2018 FEDERAL TAX UPDATE

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

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

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

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

A. INTRODUCTION AND THE PATH TO ENACTMENT

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

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

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

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

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

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

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

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

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

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

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

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

B. INDIVIDUAL INCOME TAX REFORM

1. Individual Ordinary Income Tax Brackets

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

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

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

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

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

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

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

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

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

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

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

PRE-TAX CUTS AND JOBS ACT*				POST-TAX CUTS AND JOBS ACT (THROUGH 2025)			
2018 Taxable Income Exceeding				2018 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Cap Gain Rate	Single	Married	Trusts and Estates	Cap Gain Rate
$0	$0	$0	0%	$0	$0	$0	0%
$38,700	$77,400	$2,600	15%	$38,600	$77,200	$2,600	15%
AGI > $200,000	AGI > $250,000		18.8%	AGI > $200,000	AGI > $250,000		18.8%
$426,700	$480,050	$12,700	23.8%	$425,800	$479,000	$12,700	23.8%

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4. Tax Treatment of Education Expenses

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

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

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

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

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

5. Other Exclusions and Deductions Applicable to Individuals

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6. Other Individual Income Tax Items of Note

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

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

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

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

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

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

C. BUSINESS TAX REFORM

1. Reduction in C Corporation Tax Rates

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

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

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

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

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

2. Reduction in Dividends-Received Deduction for C Corporations

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

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

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

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

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

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

a. Executive Summary of the New §199A Deduction

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

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

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

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

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

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

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

ZONE 1 → No restriction

ZONE 2 → Your deduction is subject to a phase out

ZONE 3 → You get no deduction at all

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

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

ZONE 1 → 20% of "qualified business income"

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

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

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

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

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

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

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

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

b. Under the Hood Look at the Statute

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

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

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

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

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

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

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

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

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

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

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

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

Example 1

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

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

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

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

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

Example 2

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

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

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

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

c. Proposed Regulations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4. Cost Recovery

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5. Other Business Income Tax Items of Note

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> *(q) Payments Related to Sexual Harassment and Sexual Abuse.—No deduction shall be allowed under this chapter for—*
>
> *(1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or*
>
> *(2) attorney's fees related to such a settlement or payment.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. WEALTH TRANSFER TAX REFORM

1. Increase in Basic Exclusion Amount

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

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

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

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

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

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

2. Retention of Stepped-Up Basis

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

3. Post-Act Estate Planning Strategies

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

E. ALTERNATIVE MINIMUM TAX REFORM

1. Corporate AMT Repealed

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

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

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

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

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

2. Individual AMT Retained with Higher Exemptions

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

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

	Pre-Tax Cuts and Jobs Act*			Post-Tax Cuts and Jobs Act		
Taxpayer	Joint Filers	Unmarried	Estates and Trusts	Joint Filers	Unmarried	Estates and Trusts
AMT Exemption Amount	$86,200	$55,400	$24,600	$109,400	$70,300	$24,600
Phaseout of exemption amount begins when AMTI exceeds	$164,100	$123,100	$82,050	$208,400	$156,300	$82,050

* Figures from Revenue Procedure 2017-58.

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

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

F. PROPOSED REFORMS THAT DID NOT SURVIVE THE FINAL BILL

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

1. Individual Tax Reforms Not Enacted

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

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

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

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

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

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

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

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

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

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

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

2. Business Tax Reforms Not Enacted

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

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

3. Wealth Transfer Tax Reforms Not Enacted

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

II. THE BIPARTISAN BUDGET ACT OF 2018

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

A. SIMPLIFIED FILING FOR OLDER INDIVIDUALS

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

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

B. NEW ABOVE-THE-LINE DEDUCTION FOR WHISTLEBLOWERS

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

C. EXTENDERS

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

III. OTHER DEVELOPMENTS OF NOTE

A. PROPOSED ANTI-CLAWBACK REGULATIONS

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

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

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

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

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

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

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

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

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

> amount allowable as a credit in computing gift tax payable for any year may not exceed the tentative tax on the gifts made during that year, and the amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate. Sections 2505(c) and 2010(d).
>
> (2) *Example.* Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.

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

B. CHARITABLE CONTRIBUTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The specific provision in the donation agreement provided as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

C. FEDERAL WEALTH TRANSFER TAXES

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

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

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

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

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

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

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

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

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

Howard Zaritsky offers the following takeaways from *Cahill*:

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

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

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

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

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

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

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

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

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

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

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

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

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

> generation member (in this case, Clara's revocable trust) pays that part of the premiums on the policies insuring the lives of one or more middle-generation members (in this case, Clara's sons). The death benefits are payable to a trust for the benefit of lower-generation members (in this case, the three dynasty trusts). Typically, the senior-generation family member pays the portion of the premium equal to the value of the present insurance coverage, determined under Table 2002 (IRS Notice 2002-8), or the insurer's alternative term rate, if lower.
>
> Proponents of this concept argue that the senior generation makes no taxable gifts by paying these premiums; rather, he or she is advancing funds with a full right to recover the greater of the cash value or the total premiums paid from the policy death benefits. Moreover, when the senior generation family member dies, the value of the right of recovery in his or her estate is merely a "collateralized receivable" that must be paid at the insured child's death. The economic benefit regime impairs the value of these receivables, potentially reducing their value for estate tax purposes. The receivables are mere unsecured promises to pay uncertain amounts at an uncertain time, with no current return on their value and with ongoing tax liabilities.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. FEDERAL INCOME TAX

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

E. OTHER TAX DEVELOPMENTS OF NOTE

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

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

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

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

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

Marriage Minefields, Planning Pitfalls

1. While the federal ban against marriage equality (DOMA) declared unconstitutional in 2013, the LGBTQ communities had a patchwork of rights where same-sex marriages entered into elsewhere were not recognized in one's home state if there was a restricted definition of marriage in that state's constitution and/or statutes. As state courts across the nation declared their bans unconstitutional, in January, 2015 Florida courts took town our ban and in June 2015 the *Obergefell v. Hodges* (14-556) case was the final nail in the coffin nationwide.
2. Top 15 (of around 1500) benefits married same-sex couples can avail ourselves of:

    1) Have standing to sue for wrongful death, loss of consortium, etc.;
    2) File joint federal income taxes;
    3) Sponsor a fiancé or spouse for immigration benefits;
    4) Collect social security benefits at retirement or death of spouse;
    5) Take family medical leave benefits;
    6) Transfer wealth at in life or at death from to the surviving spouse without incurring gift or estate tax, respectively;
    7) Defer income taxes on an inherited IRA or other qualified retirement plan, delay RMD and benefit from hardship withdrawals;
    8) Create joint marital trusts and use techniques such as QTIP, QDOT, credit shelter or A/B trusts
    9) Own property as tenants by the entireties for greater protection from both creditors and from one another;
    10) Split gifts since spouses can combine their annual exclusions in order to double the amount the couple can transfer per year per donee;
    11) Take advantage of portability to use any remaining applicable exclusion amounts after the death of the second spouse;
    12) Benefit from the parental presumption, do stepparent adoptions and adopt children privately or from foster case jointly without need for second parent adoption;
    13) Provide health insurance to an employee's spouse without it being taxable income to employee;

14) Transfer property incident to a divorce without it being subject to transfer tax and provide spousal support deductible by the payor and includible as income to the payee, and;
15) Others such as joint bankruptcy protection, creation joint marital trusts and use techniques such as QTIP, QDOT, credit shelter or A/B trusts, and much more.

3. Some other issues to consider:
   a. Prenuptial agreements
      i. Essential for many couples to consider and when so doing, address date of "marriage." Imagine you're together 20 years, then marry in 2015 and divorce in 2019. Long term v short term marriage and its consequences in Florida
      ii. ETHICS: Separate representation unlike estate planning
   b. In the current climate, "religious freedom" means bigots are emboldened. It is more important than ever for same-sex couples to have our ducks in a row including health care advance directives (living will, health care surrogate, pre-need guardian and anatomical donation) and testamentary documents (wills and trusts) because those privileges could be denied if traveling or relocating to a non-marriage jurisdiction.
   c. Second/step parent adoption is important for clients with kids. No, they don't get parental rights by marrying a partner with kids.
      i. A birth certificate is not sufficient protection: presumptive vs. conclusive evidence of parentage. A BC is a diploma, the court order is the transcript.
      ii. ETHICS matter of not empowering the bio parent to exclude non-bio.
      iii. Portability concern. It is crucial for a nonbiological/de facto parent to be protected and without a second/step parent adoption, that's a lot harder. Can be challenged on death or divorce or by govt org (SSA asking for adoption proof). Maybe harder to inherit intestate in some places.
      iv. ETHICS issue to flag about joint representation: get a written acknowledgement from the clients that this is a joint representation and that you won't keep secrets from one another
   d. Domestic Violence – not that it's more common but might be more reported as people are more comfortable to be out.
   e. Surrogacy
      i. parentage judgment/affirmation of parental status
      ii. be sure international clients have a lawyer in home jurisdiction

f. DIVORCE!!!
    i. Date of marriage
    ii. Date of separation
    iii. Retroactivity cuts both ways
    iv. “holding out” de facto marriage
g. Name changes/gender marker changes
    i. Having proof that spouse is aware spouse is trans
    ii. Judicial education please (powers of general jurisdiction/do equity)

4. Please be sure you:
    a. Use their PGP and don’t be afraid to ask (perhaps on intake)
    b. Words not to use – see GLAAD Talking About Series’ Ally’s Guide to Terminology
    c. Change your forms- married/divorced/partner, parent/parent
    d. Have resources available (therapists, CPAs, financial advisors)
    e. Don’t assume they’re married or want to be
5. To Marry or Not to Marry? possible reasons not to marry:
    a. Obligations upon death or divorce (ETHICS issue when meeting a couple together)
    b. Higher income tax brackets for married couples filing jointly.
    c. Getting spousal support from prior spouse (but “supportive relationship” can disqualify).
    d. Household income inclusion for Medicaid and SSI (ETHICS issue: “gaming” the system)
    e. FAFSA
    f. Tax concerns
        i. Adoption tax credit is substantial but you don’t get it if you’re married to your partner because then it is a stepparent adoption.
        ii. A taxpayer's spouse cannot be a dependent of the taxpayer and for some couples that's a better benefit than filing jointly-you have to run the numbers both ways.
        iii. A married taxpayer can't itemize if his spouse takes the standardized deduction.
        iv. Wanting to use a tool like a GRIT (Grantor Retained Interest Trust) – No longer allowed for opposite –sex couples after 1990 because you can’t be a “family member.”
        v. Don’t believe in the institution
            1. See Paula Ettelbrick’s 1989 article “Since When is Marriage a Path to Liberation?”
            2. Prof Nancy Polikoff’s scholarship including powerful points about decoupling rights and privileges from marriage.

ALT CTRL DELETE:

Protecting Your Client's Digital Legacy - Without Going To Jail

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Mr. Parthemer is a nationally recognized speaker and frequently published author. He is an ACTEC Fellow, and is in leadership of the Real Property Trust and Estate Section of the American Bar Association, the Florida Bankers Association (Board Member; Past Chair Legislation Committee) and the Florida and Pennsylvania Bar Associations. He is an Associate Editor and Columnist for the Journal of Financial Service Professionals, member of Synergy Summit (Past President), the Palm Beach County Estate Planning Council (Board Member), and the Palm Beach Tax Institute. He was awarded the 2014 Article of the Year from the American Bar Association's Probate & Property magazine and named the Florida Bankers Association 2015-2016 Banker of the Year.

He frequently is faculty for the University of Miami's prestigious Heckerling Institute, was an Adjunct Professor, Widener University School of Law, and guest lectures at the Dickinson School of Law and the University of Miami School of Law's LLM program. He has been quoted in the Wall Street Journal, Barron's, NY Times and MONEY Magazine, and has been honored by Best Lawyers in America with their Lifetime Achievement Award.

He earned a J.D. from The Dickinson School of Law, B.A. and B.S. degrees in philosophy and government from Franklin and Marshall College, conferred status of an Accredited Estate Planner, and completed MBA Phase I curriculum.

3 Goals for Today

1. Define & Educate -What are Digital Assets

2. Update on the Law – Federal and State.

3. Digital Asset Estate Planning - What Can & Should Be Done

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Digital Asset Factoids

Various Uses - Financial, Social, Work, Leisure, Creative.

- 3.2 billion use social media every month, absorbing more than 25% of all time spent online.
- 1 million new users a day – about 1 new every 11 seconds.
- More than 39% of Americans receive paperless credit card & bank statements; 71% are active social media users.
- 99% internet penetration - Qatar & United Arab Emirates (T-1st); .06% - North Korea (213th). USA is at 88%.

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Presently, Every 60 Seconds…

- 168,000,000 emails are sent/received.
- 695,000 Facebook accounts are updated/posted.
- 600 digital videos are added to YouTube.
- 320 new Twitter accounts are created.
- 100 new people join LinkedIn.
- 6,600 photos are uploaded to Flickr.

Seniors are Online!

- More than 50% are online (email and/or social media).

Juniors are Online, Too!

- 92% of children under 2 have an online presence.

B
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Digital Estates Have Value

Monetary Value:
Recent survey showed U.S. consumers value their digital assets, on average, at $55,000.

Sentimental Value:
Digital photo/videos, social networking accounts, blogs, e-mail accounts, etc.

Perceived Value:
"Real Estate" in the virtual world **Entropia** Universe sold for $635,000.

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Domains Have Value

Here are the 10 most expensive domain names publicly reported:

1. CarInsurance.com — $49.7 million
2. Insurance.com — $35.6 million
3. VacationRentals.com — $35 million
4. PrivateJet.com — $30.18 million
5. Internet.com — $18 million
6. 360.com — $17 million
7. Insure.com — $16 million
8. Fund.com — £9.99 million
9. Sex.com — $14 million (2005 sale)
10. Sex.com — $13 million (2010 sale)

1. What are Digital Assets?

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Digital Assets:

Information created, generated, sent, communicated, received or stored by electronic means on a system for the delivery of digital information or on a digital device.

Think Any Electronic Record

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Digital Assets Examples

- **Emails**
- **Social Media Accounts –** Facebook, Twitter, LinkedIn, Instagram, MySpace
- **Documents, PDFs, Spreadsheets, Contacts, Calendars -** Office
- **Online Banking/Brokerage/Investment Accounts –** Paypal
- **Online Stores/Shopping Accounts –** Amazon, eBay
- **Digital Photos and Videos –** Flickr, YouTube, Vine
- **Online Video Games –** Game of War, Minecraft
- **Websites & Domain Names –** GoDaddy
- **Music Library –** iTunes, Pandora
- **Streaming Movie Services –** Netflix
- **Cloud Storage**
- **Blogs & Online Publishing**
- **Electronic Medical Records**
- **E-Books** – Kindle, iBooks

Barrier to access: Most require passwords.

Where are Digital Assets Found?

Simple Terms: Any device that stores electronic information.

- **Home Computer/Laptop**
- **Smart Phones**
- **I-Pads/Tablets**
- **I-Pods and MP3 Players**
- **E-Reader** - Kindle, Nook, eBooks
- **USB Flash Drives**
- **External Hard drives**
- **Digital Cameras**
- **Items stored in the "cloud"** - Dropbox, iCloud
- **CDs and DVDs**

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Two Critical Terms Relating to Digital Assets

Custodian:

A type of organization that stores digital assets on their servers.

Terms of Service Agreement (TOSA):

- Rules which one must agree to abide by in order to use a service.
- Legally binding agreement used by Custodians.

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Terms of Service Agreements ("TOSA")

- Consumer must accept or decline – non-negotiable.
- Very one sided/self serving.
- Dictates who has authority to access account and to close it.
- Sets forth the company's privacy policies.
- Imposes limitations on liability and indemnification.
- Imposes jurisdiction if disputes arise.
- Some allow the provider to may make unilateral changes to the

TOSA without notification to the user.

☐ Click-through policies are generally enforceable

☐ I just agreed to what?

Agree

Whatever

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TOSA Govern & May Inhibit Access to Fiduciaries

Twitter: "In the event of the death of a Twitter user, we can work with a person authorized to act on the behalf of the estate or with a verified immediate family member of the deceased to have an account deactivated."

Instagram: "In the event of the death of an Instagram User, please contact us. We will usually conduct our communication via email; should we require any other information, we will contact you at the email address you have provided in your request."

iTunes: Silent about fiduciaries. Fiduciary should get account holder's Apple ID to access account. Cannot merge accounts.

Many web-service providers prohibit you from allowing anyone else access.

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FACEBOOK'S TOSA

- Safety: You will not solicit login information or access an account belonging to someone else.
- Registration and Account Security: You will not share your password (or in the case of developers, your secret key), let anyone else access your account, or do anything else that might jeopardize the security of your account.
- You will not transfer your account (including any Page or application you administer) to anyone without first getting our written permission.

2. Status of Federal/State Laws

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Computer Fraud and Abuse Act ("CFAA")

Federal CFAA* – 18 U.S.C. § 1030(a)(2)(C), enacted in 1986 (as amendment to 1984 law and in response to movie War Games. Criminalizes internet crime. Basically, the anti-hacking law.

This law makes unauthorized access to any computer, any online service or account a crime.

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Computer Fraud and Abuse Acts (TOSA violations)

Even with an account holder's authorization, a potential crime exists under the CFAA.

Example – most social media TOSAs prohibit anyone besides the account holder access to an account.

- Access to another's online account requires accessing the custodian's computers.
- It's not enough to have the account holder's authorization.
- Thus, if a 3rd party (including a fiduciary) uses the account holder's password such action exceeds "authorized access" under the TOSA.
- By violating the TOSA, the 3rd party has in turn violated the CFAA.

Computer Fraud and Abuse Acts (TOSA violations)

Federal prosecutors have used the CFAA to prosecute defendants *based solely on violations of a TOSA.*

- Aaron Schwartz – impermissibly downloaded 4.8 million academic articles from the JSTOR (Journal Storage) *digital* library system.

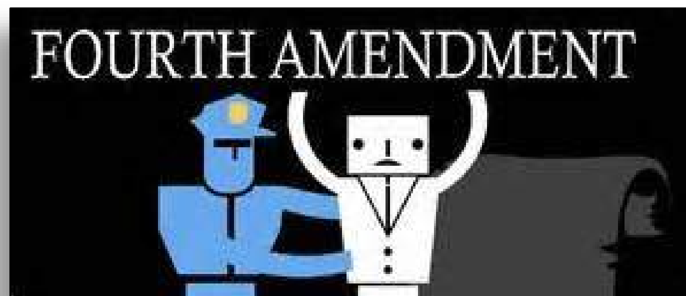
- Lori Drew created a fake "MySpace" profile (in violation of MySpace's TOSA) to bully 16 year old Missouri teenager Megan Meier.

Federal Privacy Laws

Fourth Amendment:

- Strong expectation of privacy in homes.
- Prevents government from searching homes.

"The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause…."



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Federal Privacy Laws

Do you have an expectation of privacy when using your computer network at home?

- Computer networks are not protected by the Fourth Amendment.
- They are not physically located or being accessed within computers or in homes.

To fill that gap, Congress enacted the Stored Communications Act ("SCA").

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Federal Privacy Laws

Stored Communications Act ("SCA")

18 U.S.C., §2701 – 2712, enacted in 1986, creates a RIGHT TO PRIVACY for data and information stored online by custodians.

- Prohibits public custodians from disclosing the content of electronic communications to third parties unless an exception applies.
- Exceptions:
  1. Several for law enforcement.
  2. §2702(b) allows a custodian to voluntarily disclose if there is lawful consent.
- Example: Sahar Daftary Estate vs. Facebook.

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SCA Exception to Non-Disclosure Rules

Private Custodians Not Subject to SCA

- Private custodian is one who only provides electronic communication to a specific people, like employees or students.
- SCA does not prohibit fiduciary access.

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Stored Communications Act (TOSA violations)

Civil Action under the SCA:

- A federal jury in Massachusetts awarded plaintiff $450,000 for a violation of the SCA, despite very scarce testimony to support the damage claim.
- The defendant was given plaintiff's email password to read consultation reports when the two parties practiced medicine together.
- When the defendant left the practice and a business dispute arose, she used the plaintiff's unchanged password to access the account.
- The plaintiff successfully sued under an unauthorized access theory.

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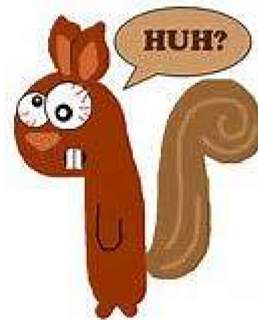
Obstacles to Discharging Fiduciary Responsibility

Fiduciaries risk liability if they refuse to manage the decedent's digital assets
and
criminal (or at least civil) liability if they perform their duties!



Revised Uniform Fiduciary Access to Digital Assets Act designed to vest fiduciaries with the authority to access and manage digital assets.

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Advancing the Cause

Uniform Fiduciary Access to Digital Assets Act (“**UFADAA**”)

“UFADAA does not break new legal ground; it simply applies the tried and true laws governing fiduciaries to the digital assets that are widely used today.” – ULC’s statement.

UFADAA – 0 for 27!

- Approved by the ULC on July 16, 2014.
- As model legislation, enacted by State not Federal legislatures.
- Delaware was the ninth state to enact such laws, but the first state law **based** on UFADAA.
- 27 states introduced the final version of UFADAA in 2015.
- Epic for a Uniform Act (average 5-6 first year introductions).
- Strong opposition from Custodians.
- Failed to pass in any of the 27 states.

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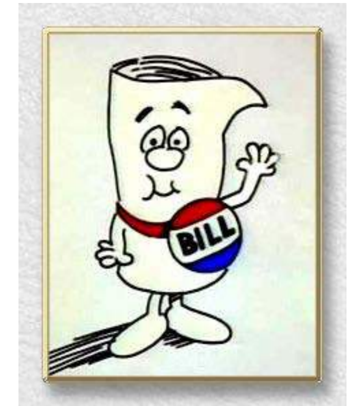
Revised UFADAA – “RUFADAA”

- The ULC “went back to the drawing board.”
- RUFADAA released September 28, 2015.
- Complete re-write – “opt-out” to “opt-in”.
- RUFADAA received support from the Custodians, including Google and Facebook.
- Florida was the first to pass (second to enact), effective July 1, 2016 (F.S. 740.001-09)*.
- Provides legal authority for fiduciaries to manage digital assets as per estate plan, while protecting a user’s private communications from unwarranted disclosure.



*Not in 2018 West’s Florida Probate Code.

RUFADDA Enacted in 41 States + Virgin Islands

- Alabama
- Alaska
- Arizona
- Arkansas
- Colorado
- Connecticut
- Florida
- Georgia
- Hawaii
- Idaho
- Illinois
- Indiana
- Iowa
- Kansas
- Maine
- Maryland
- Michigan
- Minnesota
- Mississippi
- Missouri
- Montana
- Nebraska
- Nevada
- New Jersey
- New Mexico
- New York
- North Carolina
- North Dakota
- Ohio
- Oregon
- South Carolina
- South Dakota
- Tennessee
- Texas
- Utah
- Vermont

- Virginia
- Washington
- West Virginia
- Wisconsin
- Wyoming
- US Virgin Islands

Introduced:

DC, New Hampshire, Pennsylvania, Rhode Island.

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Digital Assets (non-RUFADAA state)

- ***Ajemian v. Yahoo,* 2013 Mass. App. LEXIS 73; SJC-12237 (Mass. Supreme Judicial Court, October 16, 2017).**
- Stored Communications Act does not prevent Yahoo from turning over emails to the personal representatives.
- Case remanded to determine if TOSA allowing withholding or destruction of emails was a valid contract.
  - Siblings, as administrators of their brother's intestate estate, brought suit seeking judgment that the decedent's Yahoo e-mails were estate assets. Initially, they sought e-mail records (not content). Yahoo agreed, but then the administrators filed a second action in which they sought the content.
  - Yahoo moved to dismiss the action on the grounds that the action based on a California forum selection clause in the website's TOSA. The Court found that Yahoo did not reasonably communicate the clause as there was no evidence that the TOSA was actually displayed on the decedent's computer screen – users were only given the opportunity to review it. The Court noted that the TOSA was never accepted by the decedent. Yahoo did not require users to click "I accept" after reading TOSA.
  - The Massachusetts Supreme Judicial Court remanded the case. SCA prohibits unauthorized third parties from accessing stored electronic communications and regulates when service providers may voluntarily disclose stored electronic communications. Voluntary disclosure is restricted unless a statutory exception applies.
    - The exception for disclosure to an agent did not apply because "agent" at common law a personal representative is not an agent.
    - Another exception permits disclosure upon receipt of "lawful consent". Lawful consent can include consent by the administrators of the principal's estate.

Data Scraping: *Facebook/Cambridge Analytica; LinkedIn/HiQ; Oracle/Rimini*

- High stakes battle over access to data in today's public marketplace – the internet.
- Targeted ads; election influencing; constant surveillance – oh, and do you want HR to know in advance when you are going to resign?!?
- Very interesting and huge issues. For wealth planners, impacts advice – and for fiduciaries, impact actions!

9 Key Points

1. Catalogue v. Content

Catalogue is information that identifies: (i) each user who has had communication, (ii) the time and date of communication and (iii) the address. Think outside of an envelope.

Content is defined as the substance or meaning of the communication, including subject line and message. Think inside the envelope.

Access to Content v. Catalogue

RUFADAA default permits access to the catalogue without prior consent. For content, fiduciary must receive express prior consent from the user.

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9 Key Points

2. Online Tool Concept

- Authorizes a custodian to offer an online tool, i.e., an electronic service for disclosure to a third party.
- The online tool is distinct and separate from the Custodian's TOSA.
- Supersedes an estate plan and the custodian's TOSA.
- User must be able to revoke designation.

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9 Key Points

3. Presumptive v. Possible Access – Fiduciaries Access Limited by creating an "Opt In" Structure

- Greater emphasis on explicit direction provided in the estate plan with respect to digital assets.

- UFADAA attempted to vest fiduciaries with presumptive access to content of digital assets.
- RUFADAA in contrast provides default to catalogue, and users may consent to disclose ***content*** to a fiduciary either by an online tool or record (will, power of attorney or trust), which overrides a TOSA's prohibition against disclosure.

Without express consent, TOSA's prohibition will control.

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9 Key Points

4. Disclosure

- RUFADAA gives the Custodian 3 options for disclosure:

(1) Grant the fiduciary full access.

(2) Grant partial access to the account sufficient enough to perform the tasks necessary to discharge duties.

(3) Provide a "data dump" of the information and assets in the users' account.

- Custodians can charge a reasonable fee for disclosure.

- Custodians do not need to disclose assets deleted by the user.

9 Key Points

5. Court Orders

- RUFADAA arguably allows a Custodian to require a court order at its discretion.

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9 Key Points

6. Protection for the Custodians

RUFADAA provides immunity to the Custodians for an act or omission done in good faith compliance with the Act.

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9 Key Points

7. Employee Context

- RUFADAA does not apply to digital asset of an employer used by an employee in the ordinary course of employer's business.

- Similarly, the SCA does not prohibit such private custodian *(e.g., the employer)* from disclosing information. The SCA does not protect an employee's electronic communications at work.

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9 Key Points

8. Custodian's Compliance

How long does a Custodian of a digital asset have time to comply?

60 days - If custodian fails to comply with request, fiduciary may apply to the court for an order directing compliance.

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9 Key Points

9. Certificate of Trust

- Used to certify the existence of the Trust and the trustee's authority to act under the terms of the Trust.
- Can be used to avoid revealing entirety of Trust (736 F.S. §1017).

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YAHOO!

"While we deeply sympathize with any grieving family, **protecting the privacy of our users remains our priority**. Yahoo is committed to ensuring that the activities of every person who signs up for an account is confidential, even after their death." Yahoo further stated that a user who is worried that family members might need access to pertinent passwords to financial accounts or other important information should "**plan for this as part of their estate-planning process**."

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3. What Can Be Done?

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How to Preserve Digital Assets

The ABC's:

A. Identify and Inventory (intangibles and password storage).

B. Define Rules and Instructions During Life (multiple users, specific power of attorney language, revocable trust).

C. Define Access after Death – (specific Will/Trust language, account representatives, tech savvy fiduciary).

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A. Identify & Inventory

Intangible Personal Property - Any non-physical item stored on a computer, phone, tablet, USB drive, online, etc.

Must It Remain Intangible? Once printed, it becomes tangible personal property (e.g., Mom's contact list).

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A. Identify & Inventory

3 Digital Asset Inventory Suggestions:

1. Handwrite.
2. Store on a Computer.
3. Use an Online Afterlife Company (electronic safe deposit box).

- Include all of your digital assets with user name & password information.
- Leave detailed instruction on how to access each account.
- Update regularly.

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A. Identify & Inventory

Password Planning Instructions

1. Have the estate planning attorney retain?
2. "There's an app for that." Online storage (e.g., 1Password).
   - Store user names, passwords, and estate planning documents.
   - Send messages upon death.
   - Release information upon death or incapacity.
   - Grants executor or guardian immediate access upon death or incapacity.

Warnings: Can they execute? Will they be in existence? Privacy concerns?

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B. Define The Rules & Instructions During Life

Grant Immediate Access to Another Over the Digital Estate

1. Create an account with multiple users.
2. Backup to Tangible Media: DVDs, flash drives, external hard drives, etc.
3. Inter-Vivos Trust? Custodians don't currently permit a trust to open an online account, but it is on their "short list".

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B. Define The Rules & Instructions During Life

Durable Power of Attorney.

- Specific language granting access is required.
- Discuss privacy concerns. Client may not want spouse or beneficiary to have complete access to all digital assets.
- Consider including in the durable power of attorney as a separate power, to be initialed.

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C. Define Fiduciary Access After Death

FL RUFADAA creates priority:

1. Custodian's "Online Tool."
2. Estate Planning Documents.
3. TOSA.

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C. Define Fiduciary Access After Death

1. Custodian's "Online Tool" Provides Access.

- Most TOSAs for social media and email accounts do not allow anyone else to access or modify a deceased user's account.
- Two exceptions (so far):

1. Facebook **Legacy Contact.**
2. Google **Inactive Account Manager.**

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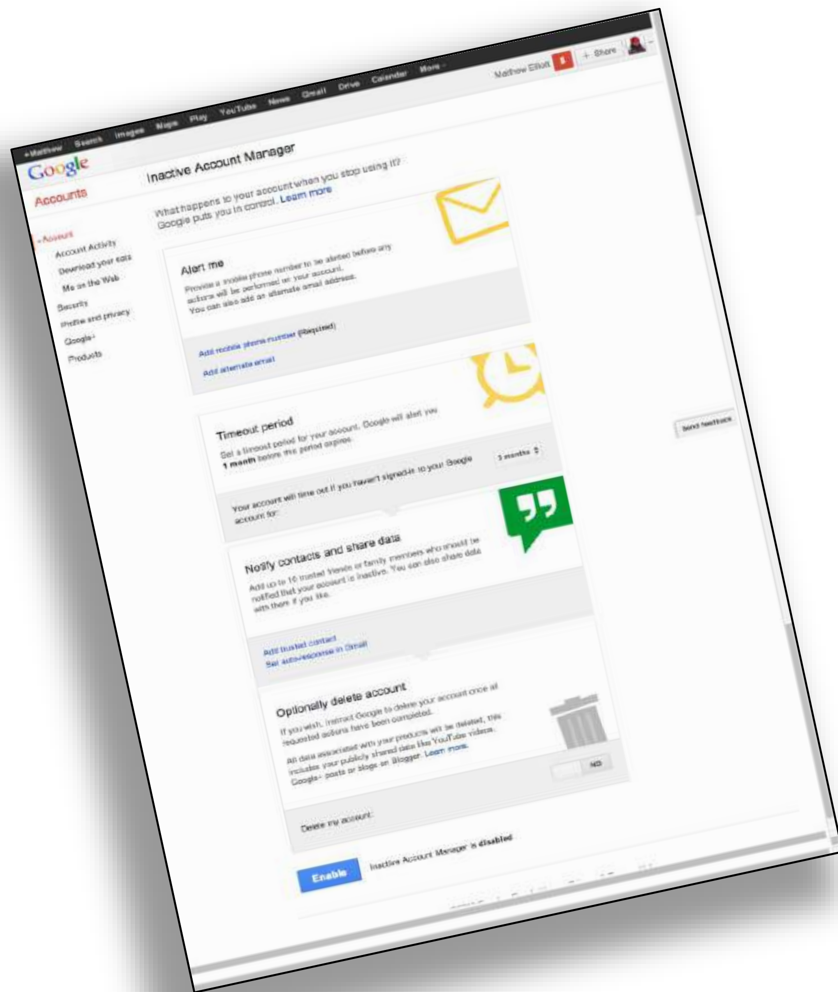
C. Define Fiduciary Access After Death

Facebook **Legacy Contact**

- Legacy Contact for a Deceased User ***Can***:
  - Download a copy of what was shared on Facebook (photos, videos, wall posts, profile information, contacts, events and friends).
  - Write a post to share a remembrance or final message.
  - Respond to new friend requests.
  - Update profile.

- Legacy Contact ***Cannot***:
  - Read or download the messages.
  - Remove friends.
  - Change photos, postings, or other items shared on the timeline.
  - Log into the account.

C. Define Fiduciary Access After Death



Google **Inactive Account Managers** can receive Gmail messages and other Google data after death or incapacity.

Select data to be shared with this trusted contact

Once your account has timed out, your trusted contact can download your data for **3 months**.

- [ ] Select all

- [ ] +1s
- [ ] Blogger
- [ ] Contacts
- [ ] Drive
- [ ] Mail
- [ ] Reader
- [ ] YouTube

C. Define Fiduciary Access After Death

2. Will/Trust:

- Include specific language to "OPT IN" if desired.
- Key word to remember is consent.
    - Custodians more likely to grant access versus a general power.
    - Access to the catalogue without undue hassle.
    - Unclear whether any language is enough for every custodian to provide content (get a court order, as needed).

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C. Define Fiduciary Access After Death

Consider - Tech Savvy Fiduciary

- Many appoint a spouse or sibling as Fiduciary.
- Person may not be sufficiently tech savvy.
- Appoint a special fiduciary.
- Query whether a delegation would be effective.

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“Treat Your Password
Like Your Toothbrush.
Don’t Let Anybody
Else Use It & Get A New One At
Least Every
Six Months!”

-Clifford Stoll

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Digital Estate Administration

- Find, access, and protect voicemail, e-mails, phones, and computers as soon as possible after death.
- Gather bank, credit card & brokerage statements.
- Monitor email as time-sensitive financial information may be delivered after death.
- Request credit report from each credit bureau; notify all 3 credit agencies of death by sending them the death certificate.
- Access contact lists from e-mail and social networking accounts.
- Back up all hard drives.
- Delete information per forensic standards (so data cannot be retrieved).
- Delete credit cards from shopping accounts, such as eBay, Amazon and PayPal.
- Cancel driver's license and ask DOMV to refuse any requests for duplicates.
- Keep e-mail, documents and photos for family.
- Maintain Website or Blog.
- Archive Digital Photos/Content to Flash Drive.

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Sample Popular Accounts

Gmail - Provides instructions for gaining access to user accounts and can provide access for authorized Fiduciary (Inactive Account Manager).

Hotmail - Will provide copies of any emails in user accounts, provide contact lists and close account.

Yahoo! - Upon receipt of death certificate, delete all content and remove account.

Facebook - Has set up a specific procedure to memorialize an account, close account upon formal request from next of kin, or Legacy Contact.

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Sample Popular Accounts

LinkedIn - After receiving verification of death, will close account.

Twitter - Upon request from next of kin, will provide copy of tweets and close account.

YouTube - Allows the PR to access user's account.

PayPal - Allows PR to close account and will distribute any remaining funds via check.

iTunes - No manner to transfer iTunes music files as user only has a license to the music.

Durable Power of Attorney Sample Language

Short form:

I consent and empower my Agent with access, use and control of my digital devices and digital assets, including to:

- Any and all digital assets to which I would be entitled, including but not limited to my passwords, user names and any and all content.
- The catalogue and the content of electronic communications and digital assets, including but not limited to my username, password, and all content, as defined in Section 740.001, the Florida Fiduciary Access to Digital Assets Act.
- (Option) Only the following digital assets:___________________.
- (Option) To all digital assets, except the following:_________________________.

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Two Part Will or Trust Sample Language

Part One:

Digital Devise: I hereby consent and authorize my Fiduciary to hold, control, and have access to, and the use of, any asset held by any kind of computing or digital storage device or otherwise in digital form, including, without limitation, lists of passwords and account information; social media sites; blogs, e-books or other web-hosted materials of which I am the owner or author; digital albums; videos; and websites on which I conduct business transactions.

Two Part Will or Trust Sample Language, cont'd

Part Two:

Digital Assets: **I hereby authorize** any individual or entity that possesses, custodies or controls any electronically stored information or that provides to me an electronic communication service or remote computing service, whether public or private, **to divulge to my Fiduciary** at any time: (1) any electronically stored information; (2) any record or other information pertaining to me with respect to that service; and (3) the **contents** of any communication that is in electronic storage by that service or that is carried or maintained on that service. To employ any consultants or agents to advise or assist my Fiduciary in decrypting any encrypted electronically stored information of mine or in bypassing, resetting, or recovering any password or other kind of authentication or authorization, and I hereby authorize my Fiduciary to take any of these actions to access: (1) any kind of computing device of mine; (2) any kind of data storage device or medium of mine; (3) any electronically stored information of mine; and (4) any user account of mine. The terms used in this paragraph are to be construed as broadly as possible, including as contemplated in the Revised Uniform Fiduciaries Access to Digital Assets Act.

This authorization is to be construed as my lawful **consent** to all such access or disclosure under the Electronic Communications Privacy Act of 1986, the Computer Fraud and Abuse Act of 1986, and any other applicable federal or state data privacy law or criminal law, as they may be amended.

IN THE CIRCUIT COURT FOR THE
EIGHTEENTH JUDICIAL CIRCUIT IN AND FOR SEMINOLE COUNTY, FLORIDA

IN RE: GUARDIANSHIP OF

JOHN DOE

File No.:
Division: Probate

MOTION TO AUTHORIZE GUARDIAN ACCESS
THE CONTENT OF WARD'S DIGITAL ASSET

COMES NOW, Jane Doe, as Guardian of the Property of John Doe, by and through her undersigned counsel, and moves this Honorable Court to enter an Order Authorizing the Guardian to Access the Content of the Ward's Digital Assets held by Google and in support thereof states as follows:

1. That Jane Doe is the duly appointed Guardian of the Property of John Doe (the Ward);
2. That Jane Doe believes the Ward's Google account contains information regarding a communication between the decedent, John Doe and Harry Roe, establishing the terms of a contractual agreement which is necessary to collect an asset of tangible value to John Doe;
3. That Jane Doe has no other means of accessing the information;
4. That Jane Doe believes accessing the content of the Ward's Google account and any and all communication between John Doe and Harry Roe between January 1, 2015 and June 2, 2015, is necessary to fulfilling her fiduciary duty to inventory and protect the assets of the Ward.

WHEREFORE, Jane Doe respectfully requests this Honorable Court enter an Order Authorizing the Guardian to access the content of the Ward's Google account.

Issue	Original UFADAA	Revised UFADAA
Estate representative's access to the *content of a decedent's electronic communications.*	Permitted unless the decedent opted out while alive.	Not permitted unless the decedent consented to disclosure. Custodian may request a court order specifically identifying the account and finding consent. Indemnification not required.
Estate representative's access to *other digital assets* of a decedent.	Permitted unless the decedent opted out while alive.	Permitted unless the decedent opted out or the court directs otherwise. Custodian may request a court order specifically identifying the account and finding that access is reasonably necessary for estate administration.
Guardian's access to the *content of a protected person's electronic communications.*	Permitted if access ordered by the court.	Custodian need not disclose contents without the express consent of the protected person/ward, but may suspend or terminate an account for good cause if requested by the guardian.
Guardian's access to *other digital assets* of a protected person.	Permitted if access ordered by the court.	Permitted if authorized by the guardianship order. Custodian may require specific identification of the account and evidence linking the account to the protected person/ward.

Issue	Original UFADAA	Revised UFADAA
Agent's access to the *content of a principal's electronic communications.*	Permitted if expressly authorized by principal.	Permitted if expressly authorized by the principal. Custodian may require specific identification of the account and evidence linking the account to the principal.
Agent's access to *other digital assets.*	Permitted under a grant of general or specific authority.	Permitted under a grant of general or specific authority. Custodian may require specific identification of the account and evidence linking the account to the principal.
Trustee's access to the *contents of electronic communications* of a trust account.	Permitted unless prohibited by the user, trust, or court.	Permitted when trustee is the original user. Also permitted when the trustee is not the original user if authorized by the trust. Custodian may require specific identification of the account and evidence linking the account to the trust.
Trustee's access to *other digital assets* of the trust.	Permitted unless prohibited by the user, trust, or court.	Permitted unless prohibited by the user, trust, or court. Custodian may require specific identification of the account and evidence linking the account to the trust.

Issue	Original UFADAA	Revised UFADAA
Effect of boilerplate term-of-service prohibiting fiduciary access.	A blanket prohibition on fiduciary access is void as against public policy.	Three tiered approach: 1. A user's direction using an online tool prevails over an offline direction and over terms-of-service *if* the direction can be modified or deleted at all times. 2. A user's direction in a will, trust, power of attorney, or other record prevails over the boilerplate terms-of-service. 3. If a user provides no direction, the terms-of-service control, or other law controls if the terms-of-service are silent on fiduciary access.
Effect of other terms-of-service.	Not addressed.	Unless the conflict with a user's direction, terms-of-service are preserved and the fiduciary has no greater rights than the user.

Issue	Original UFADAA	Revised UFADAA
Procedure for disclosing digital assets.	Not addressed, but use of the term "access" throughout the act arguably contemplates the fiduciary logging on to the user's account.	The custodian has three options for disclosing digital assets: 1. Allow the requestor to access the user's account. 2. Allow the requestor to partially access the user's account if sufficient to perform the necessary tasks. 3. Provide the requestor with a "data dump" of all digital assets held in the account.
Administrative fees.	Not addressed.	A custodian may assess a reasonable administrative charge for the cost of disclosing a user's digital assets.
Deleted assets.	Not addressed.	Deleted assets need not be disclosed.
Unduly burdensome requests.	Not addressed.	A request for some, but not all, of a user's digital assets need not be fulfilled if segregation is unduly burdensome. Instead, either party may petition the court for further instructions.
Fiduciary duties.	Incorporated by a generic referenced to "other law."	Expressly incorporated.

Issue	Original UFADAA	Revised UFADAA
Account termination.	Not addressed.	If termination would not violate a fiduciary duty, the fiduciary may request account termination rather than disclosure of assets. A custodian may require specific identification of the account and evidence linking the account to the user.
Joint Accounts.	Not addressed.	Custodian need not disclose if aware of any lawful access to the account after receipt of the disclosure request.
Timely compliance.	Required within [60] days, or fiduciary may request an order of compliance	Required within [60] days, or fiduciary may request an order of compliance. The order must contain a finding that disclosure does not violate 18 U.S.C. § 2702.
Custodian immunity.	Custodian is immune from liability for an act or omission done in good faith compliance with the act.	Custodian is immune from liability for an act or omission done in good faith compliance with the act.