 (2015), the Supreme Court held that for all federal tax purposes the term of "husband and wife" means two persons lawfully married to one another. Whether two persons are lawfully married in turn depends upon the state in which the individuals reside. The regulations make clear that for federal tax purposes a union will not be considered a lawful marriage unless the state in which the union was consummated itself recognizes the union as a lawful marriage.

Taxpayer Cannot Benefit From Own Mistake at Expense of Treasury

The taxpayer in *Squeri v. Com'r*, 2016-16 had been under audit by the IRS for the tax years 2009, 2010 and 2011. Certain checks the taxpayer received in 2008 were not deposited until 2009. The IRS included in the calculation of the deficiency the 2008 checks in calculating the taxpayer's gross income for 2009. The taxpayer objected, arguing that the statute of limitations barred the inclusion of income relating to 2008. The Tax Court rejected the taxpayer's argument, finding that the "duty of consistency" precluded the taxpayer from benefitting from its own error, which in this case would allow the taxpayer to avoid payment of tax on $1.634 million of income.

Tax Court Finds Faults in IRS Interpretation of IRC §1041 Regs

Under IRC §1041, exchanges between taxpayers "incident to divorce" are not taxable. The term "incident to divorce" means that the transfer must occur within one year following the cessation of the marriage or be "related to the cessation of the marriage."

In *Belot v. Com'r*, T.C. Memo 2016-113, the issue was whether an agreement between ex-spouses entered into after the divorce, which called for payments from one ex-spouse to the other, was "incident to divorce." The IRS argued that the agreement was not incident to divorce because it was not part of the original settlement agreement. However, the Tax Court rejected the argument, noting that although the regulations provide for a presumption against the applicability of Section 1041 where the transfer was not pursuant to a written agreement, the regulations also provide that the presumption can be rebutted by showing that the transfer furthered the purpose of the original agreement.

Federal Appeals Court Reinstates View of Tax Court Involving Deduction Under IRC §1341

In *Naccio v. U.S.*, 824 F.3d 1370, the taxpayer upon losing an appeal involving insider trading, sought to claim a deduction under IRC §1341 for $18 million in taxes which he paid on the $44.6 million gain he had forfeited. Section 1341 allows an offset or deduction for amounts repaid to the government that had previously been included in income. The IRS disallowed the deduction on the grounds that the taxpayer's forfeiture constituted a nondeductible fine or penalty.

The Federal Circuit did reject the position of the Tax Court and found that the deductions — even if not allowed under IRC §1341 as the taxpayer had argued — were allowable as a loss under IRC §165. However, that finding provided no benefit to the taxpayer, since the Court of Appeals then cited the existence of a public policy exception to IRC §165, which did operate to disallow the deduction.

Innocent Spouse Relief

In *Boyle v. Com'r*, T.C. Memo 2016-87, the Tax Court granted equitable relief and abated penalties and interest relating to a tax return prepared by the taxpayer's deceased spouse, which had never been filed. Although the income related to income earned by the taxpayer's business, his deceased wife had deceived him concerning the filing of returns. The Tax Court decided that relief from the penalties was appropriate.

A contrary result was reached by the Tax Court in *Arobo v. Com'r*, T.C. Memo 2016-66. Here, returns prepared by the husband were filed only when the IRS began an audit. Ultimately, the IRS found $1.5 million in unreported income as well as unsubstantiated business expenses.

The Tax Court denied innocent spouse relief on the grounds that the spouse should have been alerted to a problem with the returns since the 2004 return reported a business loss of $58,000 at a time when the couple's standard of living was unchanged. The spouse seeking relief had thus enjoyed the windfall of avoiding "hundreds of thousands of dollars" in tax.

II. New York State Courts and Tax Tribunals

In *Matter of Sobotka*, DTA No. 826286, ALJ Galliher agreed with the taxpayer that since the residency statute provides that a statutory resident of New York is someone other than a "domiciliary," the time in which one is a domiciliary cannot be counted in determining whether one meets the 183-day test for determining whether one is a statutory resident. The case is surprisingly favorable, given that the taxpayer was challenging wording of the statute that has existed for years, and the issue is likely not one that existed before, even if not brought to the attention of a tax tribunal.

In any event, the decision was less important than it may seem, since it involved merely a motion for summary judgment which was denied since no evidence was submitted on the number of days the taxpayer was in New York. Further, decisions of the Division of Tax Appeals, the lowest administrative tribunal in the Division of Taxation, cannot be cited as authority in any tax dispute.

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vested in the transferee family member, even if the rights do indeed lapse with respect to the transferor.

Section 2704(b) disregards restrictions on liquidation, but only if the restrictions are more stringent than those imposed under state law. Thus, drafting an operating agreement which imposes restrictions not more stringent than under state law became a tool used by tax planners to effectively limit the applicability of the statute.]

The IRS has long fought a losing battle with taxpayers, who have been aided by their states, which have enacted default statutes operating to greatly attenuate the reach of Section 2704. Courts too have had little difficulty (or choice) handing victory to taxpayers since the taxpayer-friendly result was not ambiguous. Thus a virtual cottage industry has evolved specializing in achieving minority and lack of control valuation discounts.

Changes Involving Voting and Liquidation Rights

As noted, under current law, if the transfer of an interest in a family entity by parent to child for example results in the loss of the right of the parent to liquidate the entity, no lapse of liquidation rights occurs provided the child may participate in a vote to liquidate. So too, under current law, the transfer of an interest resulting in the former holder of the controlling interest no longer having a controlling interest would not trigger a lapse of voting rights provided the family member to whom the interest was transferred still maintained voting rights with respect to the transferred interest.

Under the proposed regulations, the existing rules would not apply to transfers occurring within three years of death, thus eliminating the discounts sought.

Changes Involving Applicable Restrictions

Under current law, only "Applicable Restrictions" more restrictive than state law are ignored in valuing interests in family entities. States (including New York) have been complicit with taxpayers in changing default statutes restrictive by default so that the taxpayer would not violate this restriction. For example, assume the operating agreement requires the approval of two-thirds of the partners for the partnership to liquidate. As long as that requirement is no more restrictive than that existing under state law, no lapse would occur.

Under the proposed regulations, it is no longer sufficient that the operative document contain restrictions no more restrictive than state law. The proposed regulations target any restriction limiting liquidation, and ignores that restriction, thus eliminating the valuation discount.

New "Disregarded Restrictions"

A new class of restrictions, called "Disregarded Restrictions" will apply to any restriction limiting the right of any interest holder to compel liquidation or redemption. For valuation purposes, since any family member owning an interest in the entity could liquidate or redeem the interest for its fair market value, no valuation discount would apply.

The proposed regulations also (i) specify when an outsider's interest in a family entity will be ignored for purposes of determining family control of the entity and (ii) expand on other rules relating to family control and attribution of ownership by family members to one another.

Legal Status of Proposed Regulations

Proposed regulations do not carry the force of law, but neither are they merely "guidance." They stand in a middle realm. While the Treasury has authority to implement regulations interpreting tax statutes, it may not legislate. Some have suggested that the proposed 2704 regulations go beyond merely interpreting 2704, and actually effectuate rules that create new legislation.

Since the proposed regulations act to decimate existing avenues of achieving minority and lack of control discounts, it will be interesting to see how taxpayer-friendly jurisdictions such as the Fifth Circuit in Texas and the Ninth Circuit on the West Coast interpret the proposed regulations. Ultimately, if Congress fails to act, the issue will be left to the courts to decide. Since any challenge to the regulations could take years to be litigated and reach federal courts of appeal, taxpayers should be aware that tax planning with valuation discounts now carries with it some risk, especially if the mandates of the proposed regulations are not strictly adhered to.

* * *

The Senate Finance Committee approved the Retirement Enhancement and Savings Act of 2016, S. 3471, 114th Cong., which proposed changes to minimum distribution rules. While under current law a designated beneficiary may calculate required minimum distributions based on his or her own life expectancy, the proposal would require payout in five years for non-spouse designated beneficiaries. The new rule would apply to that portion of an IRA whose account balance exceeded $450,000. Some exceptions would apply to certain beneficiaries, among whom include elderly or disabled persons. The provision would generate an estimated $3.18 billion over ten years.

* * *

Sales to intentional grantor trusts continued to attract the scrutiny of Treasury in 2016. Among the Administration's revenue proposals included one that would include in the gross estate of the grantor that portion of the trust attributed to a "sale, exchange, or comparable transaction," if the transaction was disregarded for income tax purposes. Given that sales to grantor trusts is conditioned on Revenue Ruling 85-13, which stated that sales to grantor trusts are ignored for income tax purposes, the rule would strike at the heart of a planning technique that has been in vogue for the past fifteen years. Chances for enactment under the new administration appear slim.

PLR 201614006 approved the creation of an irrevocable trust (an "ING" or intentional nongrantor trust)

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for the grantor's benefit where distributions to the grantor-beneficiary required to be approved by a majority vote of a distribution committee. The IRS found that the existence of the distribution committee resulted in the trust not being a grantor trust, and also found no taxable gift would occur upon contributions of the grantor to the trust since the grantor had retained the right to veto distributions to other beneficiaries.

These trusts had been used to avoid state income tax (New York enacted a statute to combat this), as well as to create self-settled spendthrift trusts for asset protection, while also avoiding the completion of a taxable gift when property was contributed to the trust. Interestingly, the IRS has approved these trusts even though they clearly interfere with various states' revenue collection regimes. This vividly shows the competing forces of Jefferson's philosophy emphasizing states' rights versus that of Hamilton which championed federalism.

President Trump Proposes Capital Gains at Death

President Trump has indicated that he favors repeal of the estate tax, installing in its place a capital gains tax at death on assets whose value exceeds $10 million. The capital gains tax at death has its adherents – Canada follows such a regime – but it poses basis determination difficulties. That is, many assets held in estates were likely acquired many years before the death of the decedent. Proving basis in this situation could be an insurmountable task. Furthermore, enacting a capital gains tax at death would likely result in efforts to transfer assets to younger family members, placing more pressure than may be warranted on the gift tax. It may be wise to eliminate the estate tax, since so few estates are now subject to it, but eliminating it only to impose a new capital gains tax at death would only create a labyrinth of new administrative problems for executors.

[The Obama administration floated a proposal that would also impose capital gains tax realized at death, but would allow a deduction on the estate tax return. Spousal bequests would be excluded from tax, but would receive a carryover basis. The decedent's estate would be given a $100,000 exclusion from tax for capital gains. The Section 121 exclusion from gain on sale of a residence would be liberalized. All residences, not merely the principal residences, would be covered, and the $250,000 exclusion would be portable.]

Consistent Basis Regulations

The Treasury issued lengthy proposed regulations containing guidance in the application of the consistent basis rules under IRC § 1014 (f), which requires estate beneficiaries to match their basis with that reported on the estate tax return. A key provision requires the executor to inform beneficiaries with a "transmittal letter" explaining the purpose of the schedule of assets included, and which identifies the values used for estate tax purposes. Beneficiaries must be expressly advised that the information is provided for tax reporting purposes. Prop. Regs. §1.1014-10. Taxpayers may rely on the proposed regulations until finalized.

Basis information will be reported on Form 8971. Required information includes the TIN of the beneficiary and a schedule of assets acquired from the decedent. Form 8971 would not be required by an estate below the filing threshold even if a return were filed for purposes of making the portability election.

Intentionally disregarding the requirement to report basis carries with it substantial penalties under IRC §§ 6721 and 6722 (*i.e.,* up to "10 percent of the aggregate amount of items required to be reported.") Accuracy-related penalties will be imposed IRC §6662 for underpayments due to reporting a basis higher than that reported under Section 1014(f).

Portability Elections and Requests For Extensions

The lifetime exclusion amount has increased to $5.49 million in 2017. The filing of an estate tax return is necessary to elect portability, even if the estate is not otherwise required to file the return. Therefore, an estate tax return is due nine months after the date of death, or at the expiration of an extension, even if the return is being filed only to make a portability election. Some estates have requested regulatory relief to file a late return electing portability. The IRS has been liberal in granting such requests, even where reliance on a professional, a requirement cited in the Regulations for § 301.9100 regulatory relief, is absent. See PLR 201648003 (among many).

Comment: The IRS has long disregarded a QTIP election if such an election was not necessary to reduce the estate tax to zero. With the advent of portability, it may now be prudent to elect QTIP treatment even in cases where there is an estate tax in order to increase the amount of the exclusion available to be ported to the estate of the surviving spouse. Revenue Procedure 2016-49 provides that in order to treat a QTIP election as void, the executor must provide documentation establishing that the QTIP election was not necessary to reduce the estate tax to zero and that no portability election was made. [QTIP elections will not be treated as void in several circumstances, including those where the QTIP election was a protective election, or in the case of some partial QTIP elections.]

Proposed Regulations Involving Charitable Contribution Deductions Abandoned

Proposed Regulations that would have dispensed with the requirement of a contemporaneous acknowledgment by the taxpayer for charitable contributions of $250 or more provided the donee organization itself furnished the same information in its return have been withdrawn after privacy concerns were voiced. The proposed regulations would have required that taxpayers furnish personal information, including social security numbers, to charitable organizations.

Court Order Correcting Designated Beneficiary Invalid For Federal Tax Purposes

In PLR 20628004, the decedent's financial advisor changed firms,

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which necessitated a change in paperwork relating to the decedent's IRAs. A new beneficiary designation form provided by the custodian named the decedent's estate as beneficiary. Following decedent's death, a declaratory judgment action was commenced by trustees of trusts created by the decedent, which sought an order modifying the beneficiary designation to reflect the decedent's intent. Although the court did grant the order requested, the IRS refused to give retroactive effect to the order, finding that since an estate cannot be a designated beneficiary of an estate for purposes of IRC §401 (a)(9), the order though valid under state law, could not be retroactive for federal tax purposes.

Non-Judicial Agreement Valid to Elect QSST Status

In PLR 201614003, the IRS approved a non-judicial agreement of interested parties to change the terms of a trust to meet the requirements of a Qualified Subchapter S Trust (QSST). Since the modification was proper under state law, the trust qualified as a QSST.

2017 Green Book Proposals

Under current law, the term "executor" now applies only for estate tax purposes. The Treasury has proposed expanding the license of the executor to also represent the decedent in income and other tax matters as well. The modification was sought because an executor handling issues relating to offshore voluntary disclosure may lack the authority to act in income tax matters. Dept. of Treas., "Green Book at 185" 2017.

The Treasury's 2017 "Green Book" proposed eliminating the current $14,000 gift tax annual exclusion to an unlimited number of donees, and replacing it with a single $50,000 annual exclusion, to be used as the donor wished. The proposal would prevent large wealth transfers utilizing many donations to different persons of up to $14,000. This proposal, as well as others contained in the 2017 Green Book may now have less significance under the new Administration.

II. New York State Matters

The exemption for New York decedent's estates through March 31, 2017 is $4.1875 million; then through December 31, 2018, the exemption becomes $5.25 million. On January 1, 2019, the New York exemption amount will track the federal exemption amount. It seems improbable that New York would abolish the estate tax, even if Washington does so. The rate of the New York estate tax reaches 16 percent on large estates.

Status of NY Estate Tax if Federal Repeal Occurs

Since the New York estate tax is inextricably tied to the federal estate tax, new legislation would appear to be required in order to retain the estate tax if the federal estate tax were repealed. Otherwise, the New York tax would appear to die on the vine. The word "appear" is intended to convey the possibility that a novel interpretation of the existing statute by the Department of Taxation could conceivably inject new life to a moribund statute.

For example, a technical reading of the statute could be interpreted to mean that a federal repeal does not automatically mean that the New York State estate tax is repealed. One could possibly argue that although the exemption amount is tied to the federal tax, repeal of the federal tax would not, by itself, invalidate the New York tax, but only create a vacuum where the exemption amount was uncertain. This strained reading of the statute would likely not prevail, even if advanced. Rather, actual legislative activity in Albany would appear to be required to resuscitate the New York tax.

* * *

Other Developments

Taxable gifts made within three years of death from April 1, 2014 through December 31, 2018, will be brought back into the decedent's estate for purposes of calculating the estate tax.

In 2018, income tax rates will be reduced to 6.33 percent for married taxpayers with income between $40,000 and $150,000; and to a slightly higher rate for taxpayers whose income exceeds $150,000 but is less than $300,000. Married taxpayers whose income is between $300,000 and $2 million will continue to be taxed at 6.85 percent.

A change in the sales tax laws now permits aircraft to be purchased sales tax free. In addition, the maximum value on which sales tax can be imposed on ships and yachts is now $230,000; any amount above that is not subject to sales tax.

Taxpayers with more than $10,000 in liabilities are subject to driver's license suspension. The unpopular program has yielded nearly $300 million in tax revenues for New York

* * *

New Jersey has repealed its estate tax effective January 1, 2018. For 2017, the state exemption is increased from $675,000 to $2 million.

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tion 215 grants the paying spouse a corresponding deduction. The alimony deduction is particularly favorable, being an above-the-line deduction which directly offsets adjusted gross income.

Nevertheless, merely designating a payment as "alimony" is not sufficient to invoke the tax treatment of Sections 71 and 215. For alimony payments (again, only those payments pursuant to divorce or separation agreements executed before 2018) to be deductible by the paying spouse for federal income tax purposes, the following requirements must be met:

A. Payment Must Be in Cash. The term "cash" includes currency, checks, or money orders payable on demand. Treas. Reg. §1.71-1T(b)(A-5).

B. Pursuant to a Divorce or Separation Agreement. For a payment to a former spouse to be treated as alimony, there must be an obligation to pay. That obligation may arise by a decree of divorce, or by an agreement for separate maintenance. IRC §71(b)(2). Payments made prior to the time an agreement or decree is executed or entered are considered voluntary payments, except if the Court issuing the decree makes the ruling nunc pro tunc. Rev. Rul. 71-416. Voluntary payments, even if they meet the other criteria for alimony, may not be treated as alimony.

C. Former Spouses Must Live Apart. IRC §71(b)(1)(C) provides that former spouses may not be "members of the same household" at the time of payment. Treas. Regs. §1.71-1T(b), Q & A-9 states that this requirement is only met if the former spouses live in separate dwellings. However, the requirement of separate dwellings applies only to divorced or legally separated spouses. Payments pursuant to a memorialized separation agreement or a support order can qualify as alimony even if the parties live in the same dwelling. IRC §§71(b)(2)(B), (C).

D. Payments to Third Party Must be Evidenced by a Writing. Payments on behalf of the payee spouse may qualify as alimony. For example, cash payments of rent, mortgage, tax or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony, provided the other requirements for alimony have been met. Such payments must be made at the written request, consent or ratification of the spouse for whom such payments are being made. Treas. Regs. §1.71-1T(b), Q & A-7.

E. Payments Must Cease Upon Death of Payee Spouse. IRC §71(b)(1)(D) provides that for a payment to be defined as "alimony," there must be "no liability to make any such payment for any period after the death of the payee spouse and . . . no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse." Thus, divorce instruments establishing alimony payments should clearly state that the duty to pay alimony is terminable upon the death of the payee, and that there shall be not be substitute payments in cash or property following the death of the payee. Note, however, that there is no corresponding limitation with respect to the payor spouse: The payor's estate may continue to be obligated under the terms of the divorce agreement.

F. There Must Have Been No Non-Alimony Election. Even though payments will fail to qualify as alimony if the requirements are not met, and therefore the parties may essentially elect non-alimony treatment by not complying with the sundry statutory requirements, the parties may also affirmatively elect non-alimony treatment. Furthermore, Treas. Regs. §1.71-1T(b), Q & A-8, states that if a written separation agreement or temporary order providing for alimony payments fails to state that the parties do not desire non-alimony treatment, they may nevertheless do so by the expedient of executing a signed writing at a later time referencing the original divorce agreement and clarifying that non-alimony treatment is desired under Sections 71 and 215.

G. Payments Must Not be for Child Support. IRC §71(c)(1) provides that payments to a recipient spouse will not be treated as "alimony" to the extent that any portion of that payment is fixed as a sum payable for the support of the children of the payor spouse. Treas. Regs. §1.71-1T(c), Q&A-16 provides that a payment is fixed as payable for the support of a child if the divorce agreement specifically designates some sum or portion as payable for the support of a child. Where a contingency relating to the child reduces a payment, the payment may also be designated as child support. Treas. Regs. §1.71-1T(c), Q&A-17 provides that a contingency relates to a child if it depends on any event relating to that child, regardless of whether such event is certain or likely to occur. Events that relate to the child include a child reaching a certain age or income level, marrying, graduating or departing from school, death of the child, or leaving the spouse's household.

H. Six Month Presumption. Treas. Regs. §1.71-1T(c), Q&A 18 provides a presumption that payments ending within six months of an identifiable contingency relating to the child will be considered as child support. To avoid the presumption, the parties may purposely state that the reduction is not conditioned on a contingency relating to the child.

I. Alimony Payments Must Not Be Not "Front Loaded." IRC §71(f) provides a formula for recapturing as income payments that diminish rapidly after the first year. Those payments are recharacterized as being non-deductible for the payor, and not includible for the payee. Recharacterization is intended to discourage divorcing parties from attempting to gain a tax benefit in the form of a deduction for the payor, from property transfers that would otherwise have no income tax consequences. Recapture can be avoided if payments diminish by no more than $15,000 in each of years two and three.

II. Taxation of Divorce Agreements Executed After Dec. 31, 2017

Payments made pursuant to divorce or separation agreements executed after December 31, 2017 are no longer deductible to the payor spouse

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and includible in income of the payee spouse. The impact of the loss of the deduction will in most cases result in a tax benefit to the payee spouse and in a significant tax detriment to the payor spouse. Although the legislative intent for repeal is not entirely clear, repeal will result in modest — although not staggering — increased tax revenues to the Treasury of approximately 6.9 billion over ten years. Congress also apparently felt that the generous tax treatment to divorcing spouses was excessively lenient when compared to the tax treatment of payments between married spouses, describing the favorable tax treatment as a "tax subsidy" to divorcing spouses.

The question arises whether repeal would apply to prenuptial agreements executed prior to 2018. The answer is fairly clear, and not helpful to the payor spouse. Since a prenuptial agreement merely defines the legal rights and responsibilities in the event of a separation or divorce – but does not itself constitute a separation or divorce agreement – it would appear that such agreements would not serve to insulate divorcing spouses from the effects of the new tax law repealing the alimony deduction. The issue is less clear with respect to postnuptial agreements, especially if the agreement were executed at a time when the spouses were actively contemplating divorce.

One silver lining to the payor spouse would occur if the drafter had included a severability provision in the prenuptial agreement. Such a provision — common in many legal agreements — typically provides that if the purpose of the agreement can no longer be achieved due to a change in the law or a change in circumstances, the agreement can be modified. Such a provision might enable the payor spouse to renegotiate the terms of the agreement so as to mitigate the harsh tax result occasioned by repeal.

III. Tax Planning After Repeal

One fairly straightforward means of dealing with repeal of the alimony deduction would be to factor in the increased tax cost to the payor, and reduce the alimony payment to adjust for the loss of the deduction to the payor, and the corresponding benefit accorded to the payee by not being required to include the payment in income. The algorithms involved might rely on fluid assumptions which could end up only partially resolving the perceived problem.

Another means of dealing with the change in the tax law would be to attempt to achieve a just result via a property transfer subject to IRC § 1041 — and avoid alimony completely. The risk is that the Service could attempt to recharacterize a purported property settlement as alimony. Local law would be relevant in determining whether transfers constituted alimony or merely property transfers which might afford the divorcing spouses greater latitude in mitigating some of the harsh tax results of the repeal.

One built-in benefit of attempting to structure a settlement as a property settlement rather than alimony is that prior to repeal, the position of the Service would be to strictly apply the conditions for a payment to constitute alimony. Now the situation has been reversed — it is no longer of benefit to the IRS that the payment be deemed not to qualify as alimony. Thus, the IRS may be the difficult position of arguing that payments which it formerly argued did not constitute alimony, are now do constitute alimony.

Thus, making nontaxable property transfers the paramount goal when structuring divorce settlement in order to completely avoid alimony may be particularly inviting. Although again, this endeavor is not without its own risk if the IRS succeeds in recharacterizing the property transfer as disguised alimony.

A. Property Transfers Between Divorcing Spouses

The Code addresses the issue of whether property transfers between divorcing spouses are subject to income tax, or are gratuitous transfers potentially subject to gift tax. In general, Congress has decided to grant divorcing spouses a tax pass. With proper planning, most transfers between divorcing spouses should not result in income tax liability, nor should they result in the transfer being subject to the gift tax.

Note that we are not speaking of alimony or child support *payments*, which indeed have income tax consequences, but rather the taxation of *property transfers* between divorcing spouses, such as the transfer of a marital residence, which would otherwise result in a sale or exchange under IRC §1001(a), resulting in capital gain under IRC §1221 if the property is a capital asset, or ordinary income under IRC §61, if it is not. IRC §61(a) imposes income tax on all income from whatever source.

B. IRC § 1041 Narrowly Defined.

It should be noted that IRC §1041 applies only to transfers between spouses and divorcing spouses *themselves*. Thus, the transfer by one spouse of shares of a closely held family entity would not be within IRC §1041 and would result in a sale and exchange with the normal attendant requirement of reporting capital gain or ordinary income on the exchange, depending upon the nature of the property transaction.

Section 1041 also overrides some other tax rules. For example, Rev. Rul. 2002-22 held that the assignment of income doctrine is inapplicable with respect to transfers of nonstatutory stock options or rights to deferred compensation between divorcing spouses. Instead, IRC §1041 dictates the counterintuitive tax result that the recipient spouse will be taxed when the options are exercised or the deferred compensation is received.

C. Transfer of Property Defined.

A "transfer" of property occurs either when there is a transfer of title or a shift of the benefits and burden of ownership. IRC §1041 includes all property in the marital estate that is transferred between spouses because of divorce. Property cannot be selected for Section 1041 treatment because this section is mandatory for all transferred property. In *Grodt & McKay Realty, Inc.*, 77 T.C. 1221 (1981) the Tax Court stated that when considering whether a transfer has occurred for tax purposes, the Service is not limited by the four corners of any

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particular agreement, but instead must consider all surrounding circumstances, including the terms of any side agreements or related contracts.

D. Factors to be Considered.

The Tax Court listed the following factors that should be considered in determining whether there has been a sale: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity is acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.

D. Nonrecognition Extends To Divorced Spouses

Section 1041(a) provides that no gain or loss is recognized on the transfer of property between spouses. Section 1041(a)(2) adds the same benign rule to **former spouses**, provided the transfer is **"incident to divorce."** Section 1041 provides that no gain or loss is recognized on a transfer of property from a spouse or a former spouse to a spouse or former spouse if the transfer is incident to a divorce. The tax treatment described by this section is mandatory and applicable to U.S. citizens and resident aliens. The parties cannot elect out of it. The section is applicable even if the spouse or former spouse pays consideration for the property by giving up rights, transferring other property, or paying cash.

IV. Meaning of Term "Incident To Divorce" As Gleaned From Code and Regulations

IRC §1041(c) Safe Harbor. For a transfer to "incident to divorce," IRC §1041(c) provides that the transfer must occur "within 1 year after the date on which the marriage ceases," **or much more liberally,** that the transfer **(merely be) "[be] related to the cessation of the marriage."** Since the one year safe harbor rule may be difficult to meet, the cynosure must often be on whether the requirement that transfer be "related to the cessation of the marriage" has been satisfied.

Treasury Regulations View of Term Related to Cessation of Marriage." Treas. Reg. §1041-1T, Q & A 7 provides that a transfer of property "is treated as related to the cessation of the marriage if the transfer **is pursuant to a divorce or separation agreement**[1]**. . .and the transfer occurs not more than 6 years after the date on which the marriage ceases."**

Presumption Arises Against Taxpayer if Transfer Not Within 6 Years. The Regulations add that "any transfer not pursuant to a divorce or separation agreement and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage.

Rebuttal of Presumption. The presumption may be rebutted by proof showing that the transfer was not made within the prescribed time period because of factors which "hampered an earlier transfer . . . such as a legal or business impediment," and that transfer was "effected promptly after the impediment to transfer [was] removed."

IRC §1041(c) Inconsistent With Regulation. Treas. Reg. §1.1041-1T[2], Q & A 7 appears to impose a stricter definition of "incident to divorce" than IRC §1041(c) – the statute itself – for the first year after cessation of the marriage by creating a presumption that a property transfer not pursuant to a divorce or separation agreement is not related to the cessation of the marriage.

Administrative Regulations. Since IRC §1041 does not expressly direct the Treasury to implement regulations in furtherance of the statute, the Regulations under Section 1041 are "administrative regulations." Administrative regulations are less authoritative than legislative regulations[3] which are drafted by Treasury pursuant to a directive contained within the statute itself. In addition, it might be argued that regulations which appear as "questions and answers," as does Treas. Reg. §1041-1T, might be less authoritative than regulations not drafted in question and answer form.

Safest Course. The safest route for divorcing spouses would be not to rely on the language of Section 1041(c)(1) which blesses transfers between divorced spouses within one year as "incident to divorce," but to memorialize the transfer in a divorce or separation agreement in order to satisfy the stricter requirement found in the regulations.

IRC §1041(b). IRC §1041(b) places transfers not subject to income tax into a basket of transfers ***potentially*** subject to gift tax. Under the statute, the donee spouse acquires the basis as well as the holding period of the transferor, whether the adjusted basis is less than, equal to, or greater than, the fair market value of the property at the time of transfer. In other contexts, the basis of a donee is determined under Code Section 1015. This difference can be significant in the case of loss property. Where basis is calculated under Code Sec. 1015, the donee's basis for computing loss is limited to the lesser of (i) the fair market value of the property at the time of the gift or (ii) the adjusted basis of the property.

No Cost Basis if IRC §1041 controls. Even if the transfer constitutes a *bona fide* sale, in a transaction governed by Code Sec. 1041 the transferee does not acquire a cost basis in the transferred property. Treas. Reg. §1.1041-1T(c).

Change in Character of Property. Taxpayers should be aware that a 1041 exchange may cause side effects, such as a change in the character (as a capital asset or not). For example, assume wife, who owns a Monet sketch which she holds for investment, as part of the divorce agreement, sells the Monet to her husband, who is an art dealer. If the husband later sells the painting at a gain, the gain will be taxed as ordinary income under IRC Section 1221(1).

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Had wife sold the painting, the gain would have been capital gain. The reverse of this is also true: The character of the property in the event of a later sale or exchange can transmute from ordinary income to capital gain as well.

Recordkeeping. A transferor is required at the time of §1041 transfer, under Treas. Regs. §1.1041-1T(e), Q & A-14, to provide to the transferee sufficient records to determine the adjusted basis and holding period of the property as of the transfer date.

V. Tax Planning For Nontaxable Spousal Transfers

Despite the lack of current tax consequences when intra-spousal transfers are made pursuant to a divorce, tax planning is nevertheless important. If marital assets consist of properties with varying degrees of appreciation, equity would suggest that each party receive a mix of property with the same relative degree of built-in gain. If this is not possible (*e.g.,* one spouse retains the personal residence with a higher basis), the parties may wish to compensate the spouse who takes the lower basis property since the sale of that property will generate future capital gains tax.

That compensation would not be gratuitous, and would therefore not be subject to gift tax. If the requirements of IRC §1041 were met, that compensation would also not be subject to income tax. Nonrecognition of both gain and loss under §1041 may be utilized by spouses in different marginal tax brackets to obtain overall tax savings by allocating higher gain assets to the lower bracket spouse and lower gain assets to to the higher-bracket spouse. Even where spouses are in the same marginal income tax bracket, the ability to assign potential gains and losses between themselves may be advantageous.

Examples:

1. A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer which is subject to the rules of Code Sec. 1041. Treas. Reg. §1.1041-1T(a).

2. A and B are married and file separate returns. A is the owner of an independent sole proprietorship, X Company. In the ordinary course of business, X Company makes a sale of property to B. This sale is a transfer of property between spouses and is subject to the rules of Code Sec. 1041. Note however that if X Company were instead a corporation owned by A, the sale would not be a sale between spouses subject to the rules of Code. Sec. 1041, unless the step-transaction doctrine were invoked. Treas. Reg. §1.1041-1T(a).

3. Taxpayer and spouse enter into a legal separation agreement, the terms of which require the taxpayer to transfer to spouse certain low-basis real property worth approximately $30,000. Taxpayer transfers the real estate, pursuant to the agreement, four years after the final divorce papers are approved by the Court. No gain is recognized. The transfer is related to the cessation of the marriage since it was made pursuant to a divorce or separation instrument and occurred within six years after the date in which the marriage ended. Treas. Reg. §1.1041-1T(b), Q & A # 7. If, however, the transfer occurred seven years after the divorce became final, the transfer would be presumed not to be related to the cessation of the marriage, a presumption that could be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.

4. Taxpayer and spouse own as equal tenants in common a condominium in New York City which has appreciated since it was purchased for $100,000. They are contemplating divorce. Taxpayer sells his interest to spouse for $500,000 in an arm's length transaction. If taxpayer had sold the interest to an outsider, he would have recognized $450,000 of gain. The sale is within Code Sec. 1041, since a "transfer" includes not only a gift, but a sale as well. However, the spouse takes the entire property with a basis of only $100,000. Treas. Reg. §1.1041-1T.

5. Taxpayer and spouse are getting divorced. In structuring their division of property, they should take into account the basis of each item. The division should, if practicable, reflect the bases of all property. If one spouse receives most of the high basis property and the other receives the low basis property, the parties may wish to make an adjustment so that the transferring spouse pays a portion of the capital gains tax to which the property is or may become subject to in the hands of the spouse who acquires predominantly low basis property.

6. Taxpayer decides to elope with her fiancé. However, after a month of marriage, they are advised by their attorney that their marriage in Tahiti was void *ab initio* under New York State law. They decide that the marriage was not meant to be, and part ways. The taxpayer permits his former fiancé to keep a rental apartment, which he owns. The cessation of a marriage that is void *ab initio* under state law is nevertheless considered a divorce within the meaning of Code Sec. 1041. The apartment is treated as a transfer incident to divorce under Code Sec. 1041 from the taxpayer to his former fiancé, who will take a transferred basis in the apartment. Treas. Reg. § 1.1041-1T(b), Q&A #8.

7. Wife owns rental property in Hilton Head worth $300,000 which has been fully depreciated. Wife and husband are contemplating divorce. Wife proposes to sell her interest in the rental property to husband for $225,000 in exchange for his promise not to contest the divorce. Wife would incur a capital gains tax of $75,000 if she sold the property (*i.e.*, unrecaptured Code Sec. 1250 gain taxed at 25 percent; Code Sec. 1(h)(1)(B). The transfer as contemplated would be within Code Sec. 1041 and the wife would not recognize income. The property would be treated as a gift to the taxpayer's spouse, who takes a carryover basis, which is zero. Husband accepts the offer. Since husband will have no depreciable basis he could consider reselling the property for its fair market

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value of $300,000, payable in installments over ten years, and reporting the gain using the installment method. Since the property was previously depreciated on a straight-line basis, the property would not be subject to "excess" depreciation recapture under Code Sec. 1250. Each year, husband would report $30,000 of capital gain, and would incur a capital gains tax of $7,500. The $22,500 in after-tax cash flow could more than cover the mortgage payments for new rental property. New rental property would also provide depreciation deductions that would offset rental income.

8. Taxpayer and spouse execute a separation agreement. Pursuant to the terms of the agreement, taxpayer is to transfer the marital residence to spouse. The basis of the residence is $100,000, and its fair market value is $1,100,000. Prior to transferring the property, the taxpayer takes out a home equity loan of $1,000,000. Under Code Sec. 1041, since the transfer is incident to divorce, no gain or loss is recognized. This is true even though the equity loan may have been motivated by a desire to reduce income taxes. *See* Treas. Reg. §1.1041-1T(d).

9. Husband owns a rental apartment with a basis of $500,000 and a fair market value of $400,000. In 2013, Husband sells the apartment to Wife for $400,000. Since the transaction is governed by IRC Section 1041, Husband cannot deduct the loss. Wife takes a transferred basis of $500,000. If wife sells the apartment in a month for $375,000, she may deduct a $125,000 loss. Now assume the same facts except Husband gifts apartment to his son. If the son later sells the apartment for $375,000, his loss will be limited to $25,000 under IRC Section 1015(a).

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turn is filed for the year in which the transaction is completed. Rev. Proc. 2019-1, Sec. 1.01.

A taxpayer may ordinarily rely on a favorable determination letter provided (1) the conclusions stated in the letter ruling are properly reflected in the return; (2) the representations upon which the letter ruling was based reflect an accurate statement of the controlling facts; (3) the transaction was carried out substantially as proposed; and (4) there has been any change in the law that applies to the period during which the transaction or continuing series of transactions were consummated. Rev. Proc. 2019-1, Sec. 10.01.

However, a taxpayer may not "rely on, use, or cite as a precedent a determination letter issued to another taxpayer." Rev. Proc. 2019-1, Sec. 10.02. Despite this admonition, significant letter rulings are often cited by taxpayers and depending upon the context, are considered somewhat authoritative. It might be fair to say that a taxpayer who relies on a PLR does so at the taxpayer's own risk. If the facts and issue appear substantially identical, it would appear that the risk might be low.

The IRS will not issue a ruling with respect to an issue that cannot be resolved before the promulgation of a regulation or other published guidance, but may issue rulings where (i) the answer is clear or reasonably certain in light of "statute[s], regulations, and applicable case law; or (ii) where the answer does not seem "reasonably certain" but would be in the "best interest of tax administration." The IRS will not ordinarily issue letter rulings in certain areas because of the "factual nature of the matter involved." However, in some cases the Service may, in the interest of sound tax administration, issue an "information letter calling attention to well-established principles of tax law." Rev. Proc. 2019-1, Sec. 5.15.

The IRS will not ordinarily issue ruling letters to business organizations concerning the application of tax laws to members of the business, or to a taxpayer requesting a letter ruling regarding the tax consequences to a customer or client. The IRS will not issue a letter ruling regarding frivolous issues, the most obvious being frivolous "constitutional" claims. . Nor will the IRS issue a "comfort" ruling with respect to an issue which is "clearly and adequately addressed by statute, regulations, decision of a court, revenue rulings, revenue procedures, or other authority. . ." Nor will the Service rule on "alternative plans of proposed transactions or on hypothetical situations." No letter ruling will be issued if a pending case is in litigation or in Appeals or if the request involves an "industry-wide" problem." Rev. Proc. 2019-1, Sec. 6.08-6.14. A ruling request that may not be acted upon by reason of the return being in examination may, at the discretion of the IRS, be forwarded to the field office that has examination jurisdiction over the taxpayer's return. *Id.*

If the IRS declines to issue a ruling based upon the position that the issue is addressed by statute, regulations, or decisions, and the taxpayer believe that the facts do nevertheless warrant a ruling, it is appropriate and for the taxpayer to explain why existing law does not adequately address the issues raised.

A simplified method of obtaining ruling request exists for issues that are frequently raised by taxpayers. For example, Rev. Proc. 2017-34 provides a simplified method for obtaining a ruling request to seek relief in order to make a late reverse QTIP election pursuant to Section 2652. User fees are lower and response time is generally faster when seeking a ruling under a simplified method. The IRS also provides executors a simplified way to request an extension of time to make the "portability" election to transfer a deceased spouse's unused estate tax exclusion to the surviving spouse. Rev. Proc. 2014-18.

A letter ruling might be desirable where parties to litigation are desirous of the IRS position with respect to an agreement which has been concluded, or which is pending. It is not the policy of the Service to rule on hypothetical issues. Moreover, the IRS "ordinarily does not issue a letter ruling or determination letter if, at the time of the request, the identical issue . . . is pending in a case involving the taxpayer." However, the IRS may issue a ruling if there exists a settlement agreement or court order. Even then, rhe IRS may be unwilling to approve a request unless the parties concur in what the desired ruling should conclude. *See* Rev. Proc. 2019-1, Sec. 6.01.

Issues of privacy may also be a concern. Ruling submissions are redacted in documents available to the public. To assist the Service, in making the necessary deletions, the taxpayer must provide a "deletion statement" indicating the deletions desired." A taxpayer who wants only names, addresses and identifying numbers deleted should so state in the deletion statement. Rev. Proc. 2019-1, Sec. 7.12.

Disclosure of all facts may not be in the best interest of the taxpayer since disclosures made to the IRS may have been in vain if the ruling request is denied. Furthermore, even if the ruling request is approved, it may be revoked — even retroactively — if "controlling facts are misstated or omitted," or if the facts at the time of the transaction are materially different from the controlling facts on which the letter ruling was based. Rev. Proc. 2019-1, Sec. 11.02.

II. Pre-Submission Conference

A different vehicle for seeking advice prior to submitting an actual ruling request exists. This is a "Pre-submission Conference." Such conference may be requested by the taxpayer, but the decision to grant such conference is within the discretion of the Service. A pre-submission conference is held to discuss "substantive or procedural issues relating to a proposed transaction." The conference will be held only if the identity of the taxpayer is provided, and only if the taxpayer "actually intends" to make a ruling request. A request for a pre-submission conference may be made either in writing or by telephone. The request should identify the taxpayer and briefly explain the tax issue so that

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it can be assigned to the appropriate branch. Rev. Proc. 2019, Sec. 10.02.

III. Procedure For Ruling Request

The IRS publishes a Revenue Procedure in January of each year which details and updates requirements for obtaining a Private Letter Rulings. See, *e.g.,* Rev. Proc. 2019-1. A request for a letter ruling must provide a "complete statement of facts and other information," including the names, addresses, telephone numbers and taxpayer identification numbers of all interested parties. The request must provide (i) a description of the taxpayer's business; (ii) a complete statement of the business reasons for the transaction; (iii) a detailed description of the transaction; and (iv) all other facts relating to the transaction. Copies of all contracts, wills, deeds, agreements, instruments, trust documents, proposed disclaimers, and other documents pertinent to the transactions must be submitted with the request Rev. Proc. 2019-1, Sec. 7.01.

The ruling request must also be accompanied by an analysis of the facts and their bearing on the issue or issues. In practice, the "analysis" must be a comprehensive tax analysis, in effect citing persuasive authority for the requested ruling. In providing the required analysis, the taxpayer must provide a statement of both supporting and contrary authorities. That is, a particular conclusion espoused by the taxpayer must include an explanation of the grounds for that conclusion. Rev. Proc. 2019-1, Sec. 7.01.

Contrary authorities "should be brought to the attention of the IRS at the earliest possible opportunity." If there are "significant contrary authorities," they should be discussed in a "pre-submission conference" prior to submitting the ruling request. The rationale for the IRS request that the taxpayer provide a discussion of contrary authorities is that such disclosure will "enable Service personnel more quickly to understand the issue and relevant authorities." Rev. Proc. 2019-1, Sec. 7.01.

A "Sample PLR Request Format" and checklist appear in Rev. Proc. 2019-1. Adherence to the format shown will improve the likelihood of compliance with the procedural aspects of the ruling request. Rev. Proc. 2019, Sec. 7.01, Appendix B.

The taxpayer may also request that personal identifying information be deleted from public inspection, as private letter rulings are published by the IRS. The ruling request must be signed by the taxpayer or by the taxpayer's representative. Even if signed by the representative rather than by the taxpayer, the taxpayer must sign a statement under penalty of perjury attesting to the truth of the matters contained in the ruling request. Each ruling request must also be accompanied by the "checklist" found in the annual Rev. Proc. 2019-1, Sec. 7.01.

Ruling requests are processed "in the order of date received," but "expedited handling" will be accorded in "rare and unusual cases." A request for expedited handling must "explain in detail" the need therefor. A request for expedited handling is discretionary. The IRS may grant the request where a factor "outside a taxpayer's control" requires a ruling in order to avoid "serious business consequences." Rev. Proc. 2019-1, Sec. 7.02.

Examples provided by the IRS include situations in which a court or governmental agency has imposed a specific deadline for the completion of a transaction, or where a transaction must be completed expeditiously to avoid an imminent business emergency and the need for expedited handling resulted from circumstances that could not reasonably have been anticipated or controlled by the taxpayer. To qualify for expedited handling, the taxpayer must also demonstrate that the taxpayer submitted the request as promptly as possible after becoming aware of the deadline or emergency. . The scheduling of a closing date or a meeting of the board of directors or shareholders of a corporation will not be considered a sufficient reason to request expedited handling. Rev. Proc. 2019-01, Sec. 7.02

Within 21 calendar days after receiving a ruling request, the IRS will advise the taxpayer (1) whether the IRS will rule as the taxpayer requested, rule adversely on the matter, or not rule; (2) whether the taxpayer should submit additional information; (3) whether the letter ruling complies procedural requirements; and (4) whether, because of the nature of the transaction or the issue presented, a tentative conclusion on the issue cannot be reached. Rev. Proc. 2019-1, Sec. 8.01.

The IRS may also request additional information, which the taxpayer must submit within 21 days. A taxpayer is entitled to one "conference of right," which may either be by telephone or at the IRS in Washington. The IRS must notify the taxpayer of the time and place of the conference, which must then be held within 21 calendar days after this contact. It is preferable to avail oneself of the conference in Washington, where the taxpayer's representative will be able to more fully discuss the position of the taxpayer and perhaps elicit information that could increase the probability of a obtaining favorable ruling. Rev. Proc. 2019-1, Sec. 8.03.

The senior IRS attorney present at the conference of right "ensures that the taxpayer has the opportunity to present views on all the issues in question." At the conference, the IRS will explain its position, and the taxpayer will have an opportunity to advance its position. No tape, stenographic, or other recording of the conference may be made by either party. Following the conference, the taxpayer will have the opportunity to submit additional information or refine its legal arguments before the IRS issues a ruling. Rev. Proc. 2019-1, Sec. 10.02.

If following the conference of right it appears unlikely that the taxpayer will be obtain a favorable ruling, the ruling request may be withdrawn at any time before the letter ruling is signed by the IRS. However, in that case the IRS may notify by memorandum the examination division reviewing the taxpayer's return. If the memorandum provides "more than the fact that the request was withdrawn . . . the memorandum may constitute Chief Counsel Advice, as defined in IRC §6110(i)(1), and may be subject to disclosure. User fees will not be refunded where a ruling request has been with-

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drawn. Rev. Proc. 2019-1, Sec. 7.06.

The time frame for obtaining a ruling is generally about three months but can take a few months longer if the issues are complex or require the participation of several branches of the IRS. The policy of the Service is to issue a ruling within six months.

IRS attorneys are generally willing to informally discuss tax issues which could become the subject of a potential ruling request without the necessity of the representative disclosing the identity of the taxpayer. Staff attorneys may even discuss whether the Service will rule on particular issues and about procedural matters for a particular case. At the discretion of the Service and as time permits, Service employees may also discuss substantive issues with taxpayers or their representatives. Such a discussion will not bind the Service or the Office of Chief Counsel, and it cannot be relied upon as a basis for obtaining retroactive relief under the provisions of § 7805(b). Rev. Proc. 2019-1, Sec. 2.03.

IV. Effect of Letter Ruling

In theory, only a taxpayer receiving a positive letter ruling may rely thereon. A similarly situated taxpayer in a nearly identical factual situation could also reasonably rely on the ruling. In practice, tax professionals tend to rely on the substance of a letter ruling where the IRS appears to be making a statement of its position which could be applicable to other situations. For example, the IRS has on numerous occasions indicated in rulings that relief from erroneously made QTIP elections is available. It might therefore be reasonable to infer that the IRS might grant relief from an erroneously made QTIP election in a similar factual situation.

The IRS may also revoke, modify, or amend a previously issued ruling if the ruling is later found to have been issued in error, or if the ruling is "not in accord with the current view" of the IRS. Rev. Proc. 2018-1., Sec. 11. Ordinarily, where a taxpayer has been forthright in furnishing information, and a change in the law requires the IRS to revoke a ruling, the ruling will not be revoked retroactively. However, if the taxpayer has not provided correct facts, the Service may revoke the ruling retroactively. The IRS explicitly states in Rev. Proc. 2019-1, Sec. 10.08

If the taxpayer is under audit when the PLR request is granted, the IRS audit division must recognize the grant of the PLR request. However, the Field Office "must ascertain" whether (1) the conclusions stated in the letter ruling were properly reflected in the return; (2) the representations upon which the letter ruling was based reflected an accurate statement of the controlling facts; (3) the transaction was carried out substantially as proposed. Rev. Proc. 2019-01, Sec. 10.08.

V. User Fees

User fees apply to all requests for letter rulings. However, user fees do not apply to elections made pursuant to §301.9100-2, relating to automatic extensions of time, to late initial classification elections made pursuant to Rev. Proc. 2009-41, or to late S corporation elections. If a request concerning one transaction involves more than one fee category, only one fee applies, but that fee is the highest that would apply to any of the categories. Similarly, even though a request may involve several issues, only one fee will apply. Nonetheless, each entity involved in a transaction that requires a separate ruling in its name must pay a separate fee regardless of whether the transaction or transactions are related. Rev. Proc. 2019, Sec. 15.03.

User fees will generally not be refunded. However, if the only reason for withdrawal is by reason of a misapprehension by the taxpayer of the amount of the user fee, and the taxpayer is unwilling to pay the higher fee, the user fee will be refunded. User fees will not be refunded where the request is "procedurally deficient" and is not timely perfected. The IRS will however, refund a user fee where the taxpayer successfully asserts that the IRS has erred or been unresponsive to a ruling request. Rev. Proc. 2019, Sec. 15.08.

A Schedule of User Fees appears in Appendix A of Rev. Proc. 2019-01. A reduced user fee of $2,800 applies to a person whose gross income is less than $250,000; and a reduced user fee of $7,600 applies to a person whose gross income is more than $250,000 but less than $1 million. Substantially identical letter ruling requests will also qualify for user fee reductions, as will a request for certain common requests. The current user fee for "all other" PLR requests is $28,300. If more than one taxpayer would be affected by the ruling request, choosing that taxpayer (or beneficiary of a trust) whose income is least might save a substantial amount of money in terms of user fees. Of course, the preparation of a ruling request is time-intensive, since the IRS will reject submissions that do not strictly follow its guidelines for PLR requests.

VI. Section 9100 Relief

The time period provided for by statute cannot be extended, as those time periods are jurisdictional. For example, a taxpayer cannot seek a ruling request to extend the 90-day period in which to respond to a Notice of Deficiency. Regulatory time periods on the other hand, may be extended either automatically, as is the case with extensions to file income tax returns, or pursuant to regs Sec. 301.9100. A request for Section 9100 relief must be in the form of a private letter ruling request. The request may be made after a return has been filed, or while the return is under audit or the matter is being litigated. To obtain Section 9100 relief, the taxpayer must have acted in good faith and the relief should must now prejudice the government. The government is generally prejudiced, for example, if the PLR request to extend the period for making a regulatory election is made for a tax period in which statute of limitations for the tax period has closed. Rev. Proc. 2019-1, Sec. 4.01.

Correspondence

Correspondence may be mail,

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by Fedex (or other courier), or be hand delivered. Letter ruling requests may not be made by fax. The addresses for each are different, and are found in Section 7.04 of Rev. Proc. 2019-1.

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tion. The second phase, triggered when taxable income crosses a threshold, identifies businesses that are deemed tainted and imposes restrictions on deductibility the intensity of which increases linearly as taxable income rises by means of complex phase-out provisions and other "limitations." The third phase, which presents when the phase-in is complete, is actually simpler than the second, because it entirely disregards income from tainted businesses in arriving at the deduction. Depending on which phase their taxable income places them in, individuals either in "Stratum I" "Stratum II," or "Stratum III."

It is important to note that first, if net capital gains equal or exceed taxable income, no Section 199A deduction will be possible; and second, that taxable income for purposes of applying the Section 199A is taxable income as if Section 199A did not exist. Only after Section 199A determines a deduction will taxable income then be reduced.

II. Key Formulas

Although 199A is complex, breaking it down into components makes learning it easier. Thus, the operative provisions of the statute requiring arithmetic calculations can be expressed by six formulas. Each formula, however, is interdependent on other formulas, as well as definitions, concepts and other Code provisions.

Each will be summarized first in formula terms, and then expressed more fully in plain language. Although at first glance the formulas may seem abstruse, they will be illuminated by the discussion of the operative provisions of the statute, and examples, which follow. They are placed first because familiarity with the formulas and frequent reference to them will be made throughout.

Formula 1.

§199A Deduction = < of CQBI and .2(TI—NCG).

The 199A deduction equals the lesser of the combined QBI plus 20 percent of the difference between taxable income and net capital gains.

Formula 2.

CQBI = x + y, where x = QBI Component and y = .2(qualified REIT dividends + qualified PTP income).

The Combined QBI equals the sum of (i) the "QBI Component" and (ii) 20 percent of the sum of aggregate qualified REIT dividends and qualified PTP (publicly traded partnership) income.

Formula 3.

QBI Component = < x or y, where x = .2(QBI) and y = > m or n, where m = .5 x (W-2 wages) and n = [.25(W-2 wages) = .025(UBIA)].

The QBI Component equals the lesser of (i) or (ii), where (i) equals 20 percent of QBI and (ii) equals the greater of (a) and (b), where (a) equals 50 percent of W-2 wages and (b) equals the sum of 25 percent of W-2 wages and 2.5 percent of UBIA of qualified property.

The simplest way to perform this calculation is to determine the "greater of" calculation required by (ii) first. Once (ii) has been determined, calculate (i). The QBI Component is simply the lesser of (i) and (ii). Note that "greater of" calculation required by (ii) is also known as the "alternative limitation."

Formula 4.

Reduction Amount = Excess amount x (TI —Threshold Amount) ÷ Phase -in Amount.

The Reduction Amount equals the *quotient* of (i) and (ii), where (i) equals the *product* of (x) and (y), where (x) equals the Excess Amount and (y) equals the difference between Taxable Income and the Threshold Amount, and (ii) equals the Phase-in Amount. In performing this calculation, first determine (y), then (i). The Reduction Amount is (i) divided by (ii).

Formula 5.

Excess Amount = x—y, where x = .2(QBI) and y = > m or n, where m = .5 x (W-2 wages) and n = [.25 (W-2 wages) = .025(UBIA)].

The Excess Amount equals the difference between (i) and (ii), where (i) equals 20 percent of QBI, and (ii) equals the greater of (a) and (b), where (a) equals 50 percent of W-2 wages and (b) equals the sum of 25 percent of W-2 wages and 2.5 percent of UBIA of qualified property. Note that "greater of" calculation required by (ii) is also known as the "alternative limitation."

Formula 6.

Applicable Percentage = [1 - (TI—Threshold Amount)] ÷ Phase-in Amount] x 100

The Applicable Percentage equals [(a) - (b)] x 100, where (a) equals 1 and (b) equals the quotient of (i) and (ii), where (i) equals taxable income minus the threshold amount, and (ii) equals the phase-in amount.

Here, find the difference between taxable income and the threshold amount, determine the fraction, subtract the fraction from 1, and multiply 100.

III. Operative Provisions

The above calculations reference new terms, all of which express themselves around the central concept of Section 199A, which is qualified business income or QBI. Individuals who qualify for the 199A deduction include S Corporations, partnerships, sole proprietorships, nongrantor trusts, and estates.

Every individual who may be entitled to claim a deduction under Section 199A is categorized into a "Stratum I," "Stratum II," or "Stratum III" individual. It is immediately apparent from Formula 1 that whether an individual is in Stratum I, II or III, since the deduction is the lesser of (i) the Combined QBI or (ii) 20 percent of taxable income less net capital gain, that if taxable income less net capital

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gain is zero, the individual will have no Section 199A deduction.

Qualified Business Income (QBI)

QBI is the "net amount of *qualified* items of income, gain, deduction and loss with respect to any qualified trade or business." QBI must be "effectively connected" with an active U.S. trade or business. Code Sec. 864 (c) applies in determining whether income is effectively connected, and Section 162 is employed in determining whether the trade or business requirement is satisfied. The regulations provide that QBI cannot be less than zero.

The terms "income" and "qualified" have their own meanings for purposes of Section 199A. Income is good for purposes of 199A, as it increases the deduction. For income to be "qualified" several hurdles must be surmounted for the income to be qualified under the statute.

"Income" as Defined in Sec. 199A

"The term "income" for purposes of 199A also includes other items not normally associated with income for federal income tax purposes. These include (i) gain or loss in partnership transactions involving unrealized receivables or inventory of a partnership resulting in ordinary income ("hot assets"), (ii) Section 481 adjustments after the 2017 tax year, (iii) previously disallowed deductions or losses attributable to tax years before 2018, and (iv) NOLs disallowed under Section 461.

Certain items which normally constitute income are excluded for purposes of 199A. Note that since income fuels the Section 199A deduction, the exclusion will work to reduce the deduction.

[Excluded items include (i) Capital gains, (ii) dividends, (iii) interest income; (iv) short and long term capital gains and losses, including Section 1231 gains and losses; (v) gains or losses from foreign commodities transactions or foreign currency gains; (vi) notional principal contracts unless qualifying under Section 1221 (a)(7); (vii) annuity amounts that are not received in connection with a trade or business; (viii) qualified REIT dividends; (ix) qualified PTP income; (x) reasonable compensation paid by an S Corporation to a shareholder, (xi) guaranteed payments to partners under IRC Sec. 707(c) for services rendered to the partnership business; and (xii) payments to a partner for services rendered in a capacity other than as a partner other than as a partner.]

Reasonable compensation paid to a shareholder of an S Corporation, as well as guaranteed payments made to a partner, or payments made to a partner for services rendered in a capacity other than as a partner will reduce QBI. However, reasonable compensation paid to partners will not reduce QBI, since partners can never be an employee of a partnership.

"Individual"

Treasury regulations state than an "individual" for purposes of Section 199A are the owners of the pass-through entities that do not themselves pay tax, these entities being S Corporations and partnerships. Individuals for purposes of the statute also includes nongrantor trusts and estates. The regulations employ the term "relevant pass-through entity" or RPE, to describe an entity operating as a trade or business and which passes through qualified income to an individual.

Relevant Pass Through Entity (RPE)

A "relevant passthrough entity" for purposes of Section 199A is an entity that directly operates a trade or business or one through which passes through items of income, gain, loss, or deduction from lower-tier RPEs to the individual. QBI is determined at the shareholder or partner level. Neither the inside basis of a partner's interest in the partnership nor the basis of an S corporation in stock is affected by Section 199A.

"Qualified" REIT Dividends and "Qualified" PTP Income

To be "qualified," a REIT dividend for purposes of Section 199A, the dividend must emanate from a REIT having been held for 45 days or more. In determining the 199A deduction for nongrantor trust or for an estate, Qualified REIT dividends are allocated among beneficiaries as is DNI. In determining DNI, the separate share rule is taken into account, but not the 199A deduction itself. If qualified REIT dividends are negative, they are netted against any positive Publicly Traded Partnership (PTP) income. Such net negative income carries forward to the next taxable year, when it may offset positive net qualified REIT dividend and qualified PTP income.

PTP income is the sum of the net amount of the individual's share of income, gain, deduction, and loss from a PTP, as defined in Section 7704, and not taxed as a corporation, plus gain or loss attributable to unrealized receivables or inventory of a partnership resulting in ordinary income under Sec. 751(a) or (b). Negative PTP income, or the sum of negative PTP income netted with REIT dividends which results in a negative number, is carried forward to the next taxable year describe above for negative qualified REIT dividend income.

"Qualified Trade or Business"

A qualified trade or business is business <u>other than</u> (i) an SSTB ("Specified Service Trade or Business") or (ii) the trade or business of performing services as an employee. Critical for purposes of 199A deduction, as many of the formulae depend upon it. Since performing services as an employee can never qualify as a qualified trade or business, income earned by an employee will never constitute QBI. What constitutes a trade or business for purposes of Section 199A is governed by the principles of Section 162.

Although not qualifying under Section 162, rental activity will be a qualified trade or business for purposes of 199A provided the property is rented or licensed to a trade or business that meets the common control requirements of the proposed regulations. An individual is not required to actively participate in the business. It remains unclear as to whether real es-

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tate rented through a triple net lease would meet the requirements under 199A as a Qualified trade or business.

"Specified Service Trade or Business" (SSTB)

Except for individuals who fall within Stratum I — for them it makes no difference — the classification of a trade or business as an SSTB has profound implications in determining Qualified Business Income. For Stratum I individuals, the taint of being an SSTB is inconsequential because Section 199A provides an exception to the exception for individuals within Stratum I: The exception preventing an SSTB from qualifying as a trade or business is itself inapplicable. Therefore, if taxable income is below the threshold amount ($321,400 for joint filers in 2019; and $160,700 for single filers; Stratum I), an SSTB will (by definition) be a qualified trade or business, and the exception preventing an SSTB as constituting as a qualified trade or business will not apply.

If taxable income exceeds the threshold amount, but does not exceed the phase-in limit, then an SSTB will constitute a qualified trade or business, but QBI, W-2 wages, and UBIA of qualified property allocated to the SSTB will be reduced. Once taxable income (again, as calculated without regard to Section 199A) exceeds the threshold amount (Stratum II individuals), the classification of a trade or business as an SSTB becomes problematic.

If taxable income exceeds the threshold amount, but does not exceed the phase-in limit, ($321,400 to $421,400; Stratum II) then the exception will be phased in, resulting in an erosion of the deduction, as QBI, W-2 wages, and UBIA of qualified property allocated to the SSTB become reduced during the phase-in period, and approach zero as the upper limit of the phase-in occurs. The farther an individual travels past the threshold amount, and the closer the individual comes to the phase-in limit, the greater the gravitational pull complex mechanisms residing in Section 199A work to curtail the deduction. These mechanisms appear in Formulas 4 through 6.

Once taxable income exceeds the threshold amount plus the phase in limitation (Stratum III), the exception preventing the adverse classification of SSTB will apply with full force, resulting in all of QBI, W-2 wages, and UBIA of qualified property allocable to the SSTB being ignored for purposes of Section 199A. Once income exceeds the phase-in limit (Stratum III), the business will not (with two exceptions) constitute a "qualified" trade or business, and classification as an SSTB will result in all income, W-2 wages, and UBIA (discussed later) of qualified property attributable to an SSTB being disregarded. The mechanisms imposed on income of individuals within the phase-in limit (Stratum II) will be unnecessary, because all of the individual's QBI, W-2 wages, and UBIA of qualified property allocable to the SSTB will be disregarded.

However, that is not to say that the individual in Stratum III whose income derives from an SSTB will not be entitled to any Section 199A deduction. This is because the individual may still have REIT dividends and PTC income, which may still generate QBI, and provided the individual has taxable income to cover net capital gains, the Section 199A deduction will be available. (Formula 2).

What becomes apparent is that Stratum I individuals can ignore SSTB considerations, individuals in Stratum II are affected by the limitations, but the limitations will not prevent the deduction, but individuals in Stratum III will be tainted by SSTB status and will be availed of no QBI unless an exception applies.

If an SSTB constitutes only a small fraction of the trade or business, then the burden of SSTB classification will not be imposed. Thus, if the trade or business has gross receipts of $25 million or less, and less than 10 percent of gross receipts are attributable to SSTB, or if the trade or business has gross receipts of $25 million or more, and less than 5 percent of gross receipts are attributable to an SSTB, then by fiat of the regulations, this small SSTB portion of the trade or business will not result in disqualification.

Section 199A defers to Section 1202 in defining trades or businesses that will result in SSTB status. The performance of services in health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and management, trading, dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. Curiously, the fields of engineering and architecture are not SSTBs.

Since performing services as an employee can never qualify as a qualified trade or business, income earned by an employee will never constitute QBI. Businesses may be segregated under Section 199A. Anti-abuse rules attempt to prevent avoidance of SSTB by preventing the segregating of businesses to contain SSTB to isolated unit.

Combined QBI

Even individuals in Strata II and III whose income is not qualified by reason of its classification as an SSTB, may qualify for a deduction under Section 199A. This is by virtue of the fact that "Combined" QBI (Formula 2) depends not only on QBI but also on REIT dividends and qualified PTP income.

But the term Combined QBI is more profound than that, as it introduces a new definitional term, the "QBI Component," referenced in Formulas 2 and 3. The QBI Component will generate two figures, and then allow the Stratum II or III individual (Stratum I individuals are exempt) to take only the lesser figure. The first figure generated is 20 percent of QBI (for each trade or business, discussed later), the second, the "alternative limitation" which is (ii) in Formula 3. Formula 3, (ii) is known as the **"alternative limitation."** The alternative limitation is also described as the "wage limitation," the "capital limitation."

Alternative Limitation

The Alternative Limitation (the "greater than" calculation in

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Formula 3) applies to those individuals in Stratum II and III. For these individuals, the QBI Component may be less than 20 percent of QBI. This occurs when the "greater than" calculation in Formula 3 yields a number that is less than 20 percent of QBI. The Alternative Limitation is applied separately to each trade or business of the individual. The Alternative Limitation is also termed the "wage limitation," since it will be triggered when wages of the individual cause the Alternative Limitation to be less than 20 percent of QBI for the business being tested.

Aggregation of Multiple Trades or Businesses

An individual may elect to aggregate multiple qualified trades or businesses and treat them as a single trade or business in applying the Alternative Limitation. Aggregation is unnecessary for Individuals whose taxable income is below the threshold amount, since they are not subject to the Alternative Limitation, but simply determine 20 percent of QBI for each trade or business.

The regulations provide that for individuals whose taxable income exceeds the threshold amount, losses and income are netted before the application of limitations for individuals in Stratum II based on W-2 wages and UBIA of qualified property

Negative QBI

The net amount of QBI from all qualified trades or businesses may be negative. When the net total QBI is zero, the negative amount is treated as a loss from a separate trade or business and is carried forward. Even if the individual has UBIA or W-2 wages, the QBI amount will be zero, and the QBI component will be zero.

Individuals whose taxable income exceeds the threshold amount are subject to the alternative limitation relating to W-2 wages and UBIA of qualified property. Even so, only negative total QBI carries forward. W-2 wages or UBIA of qualified property related to the trades or businesses that produced negative QBI will not carry forward.

If after netting positive and negative QBI, net QBI is negative, QBI for year will be zero, and loss will be treated as coming from a separate trade or business and will be carried forward to the following year to use in calculation the 199A deduction for that year. This rule applies regardless of whether the individual is above or below the threshold amount.

Phase-in Limit and Range

The phase-in limit (or phase-out amount) is $50,000 for single filers, and $100,000 for joint filers. The phase-in range is the spectrum between the threshold amount and the threshold amount plus the phase in limit. Stratum II individuals are within the phase-in range. [complete later].

Applicable Percentage

The Applicable Percentage (Formula 6) limitation applies to Stratum II individuals (within the phase in limit) and who are allocated items from an SSTB in order to reduce the 20 percent of QBI calculation derived from W-2 wages, UBIA of qualified property, and SSTB status. The limitation is inapplicable to individuals in Stratum I because only Formulas 1 and 2 are applicable to them. It is also inapplicable to individuals within Stratum III, because all QBI, W-2 wages, and UBIA of qualified property from an SSTB are disregarded when an the 199A deduction for these individuals which would make its application superfluous.

Reduction Amount and Excess Amount

The Reduction Amount (Formula 4) applies if (i) the income of an individual falls within phase-in range (Stratum II individuals) and (ii) the 20 percent of QBI portion of the QBI component is the greater of the two limitation amounts determined under the QBI component formula. (Formulas 2 and 3). This limitation will operate to further reduce the reduce the QBI Component, which will then equal 20 percent of QBI less the Reduction Amount. The reduces the QBI element of the combined QBI in proportion to how far the individual has advanced within phase-in range. The Reduction Amount is applied to amounts allocated from an SSTB only after the Applicable Percentage (Formula 6) has been applied.

The Excess Amount (Formula 5) applird if (i) the taxable income of an individual is within the phase-in range (Stratum II) and (ii) the 20 percent portion of the QBI component is the greater of the two limitation amounts determined under the QBI component formula. (Formula 3).

Determining Applicable Formula

Which formula applies depends on the taxable income of the individual. If individual's taxable income is equal to or less than "threshold" amount, the Section 199A deduction equals 20 percent of QBI for all qualified trades or businesses (including SSTBs) plus 20 percent of the individual's aggregate qualified REIT dividends and PTP income for the year or, if less, 20 percent of the individual's taxable income less net capital gains. In this case, Stratum I will apply, and the calculation is fairly straightforward.

If taxable income of an individual is more than the threshold amount plus the phase-in limitation amount, the 199A deduction is subject to further limitations based on W-2 wages and UBIA of qualified property of each trade or business of the individual, but everything related to SSTB is ignored since no business will qualify (except under an exception). Stratum III will apply to these individuals.

If the taxable income is more than the threshold amount but within the phase in limit, one percentage reduces the QBI, W-2 wages, and UBIA of qualified property from any SSTBs, and a separate ratio may reduce the 20 percent of QBI calculation based upon the individual's taxable income, threshold amount, and QBI, W-2 wages, and UBIA of qualified property for each qualified. Stratum II will apply

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to these individuals.

Qualified Property

Section 199A defines qualified property as tangible property held by, and available for use in a qualified trade or business at the close of the taxable year, and subject to depreciation under Section 167(a). The property must be used during the taxable year in the production of QBI, and its depreciable period must not have ended prior to the close of the taxable year. The regulations impose a holding period to prevent taxpayers from quickly purchasing and disposing of property near the end of the taxable year to alleviate the effects of the Alternative Limitation. (See Formula 3, second element of "greater than" calculation.)

Depreciable Period

Only qualified property for which the depreciable period has not ended before the close of the taxable year is considered for purposes of calculating 199A deduction. The depreciable period starts on the date when the pass through entity first places the property in service, and ends on the date which is the later of (i) 10 years after that date and (ii) the last day of the last full year of the class life of the property based upon the applicable recovery period under ACRS. Additional first year depreciation for other purposes is disregarded. Because of this and other variances, separate tracking is necessary. Once the depreciable period ends, the property ceases to be qualified property.

UBIA of Qualified Property

Individual's share of UBIA may limit 199A deduction or conversely, if high enough may offset that limitation. Stratum I: Individual's share of UBIA from qualified property ignored. If taxable income exceeds threshold amount (Stratum II or III), individual's share of UBIA from qualified property operative. However, if individual's income exceeds threshold amount and the phase -in limitation, then any UBIA of qualified property is ignored. Unadjusted basis is generally cost immediately after acquisition. Section 1012 and 1014 are applied. In nonrecognition transfers, unadjusted basis will that which carried over. UBIA determined without taking into effect expensing under Section 179 or bonus depreciation. Special partnership adjustments under Sections 754 are ignored. However, 199A deduction has no effect on a partner's outside basis, or a shareholder's basis in stock. Depreciable period only relevant in determining whether property is qualified property. The date property placed in service is important for both basis and determination of whether property is qualified property purposes. Improvements treated as separate qualified property; separate UBIA must be tracked for that property.

The regulations provide that the Regs. 1.263(a) provides a reasonable basis to determine UBIA under Section 199A.

Understatement Penalty

The penalty for a substantial understatement of tax under Section 6662(b)(2) is tightened for purposes of Section 199A. The substantial understatement will be triggered by an understatement of 5 percent (rather than 10 percent) or $5,000.

Self-Employment Taxes

The regulations provide that the Section 199A deduction will nto reduce net earnings from self employment under Section 1402 or net investment income under Section 1411. Nor will Section 199A result in AMT consequences.

Compliance

The regulations require that the RPE (Relevant Passthrough Entity) maintain records and report relevant information to owners on Schedule K-1. The RPE must determine (i) whether it is engaged in one or multiple businesses, (ii) whether any business is an SSTB, (iii) W-2 wages and UBIA. On an attachment to the K-1, the RPE must report qualified REIT dividends earned by the RPE. The Schedule K-1 must report each owner's share of QBI, W-2 wages, and UBIA, and qualified REIT dividends. The rules for compliance are extremely strict: Failure to report any item required will result in the presumption that the owner's share of QBI, W-2 wages, and UBIA of qualified property is zero.

Allocating W-2 Wages to QBI

W-2 wages include all amount paid during calendar year ending in taxable year, including elective deferrals, deferred compensation, and Roth contributions. Wages must allocable to QBI and must be reported to the Social Security Administration on or before the 60th day after the due date of the return, including extensions. . If wages are not reported for Social Security purposes, they are presumed to be zero. Wages are determined before applying the aggregation rules.

If the RPE conducts more than one trade or business, wages must be allocated to the trade or business that generated the W-2 wages. If a trade or business is acquired or disposed of during the year resulting in different employers, W-2 wages must be allocated based upon the time of employment.

In a manner similar to that used to allocate W-2 wages among multiple trades or businesses, the RPE must also identify W-2 wages that are properly allocable to QBI for each trade or business. W-2 wages are properly allocable to QBI if the wage expense was also used to compute QBI.

Allocating UBIA of Qualified Property

IV. Hypotheticals

Example 1
[Stratum I]

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Facts: Individual A is married and files jointly. A receives a K-1 showing QBI from a qualified trade or business of $200,000. The spouse of A has no income in 2019. For tax year 2019, A has taxable income of $200,000 and deductions of $25,000, $5,000 of which are net capital gains. A has no qualified REIT dividends or PTP income.

Analysis: Since A is below the threshold of $321,400, SSTB considerations can be ignored. The Alternative Limitation in Formula 3 is ignored. The QBI component is 20 percent of QBI, or $40,000. Since aggregate REIT dividends and PTP income is zero, the Combined QBI of A is also $40,000 per Formula 2. The Section 199A deduction is the lesser of $40,000 or 20 percent of A's taxable income minus his net capital gains per Formula 1. A has taxable income before deductions of $175,000 and net capital gains of $5,000. Twenty percent of the difference between $175,000 and $5,000 is $34,000. The lesser of $40,000 and $34,000 is $34,000. A has a Section 199A deduction of $34,000.

Example 2
[Stratum III]

Facts: Individual X is an architect and does consulting as a physician on a part time basis. X is single and has income of $600,000, from his three trades or businesses, A, B, and C. X has net capital losses of $20,000, and qualified REIT dividends of $10,000 as well as qualified PTP income of $10,000. X has 30,000 of deductions, which includes his $3,000 deduction for capital losses. X has made no election to aggregate his businesses.

X has $300,000 of QBI from his architectural practice, business A. X's allocated share of W-2 wages is $100,000, and his allocated share of UBIA of qualified property is $10,000.

X is allocated QBI of $200,000 from business B, his consulting practice as a physician, with W-2 wages of $20,000, and UBIA of qualified property of $1,000.

X is allocated QBI loss of $10,000 from business C, which is a qualified trade or business as to X. X is not allocated any W-2 wages or UBIA of qualified property from business C.

Analysis:

Business A: The architectural practice of X is a qualified trade or business, since it is expressly excluded from the list of businesses that are SSTBs. Per Formula 3, the QBI Component is the lesser of (i) 20 percent of $300,000, and (ii), where (ii) is the greater of (m) 50% of W-2 wages or (n) 25% of W-2 wages plus 2.5% of UBIA. M = $50,000 and N = $25,250. The lesser of $60,000 and $50,000 is $50,000. X's QBI Component is $50,000.

Business B: X's consulting practice as a physician is an SSTB. Since the taxable income of X exceeds the threshold amount plus the phase-in limit, the QBI amount allocated to X is disregarded. B's trade or business as a physician is not a qualified trade or business for purposes of Section 199A.

Business C: Per Formula 3, in determining the QBI Component, it is apparent that the loss of $2,000 is less than 0. Therefore, X's QBI Component for business C is a loss of $2,000.

The QBI Components from business A and business B must now be netted. Netting $50,000 and ($2,000) results in a QBI Component for businesses A and C of $48,000. Per Formula 2, in order to determine

Combined QBI, which is necessary to calculate the Section 199A deduction, includes (per Formula 2) 20 percent of qualified REIT dividends and qualified PTP income. 20 percent of qualified REIT dividends and qualified PTP income equals $2,200. Combined QBI therefore equals $50,200.

Turning to Formula 1, we can now calculate the Section 199A deduction. The deduction is the lesser of $50,200 and twenty percent of X's taxable income less net capital gains. X has taxable income of $570,000 and no net capital gains. Twenty percent of $570,000 is $114,000. Since $50,200 is less than $114,000, X has a Section 199A deduction of $50,200.

Example 3
[Stratum II]

Facts: Individual Y is single and has taxable income, net of deductions, of $170,000 of which $25,000 constitutes net capital gain. Y has an allocation of QBI of $100,000 from business A, which is a qualified trade or business. Y has no qualified REIT dividends or qualified PTP income. Y's allocated share of A's W-2 wages

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is $10,000, and A's allocated share of UBIA of qualified property is $500,000.

Analysis:

If pursuant to Formula 3 20 percent of QBI is less than the Alternative Limitation (*i.e.,* the "greater than" calculation in Formula 3), then the QBI Component is that lesser number. However, if 20 percent of QBI is greater than the Alternative Limitation, then the QBI Component must be reduced by the Reduction Amount. In order to calculate the Reduction Amount, the Excess Amount must be known.

Here, the QBI Component must be reduced by the Excess Amount, since 20 percent of $100,000, $20,000, is greater than Alternative Limitation of $15,000. [50% of W-2 wages is $5,000; 25% of (W-2 wages + UBIA) is $15,000]. The Excess Amount (Formula 5) is $20,000 minus $15,000, or $5,000. The Reduction Amount (Formula 4) is the Excess Amount ($5,000) times Taxable Income less the Threshold Amount over the phase-in Amount.

Taxable Income ($170,000) less the Threshold Amount ($160,700) over the phase-in Amount ($50,000) equals .186 The Reduction Amount equals $5,000 times 0.186, or $930. The QBI Component for Y is $20,000 minus $930, or $19,070. The difference between Y's taxable income and net capital gains is $150,000. Since $19,070 is less than $150,000, Y's Section 199A deduction is $19,070

Example 3A
[Stratum II]

Facts: The facts are the same as in Example 3, except the business is an SSTB, W-2 wages are $70,000, and Y has net capital gains of 160,000.

Analysis: Since the business, although qualified, is an SSTB, the Applicable Percentage must be determined. (Formula 6). The Applicable Percentage will operate to reduce items flowing from the business to Y. The Applicable Percentage equals 1 minus taxable income less the threshold amount over the phase-in amount, times 100.

The Applicable Percentage is 1 minus [170,000 - 160,700/$50,000] x 100, or (1 - .186) x 100, or .818 x 100, or 81.8 percent. QBI, W-2 wages, and QBIA of qualified property must each be multiplied by the applicable percentage. After applying the Applicable Percentage, QBI is 16,360, W-2 wages are $57,260, and UBIA of qualified property is $409,000.

20 percent of QBI is $16,360, and 50 percent of W-2 wages is $28,630. (25 percent of the sum of W-2 wages and 2.5 percent of UBIA is less than 28,630). Since $16,360 is less than $28,630, Y's QBI Component is $16,360. Since $16,360 is less than the Alternative Limitation of $28,630 (Formula 3, "greater than" calculation), calculation of the Reduction Amount (Formula 4) and the Excess Amount (Formula 5) are unnecessary.

Per Formula 1, Y's Section 199A deduction is the lesser of $16,360 and $10,000 (i.e., $170,000 minus $160,000). Y has a Section 199A deduction of $10,000.

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