LOEB & LOEB LLP

High Net Worth Families

APRIL 2018

CONTENTS

Vol. 13, No. 1

Interest on Certain Home Equity Loans May Still be Deductible

The Tax Cuts and Jobs Act ("TCJA") further restricted the deduction of interest expense incurred by taxpayers to acquire or improve their principal home and/or a second home. Prior to the TCJA, taxpayers were permitted to deduct interest expense on up to $1 million of debt used to acquire or improve a principal residence and secured by the residence. Taxpayers were also allowed to deduct interest expense on up to $100,000 of home equity debt. The home equity debt had to be secured by the principal and/or second residence; however, the proceeds of such debt could be used for any purpose.

Under the TCJA, two significant changes were made. First, interest on home equity debt is not deductible for tax years 2018 through 2025. Second, the limitation on acquisition debt was reduced from $1 million to $750,000 for taxable years 2018 through 2025. For acquisition debt that was incurred prior to December 15, 2017, interest will remain deductible on up to $1 million of such debt. There is also a binding contract exception that allows the $1 million limit to apply if the taxpayer had a binding written contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and the taxpayer actually purchased the residence before April 1, 2018. Indebtedness that qualifies for the $1 million limitation may be refinanced after December 15, 2017; as long as the principal amount of the debt is not increased, the interest will remain deductible on $1 million of such debt.

The Internal Revenue Service ("IRS") recently issued IR 2018-32 to remind taxpayers that certain debt commonly thought of as home equity debt may still give rise to deductible interest. The IRS gave several examples. If a taxpayer borrows $500,000 to purchase his principal residence, he could later borrow up to an additional $250,000 in order to expand or improve that residence and still deduct all of the interest. Alternatively, if a taxpayer borrows $500,000 to purchase his principal residence, he can borrow up to $250,000 to purchase a second home and still deduct all of the interest.

New Limit is Imposed on the Deduction of Business Losses

Another significant change made by the TCJA is the limitation on the deduction of business losses for taxpayers other than C corporations. New Internal Revenue Code ("IRC") Section 461(l) provides that if the gross income and deductions of a taxpayer's trade or business are aggregated, and if the net result is a loss, only $500,000 of that net operating loss ("NOL") may be deducted in the current year on a joint return, or $250,000 for a single individual or a married taxpayer filing separately. The portion of the loss that is disallowed is carried forward to subsequent tax years as a net operating loss. The TCJA also limited the use of NOL deductions in subsequent tax years to offset 80% of a taxpayer's taxable income.

In the case of partnerships and S corporations, the limitation is applied at the partner or shareholder level, and the partner or shareholder takes into account his share of business income and deductions from the partnership or S corporation along with any other gross income or deductions the taxpayer may have from other businesses. C corporations are not subject to this limitation.

In many cases, a taxpayer's ability to deduct losses may already have been affected by the limitations on deducting passive losses and the business loss limitation will not impose any new limitations, although the new limitation may become applicable in the year the taxpayer disposes of the passive activity and any loss remaining from that activity after offsetting gains on the disposition becomes a nonpassive loss.

These limitations may be onerous for taxpayers who start new businesses that will have losses in the early years, especially where the taxpayer has significant income from other activities. The limitation will also apply to losses from real property holdings if the activity related to the real property is considered a trade or business. Like the other provisions of the TCJA that apply to individuals, the limitation on business losses will cease to apply after 2025.

Conversion of a Non-Grantor Trust to a Grantor was Not a Taxable Event

In *PLR 201730018*, the IRS addressed the question whether income tax resulted from the conversion of a non-grantor trust to a grantor trust. The trust in question was a non-grantor charitable lead trust. Such a trust provides for an annual distribution to a charity for a number of years and thereafter holds any property remaining in the trust for non-charitable beneficiaries. The trust was amended to add a power that would cause the trust to become a grantor trust for income tax purposes.

The IRS ruled that such conversion was not treated as a transfer of property from the trust to the grantor, nor did it otherwise give rise to any taxable event. The IRS also held that the conversion did not constitute a prohibited act of self-dealing under Section 4941 of the Code. Finally, the IRS held that the conversion of the trust to a grantor trust did not give rise to any charitable contribution deduction for the grantor.

This ruling presents the flip side of a more common scenario. Taxpayers often create a trust that is treated as a grantor trust for income tax purposes; however, the trust does not contain any provisions that would cause the assets of such trust to be included in the taxpayer's gross estate for estate tax purposes at his death. Trusts of this nature allow the children and grandchildren of the taxpayer to benefit from any appreciation in the value of the property owned by the trust.

Since the trust is a grantor trust for income tax purposes, the taxpayer who created the trust is required to pay income tax on any income generated by the property held in the trust. This increases the benefits to the children or grandchildren because the payment of tax by the taxpayer depletes his taxable estate and the trust assets will grow at a pretax rate.

Sometimes the taxpayer who created the trust reaches a point where he wants to stop paying the income tax on the income generated by the property held by the trust. Trusts of this nature often contain a provision that allows a disinterested third party to remove the power from the trust that caused it to be a grantor trust. Following the removal of such power, the trust itself becomes a taxpayer and either it pays income tax on the income generated by the property of the trust or, if such income is distributed to the beneficiaries of the trust, the beneficiaries pay the income tax. The IRS has issued several rulings where it concluded that such a conversion in the nature of the trust did not give rise to a taxable event, provided that the property of the trust was not encumbered by liabilities that were in excess of the tax basis of such property.

Family Office Structured as a Limited Liability Company is Considered to be in a Trade or Business

In December, the Tax Court decided a case that is very significant for families that maintain family offices. In *Lender Management, LLC v. Commissioner (December 13, 2017)*, the court held that a family office structured as a limited liability company was engaged in a trade or business. The result of the court's holding is that the company could deduct the significant expenses it incurred in managing various investment vehicles for the family as business expenses rather than as investment expenses.

For the tax years at issue, this meant that the expenses could be deducted in full by the members of Lender Management, LLC. If the expenses had been considered investment expenses, they would have been deductible only to the extent they exceeded 2% of the adjusted gross income of the various family members.

Beginning in 2018, this case takes on increased importance as investment expenses which were treated as miscellaneous itemized deductions are no longer deductible at all. We will include a more detailed analysis of this important case in our new Family Office Newsletter, which is scheduled to begin publication in June.

Taxpayer Not Permitted to Use Passive Losses from Aircraft Chartering Against Real Estate Income

The Tax Court recently rebuffed a taxpayer's attempt to deduct losses incurred through the ownership and chartering of a jet aircraft to reduce income generated by his real estate business. Charles Brumbaugh was engaged in the business of developing low-income housing projects. In 2005, he purchased property to be developed that was located northeast of Oakland, California. His company was based in Bakersfield, and flying commercially to the job site was very time-consuming. To make his trips less time-consuming, he purchased a jet aircraft. He entered into an agreement with an aviation management company to maintain his aircraft, provide pilots and charter the jet to third parties when he was not using it. The charter activities with respect to the aircraft resulted in a tax loss of around $350,000 for the 2007 tax year.

The loss from chartering the jet was a passive loss because the taxpayer did not participate in the activity for more than 500 hours. However, he did participate for more than 500 hours in his real estate business, so he took the position that the chartering of the jet and his real estate development and construction were the same activity for purposes of the passive loss rules. If the activities could be so combined, the taxpayer did participate for more than 500 hours and the tax loss from the jet would not be a passive loss.

Upon audit, the IRS did not allow the activities to be grouped together and the taxpayer took his case to the Tax Court. In *Brumbaugh v. Commissioner (April 3, 2018)*, the court agreed with the IRS. The court looked at factors set forth in the passive loss regulations to determine whether different activities can be grouped as a single activity: i) similarities or differences between the two businesses; ii) extent of common control; iii) extent of common ownership; iv) geographic location of the business activities; and v) interdependence between the activities. The court determined that the two businesses had no real similarity. The taxpayer did hold controlling interests in both businesses; however, they were not geographically proximate to each other as the real estate activity was being conducted northeast of Oakland during the year at issue and the jet chartering took place from the Ontario Airport. Finally, the court found there was no interdependence between the businesses as they did not have the same customers and did not even have meaningful transactions between them. In fact, the taxpayer used his own plane only one time during 2007. The balance of the time he needed to travel, his plane was being chartered to a third-party customer, so he chartered another plane from the management company.

Tax Court Decides Several Cases on the Tax Consequences of Land Sales

In the past few months, the Tax Court has decided several cases where the question was whether the taxpayer realized ordinary or capital gain or loss when he sold real property. In *Conner v. Commissioner (TC Memo, 1/22/18)*, the taxpayer was the sole shareholder of an S corporation called America's Home Place that was engaged in the business of building custom homes.

The taxpayer had also acquired several tracts of land through single-member limited liability companies. One of these tracts, called Shoreline, consisted of 95 acres of land, which the taxpayer purchased between 2005 and 2007. The taxpayer commenced plans to develop the property into a lakeside community of 94 lots, obtaining approvals from the Army Corps of Engineers and securing water availability for a sewage treatment system. He hired a firm to draw plans for houses. Due to the unavailability of financing in 2008 and 2009, the taxpayer decided not to continue the development of the property and sold it for a significant loss in 2013.

The taxpayer deducted the loss as an ordinary loss, taking the position that he had acquired the property for use in his homebuilding business. The IRS and the Tax Court did not agree with this treatment, holding that his loss was a capital loss. A key factor in determining whether land is held for investment or development and sale is the number, extent, continuity and substantiality of sales, as well the extent of subdividing, developing and advertising undertaken by the taxpayer. In this case, Shoreline LLC made only a single sale of property in 2013 and had not made any other sales since the property was acquired in 2005. No effort was made to sell the property prior to its sale in 2013, and it was never advertised for sale. It was not listed with brokers, there was no sales office and no sales force was maintained. The taxpayer had not taken any actions oriented toward the development of the property since 2007. On these facts, the court concluded that even though the land was initially purchased for development, over time it became investment property, which gave rise to a capital loss when it was sold in 2013.

Although the investment characterization hurt the taxpayer in this case — where he realized a loss that was determined to be a capital loss — in many instances developers have property with built-in gains. They may wish to sell parcels they decide not to develop, hoping to obtain capital gain treatment. This case may serve as a road map toward achieving such treatment.

Sugar Land Ranch Development, LLC, v. Commissioner (TC Memo, February 22, 2018) presents the issue considered in the Conner case in the context of land with a built-in gain. Sugar Land Ranch Development LLC ("SLRD") was formed to acquire land around Sugar Land, Texas, and develop such land into single-family building lots and commercial tracts. In 1998, it purchased and otherwise acquired over 900 acres of land. Through 2008, SLRD engaged in a number of activities related to developing this land, including capping old oil wells, removing oil lines, undertaking environmental cleanup, building a levee and entering into a development agreement with the city of Sugar Land.

By 2008, the managers of SLRD decided that the land should not be developed because of the effects of the subprime mortgage crisis on the local housing market and the lack of financing for such a development. They decided to hold the property for investment until conditions improved sufficiently for it to be sold. This change of purpose was memorialized in resolutions adopted by SLRD. Nothing further happened regarding the property until 2011 and 2012, when the property was sold to a single buyer through two contracts of sale. The sales involved a fixed price and another payment of 2% of the selling price of each home the buyer constructed on the property.

In this case, the IRS took the position that the gain realized by SLRD was ordinary income. Compared with the *Conner* case, this seems to be a “heads I win, tails you lose” approach on the part of the IRS. At least the Tax Court applied a consistent analysis in the two cases. The court found that no development activity occurred after 2008, as documented by the resolutions adopted. The land was not sold through a marketing campaign or with advertising or other promotional activities. The buyer had actually approached SLRD and inquired about making a bulk purchase of the land. The court determined on these facts that the land was being held for investment at the time it was sold and capital gain income resulted from the sale.

In both the *Conner* and *Sugar Land* cases, significant amounts of time elapsed between the clear cessation of development activity and the ultimate sale of the property. In both cases, when the property was finally sold, it was sold in bulk without any advertising or other significant marketing activity. The fact that the taxpayer in the *Sugar Land* case documented the change of purpose through formal resolutions also seemed to make a favorable impression on the court.

In a third recent case, the Tax Court also addressed the character of gain or loss realized on the sale of real property on which some development or redevelopment activity had occurred. In *Keefe v. Commissioner (Tax Court, March 15, 2018)*, the taxpayers, a husband and his wife, purchased a historic but rundown home in Newport, Rhode Island, in January 2000, intending to restore it.

The taxpayers borrowed over $9 million in connection with their efforts to restore the property. The taxpayers also sought state and federal tax credits available for restoring certain historical structures. The federal credit required that the house be rented to tenants for at least five years. The state credit was obtained, but the taxpayers never attempted to claim the federal credit.

Following a long and difficult period of construction, a certificate of occupancy was finally obtained in 2008. The taxpayers met with a broker in 2006 to discuss renting the house during the summer season, in the hope that the house would be ready for rental in 2007. The broker communicated the pending availability of the house to her clients, and one expressed interest in renting it for the summer season of 2008. The construction was not finished in time for rental of the house during the summer season of 2008.

The house was never registered for rental with the city clerk of Newport and in fact was never rented. Under pressure from the lenders, the taxpayers had listed the house for sale from 2004 through 2009, at which time it was sold in a short sale at a significant loss. The issue before the Tax Court was whether the loss sustained by the taxpayers was ordinary or capital. The court’s analysis began with Section 1221 of the Code which sets forth a general rule that property is a capital asset. Among the exceptions, however, is real property used in a trade or business of the taxpayer. The question was whether the taxpayers’ activities regarding the house rose to the level of a trade or business, or were simply investment activities.

In order to have a trade or business involving real property, taxpayers must be engaged in continuous, regular and substantial activity in relation to the management of the property. The taxpayers argued that the house was used in a rental business. In order for rental property to be considered used in a trade or business, the activities related to renting the property must be continuous, regular and substantial. The taxpayer must make significant effort to rent the property, provide maintenance and repairs either directly or through an agent, collect rent, and pay expenses related to the property. In this case, the court determined that the rental activity never commenced in any meaningful way, so the house remained a capital asset that gave rise to a capital loss on its sale.

This case has significance in light of the new 20% pass-through deduction enacted as part of the Tax Cuts and Jobs Act. The deduction applies to activities that constitute a trade or business. There has been a lot of speculation around whether passively held real estate investments, such as properties subject to triple net leases, would qualify. Most triple net leased property would not meet the trade or business criteria applied by the court in the *Keefe* case. It remains to be seen whether the IRS will apply similar criteria in determining the eligibility of rental real estate for the new pass-through deduction.

Time to Review Partnership and LLC Agreements

With significant changes to the tax law taking effect in 2018, now is the time to review your partnership and LLC agreements. Two major areas to consider are the new partnership audit rules and tax distributions.

Some agreements may not take into account the new partnership audit rules, which are effective for tax years beginning after 2017. Although the rules were first enacted in 2015 with a delayed effective date, they were amended as recently as last month. Under the new rules, the tax matters partner has no authority. Rather, the partnership representative (or individual designee), who does not have to be a partner, has the sole authority to deal with the IRS and can bind all partners. Moreover, the affected partner, no matter how large an interest he has in the partnership, no longer has the right to attend meetings with the IRS or to enter into his own settlement agreement. The determination of the partnership representative binds all partners in connection with any transaction involving the partnership, even with respect to items that do not necessarily affect the partnership (e.g., the partner's basis in property sold to the partnership). Because of the dramatically increased power of a partnership representative, as compared with the tax matters partner, anyone not affiliated with the partnership representative will want protections, and the place for such protections is in the partnership agreement. And the partnership representative needs to sign the agreement in order to be bound to provide such protections.

Agreements should also be reviewed with respect to tax distributions. Although tax distributions are intended only to assist the partners in paying their taxes attributable to their share of the partnership's income, partners hate having to reach into their pockets to pay any portion of such taxes. Some partnership agreements use a fixed rate for paying tax distributions. Some use a formula that assumes state and local taxes are deductible for the partners. But tax rates changed as a result of the TCJA and the deduction for state and local taxes was limited to $10,000 through 2025. Should the new pass-through deduction be taken into account in computing tax distributions? Although the deduction is based on the partnership, it is a partner level deduction and may be affected by the partner's other tax attributes.

We would be happy to assist in reviewing your partnership and LLC agreements and recommending changes to suit your particular needs.

IRS and Treasury Seek Comments on Proposed Donor Advised Fund (DAF) Regulations

The IRS on December 4 issued Notice 2017-73, stating that it is considering developing the following proposed regulations for IRC Section 4967:

- **Tickets as Non-Incidental Benefits to Donors.** The IRS proposes providing that distributions from a DAF that pay for tickets for a donor, donor advisor or related person to attend or participate in a charity-sponsored event would be a non-incidental benefit to such person under IRC Section 4967, and thus subject to penalties.

- **Fulfilling Charitable Pledges as Incidental Benefit to Donors.** The IRS proposes providing that distributions from a DAF to a charity that fulfill a charitable pledge made by a donor, donor advisor or related person are an incidental benefit to such person, if certain requirements are met. More specifically, the IRS proposes to consider such pledge fulfillment as an incidental benefit if:

    - The sponsoring organization makes no reference to the existence of a charitable pledge when making the DAF distribution;

    - No donor or advisor receives, directly or indirectly, any other benefit that is more than incidental on account of the DAF distribution; and

    - A donor or advisor does not attempt to claim a charitable contribution deduction with respect to the DAF distribution, even if the distributee charity erroneously sends the donor or advisor a written donor acknowledgment for the DAF distribution.

The IRS emphasized that this proposed rule would apply only to DAFs and their donors/advisors, and not to private foundations and their disqualified persons.

- **Public Support Computation Look-Through Rule for DAFs.** The IRS proposes changing the public support computation rules to prevent the use of DAFs to circumvent the public support requirements. Ordinarily, donations from a private individual or a private foundation are subject to the "2% limit" in counting toward a public charity's required public support percentage. The IRS has identified a potential for abuse in that a private individual or a private foundation could make contributions to a DAF (the sponsoring organization of which is usually a public charity) and then use the DAF to make charitable contributions, which would not be subject to the 2% limit. The IRS is considering deeming a distribution from a DAF as an indirect contribution from the donor that funded the DAF, solely for purposes of determining whether the distributee charity meets the public support test.

The IRS is requesting comments on (1) how private foundations use DAFs in support of their purposes, (2) whether a transfer of funds by a private foundation to a DAF should be treated as a "qualifying distribution" under IRC Section 4942, (3) any additional considerations relating to DAFs and the public support computation and (4) methods to streamline any required recordkeeping under the proposed changes to the public support computation.

New York State 2019 Budget Includes Significant Tax Changes

The recently enacted New York State (NYS) budget act is important for both the tax provisions it includes and those that were not included.

New York is the first state to implement legislation to combat the federal amendment that limited the deduction for state and local taxes to $10,000. New York adopted a two-tier attack. First, the budget establishes two state-operated Charitable Contribution Funds to accept donations, which allows the taxpayer a credit against his NYS personal income tax for 85% of the contribution. It appears doubtful, however, that the IRS will allow the taxpayer a federal charitable contribution deduction for a donation to any such fund.

New York also allows an employer to voluntarily pay a payroll tax on its employees who have wages in excess of $40,000 a year. The tax, which phases in over three years, is 1.5% in 2019, 3% in 2020 and 5% thereafter. The employee is entitled to credit an after-tax portion of the payroll tax against his NYS personal income tax. Even assuming this is respected as a deductible employer tax, in order for this to work, the employee must agree to a reduction in his compensation. In addition, the employer or employee has to agree to bear the additional administrative cost. If the payroll tax conversion works, the parties will not only convert a nondeductible NYS personal income tax into a deductible payroll tax, but the parties will also benefit from paying federal income and employment tax on a lower amount of wages. It remains unclear whether the IRS will bless this structure, and, even if it does, whether because of the complexity any employers will elect to pay the tax.

Under the budget act, filing an amended return will give NYS an additional year to assess additional tax. The new law also reverses the *Sobotka* case, again providing that the 183-day rule for a statutory resident is based on all days during the tax year, not just those for which the taxpayer is not domiciled in NYS. In addition, the new law codifies the Tax Department's policy that a member of a limited liability company and a limited partner are not personally liable for the limited liability company's or limited partnership's NYS sales tax if he can show that he had no duty to act on behalf of the company in complying with its sales tax and that he owns less than 50% of the company.

NYS decouples from the new federal tax changes in certain cases. For example, an individual may claim the federal standard deduction but still itemize for NYS, and can continue to claim certain deductions that are no longer allowed federally. In addition, corporate transition income under IRC Section 965 is not taxable for NYS, but the related deduction is also not allowed.

Various provisions that had been proposed by Governor Cuomo were not adopted. These include the 17% additional tax on carried interests, a required deferral in the use of certain business tax credits in excess of $2 million and a requirement for certain marketplace providers to collect sales tax. Of course, the fate of remote sellers in having to collect sales tax is now before the Supreme Court.

If you see anything in these reports that you believe may have application to your own situation, please contact any member of our Tax or Trusts and Estates practice. We hope you feel free to pass on the report to other family members, friends and colleagues.