Tax Update

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TAX REFORM

On December 22, 2017, President Trump signed H.R. 1, enacting a sweeping tax reform bill into law. The tax changes impacting individuals and fiduciaries are numerous and wide-ranging, including:

- The income tax brackets have been somewhat consolidated, with a top marginal rate of 37%, applying to income exceeding $500,000 for single filers, $600,000 for married couples (whether filing separately or jointly), and $12,500 for estates and trusts.

- Many deductions have been adjusted, limited, or repealed. The standard deduction has increased to $12,000 for single filers and estates and trusts, $18,000 for heads of household, and $24,000 for married couples; meanwhile, personal exemptions have been repealed, and real estate taxes and state and local income taxes are deductible only up to $10,000 per year, in the aggregate. Items treated as miscellaneous itemized deductions subject to the 2% floor under the current tax law will no longer be deductible to any extent. Contributions of cash to public charities are deductible up to 60% of adjusted gross income.

- The threshold for the alternative minimum tax has increased to $70,300 for individuals and $109,400 for married couples, phasing out at $500,000 and $1,000,000, respectively. The AMT is unchanged for estates and trusts.

- Certain business income, whether from passthrough entities or from sole proprietorships, will be deductible up to the lesser of 1) 20% of the qualifying income; 2) 50% of the wages paid; or 3) 25% of wages paid plus 2.5% of the unadjusted cost of depreciable property. For business owners with taxable income below $157,500 (single) or $315,000 (married), the wage and cost limitations will not apply, and the deduction will simply be 20% of the business income; the wage and cost limitations phase in above those income levels. This deduction is below the line, so it does not affect the taxpayer's adjusted gross income, but it is not itemized, so it is available to any taxpayer regardless of their other deductions. The deduction phases out for owners of specialized service businesses who have taxable income in excess of $157,500 (single) or $315,000 (married), and is fully phased out at $207,500 or $415,000, respectively. Specialized service businesses include health, law, accounting, actuarial science, performing arts, consulting, athletics, and financial services.

- The exemption from estate, gift, and GST doubles, and will equal roughly $11.2 million per person in 2018. The Treasury Department is instructed to issue regulations concerning "clawback," so that lifetime gifts which utilize the increased exemption amount should be given

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due credit in the donor's eventual estate tax calculation, so that the benefit of the increased exemption is respected. The mechanism remains to be determined, however, so taxpayers should consult with their estate planning advisors.

- Most of these changes will sunset as of 12/31/2025.
- All inflation adjustments built into the tax code will now be calculated using the "chained CPI," which will have the effect of slowing the growth of these items. This change is permanent.

TREASURY REGULATIONS

Centralized Partnership Audit Regime. In TD 9829 (1/2/2018), the IRS affirmed, without substantial change, the regulations issued in June 2017 implementing the new Centralized Partnership Audit Regime for all entities taxed as partnerships. Under the June regulations, the audit is conducted between the IRS and the partnership representative, an individual who is nominated by the partnership each year on its tax return, but who does not have to be a partner. If the partnership fails to nominate a partnership representative, the IRS may select one without input from the partnership. The partnership representative will hold far greater authority than the tax matters partner, as s/he will have the sole authority to communicate and negotiate with the IRS regarding the audit proceedings and generally will not have notice obligations to the partners under the regulations. Assessments resulting from partnership audits will ordinarily be paid at the partnership level. Certain partnerships may opt out of the new audit regime, but any entity with more than 100 partners or with at least one ineligible partner- including trusts, disregarded entities, and partnerships- may not opt out. Instead, in the event of an audit, ineligible partnerships may make a "push out" election by which the assessments are paid by the partners, not by the partnership. The June regulations did not address tiered partnerships, i.e., partnerships with further passthrough entities as partners.

In 82 Fed. Reg. 60,144 (12/19/2017), the IRS proposed rules dealing with tiered partnerships. Generally speaking, the push-out election may be made at each level, so that if the proper elections are made timely, the assessment may be made by the ultimate taxpayer, and not by the audited partnership or any intermediate entity.

COURT DECISIONS

Green v. US, 10th Circ. 16-6371 (1/12/2018). The Barbara Green 1993 Dynasty Trust authorized the trustee to distribute trust property to one or more qualified charities so much of the trust income as the trustee determined to be appropriate. In 2004, the trust donated cash and real estate interests to qualified charities. The trustee filed the trust's 2004 income tax return and deducted the fair market value of the transferred property, which he claimed totaled approximately $29 million, pursuant to Code Section 642(c)(1). The IRS disallowed the deduction in part, stating that the trust could only deduct the basis of the real estate, not its fair market value. In February 2016, the Western District of Oklahoma found in favor of the trustee, and the IRS appealed. The Tenth Circuit read Section 642(c)(1) to permit the trustee to deduct only amounts that comprise the trust's gross income. To the extent that the trust's gross income was reinvested in the real estate, it is deductible; but to the extent that unrealized gain has not yet

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been included in gross income, there is no deduction available under Section 642. The Circuit Court distinguished Section 170, which specifically allows taxpayers who contribute appreciated property to charity to deduct the fair market value of the property; finding no similar provision in Section 642, the Tenth Circuit agreed with the IRS.

Salt Point Timber, LLC v. Commissioner, T.C. Memo. 2017-245 (12/11/2017). In 2009, the taxpayer granted a conservation easement over 1,000 acres of land to the Lord Berkeley Conservation Trust, and claimed a charitable deduction of $2.13 million. The grant contained language allowing the easement to be transferred to a replacement holder if any portion of the property were transferred to an owner of adjacent property subject to a “comparable” easement, but did not specifically require that the replacement holder be a qualified organization. The IRS disallowed the charitable deduction and the Tax Court agreed, finding that there was a non-negligible possibility that the easement would be transferred to a nonqualified holder.

Farr v. Commissioner, T.C. Memo. 2018-2 (1/9/2018). Joan Farr established the Association for Honest Attorneys as an exempt organization in 2003, and from then on, served as the CEO and as a director. During 2010, 2011, and 2012, Joan used the Association’s checking account for personal purchases, but did not draw a salary. The IRS assessed a deficiency against her, imposing first-tier and second-tier excise taxes on those amounts as excess benefit transactions under Code Section 4958. Joan argued to the Tax Court that the amounts were actually her salary, but the Tax Court found her argument unconvincing and affirmed the assessment.

IRS PRONOUNCEMENTS

Notice 2017-73 (12/5/2017). The IRS issued a notice of proposed regulations regarding donor advised funds. Among other things, the IRS proposes that:

- Distributions from a DAF enabling a donor, advisor, or related person to participate an event, or satisfying the deductible portion of such a person’s membership fee with a charitable organization, would be treated as granting more than an incidental benefit to that person.

- Distributions from a DAF to a charitable organization to which a donor, advisor, or related person has also made a pledge, without more, will be treated as granting only an incidental benefit to such person, even if the charity uses the grant to satisfy the pledge; however, the donor, advisor, or related person may not direct the charity to apply the grant to the pledge.

- Distributions from a DAF to a charitable organization would be treated as a contribution by the donor(s) of the DAF, and not from the organization managing the DAF, for purposes of the donee organization’s public support test.

- The IRS has requested comments on how private foundations utilize DAFs and whether distributions from private foundations to DAFs should be treated as qualifying distributions under certain circumstances.

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