GENOVA BURNS
ATTORNEYS-AT-LAW

Genova Burns LLC
494 Broad Street, Newark, NJ 07102
**Tel:** 973.533.0777 **Fax:** 973.533.1112
**Web:** www.genovaburns.com

Judson M. Stein, Esq.
Partner
Member of NJ Bar
jstein@genovaburns.com
Direct: 973-230-2080

March 23, 2018

Dear Clients and Colleagues:

The following is a summary of some of the more important tax developments that have occurred during the fourth quarter 2017 that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

*Tax Cuts and Jobs Act*

As many of you are aware, Congress passed the Tax Cuts and Jobs Act at the end of 2017, which took effect January 1, 2018. Among the many changes, those which may be most relevant to you include (1) the doubling of the standard deduction; (2) the cap on deductions for state and local taxes at $10,000.00; (3) a 20 percent deduction for qualified business income from pass through entities (such as LLCs); (4) an increase in the federal estate, gift, and generation skipping transfer tax exemptions to $10,000,000.00 per person, indexed for inflation from 2011; (5) increase in the child tax credit; (6) suspension of personal exemptions; and (7) reduced income tax rates and revised brackets, among others.

**Many of the changes pertaining to individuals are temporary. Among the temporary provisions are those that increase the federal estate, gift, and generation skipping transfer tax exemptions. These increases are scheduled to expire after 2025 (and could sooner expire by reason of an earlier legislative repeal of the increased exemptions). These temporary changes not only present wealth transfer opportunities that may be relatively short-lived, they also may cause aspects of prior planning to result in unexpected and unintended consequences. As such, it is very important, among other things, for everyone's estate planning to be carefully reviewed.**

For businesses, the legislation permanently reduces the corporate tax rate to 21 percent, repeals the corporate alternative minimum tax, imposes new limits on business interest

deductions, and makes a number of changes involving expensing and depreciation. The legislation also makes significant changes to the tax treatment of foreign income and taxpayers, including the exemption from US tax for certain foreign income and the deemed repatriation of off-shore income.

*Regulations Issued for Electing Out of New Partnership Audit Rules*

The IRS has issued final regulations on the election out of the centralized partnership audit regime rules which are generally effective for tax years beginning after December 31, 2017. Under the new audit regime, any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership tax year (and any partner's distributive share thereof) generally is determined, and any tax attributable thereto is assessed and collected, at the partnership level. The applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share is also to be determined at the partnership level. However, new regulations provide guidance on how eligible partnerships that are required to furnish 100 or fewer Schedules K-1 (Partner's Share of Income, Deductions, Credits, etc.) may elect out of this new regime.

*Safe Harbor Methods for Non-Business Casualty Losses*

The IRS provided safe harbor methods that individual taxpayers may use in determining the amount of their casualty and theft losses for their personal-use residential real property and personal belongings. Taxpayers often have difficulty determining the amount of their losses under the IRS regulations. In order to provide certainty to both taxpayers and the IRS, the safe harbor methods provide easier ways for individuals to measure the decrease in the fair market value of their personal-use residential real property following a casualty and to determine the pre-casualty or theft fair market value of personal belongings. In addition, the IRS provided a safe harbor under which individuals may use one or more cost indexes to determine the amount of loss to their homes as a result of Hurricane and Tropical Storm Harvey, Hurricane Irma, and Hurricane Maria.

*Deductions Denied for Home Rented to Daughter*

The Ninth Circuit determined that married taxpayers were not entitled to claim business deductions with regard to their second house that they rented to their daughter at below-market rates. During 2008 through 2010, the taxpayers reported rental income from daughter ($24,000.00 for 2008, $24,000.00 for 2009, and $6,000.00 for the first three months of 2010) and

claimed deductions relating to the property for, among other things, mortgage interest, taxes, insurance, and depreciation. Overall, they claimed net losses for each year of $134,360.00, $84,600.00, and $107,820.00. The Court determined that the daughter's use of the house was, in effect, personal use by her parents for purposes of Code Sec. 280A(d)(1) 's limit on deductions with respect to a dwelling unit used for personal purposes. Because she did not pay fair market rent, they did not qualify for an exception to the general rule in Code Sec. 280A(e) disallowing deductions in excess of rental income.

*Taxpayer is Liable for $1,000,000.00 FBAR Penalty*

The Ninth Circuit found that a taxpayer willfully failed to file a Report of Foreign Bank and Foreign Accounts (FBAR) where IRS assessed a penalty of approximately $1.2 million against the taxpayer for failing to disclose her financial interests in an overseas account. The Court rejected a variety of the taxpayer's arguments, ranging from the contention that the imposition of the penalty violated the US Constitution's excessive fines, due process, and ex post facto clauses, to assertions that it was barred by statute of limitations or treaty provisions.

*IRS Confirms $15,000.00 Annual Gift Tax Exclusion for 2018*

The IRS, in "What's New—Estate and Gift Tax", January 12, 2018, confirmed that notwithstanding the change in the method of indexing the annual exclusion for 2018, the amount of the exclusion remains $15,000.00 per donee per year. The Tax Cuts and Jobs Act changed the method for calculating the inflation adjustment for the gift tax annual exclusion and other provisions throughout the tax code. For taxable years after December 31, 2017, the new law relies on a less-generous Chained Consumer Price Index for All Urban Consumers ("C-CPI-U") rather than the current Consumer Price Index for All Urban Customers ("CPI-U"). The two methods differ in that the C-CPI-U attempts to account for the ability to alter consumption patterns in response to price changes. The C-CPI-U allows for consumer substitution between item categories of consumer goods and services that make up the index, while the CPI-U only allows for modest substitution within item categories. Unlike many other provisions enacted under the new law, this modification to the inflation indexing calculation method does not sunset after 2025.

*First Circuit Upholds IRS' Reduction in Cost of Goods Sold and Compensation Deductions*

For compensation to be deductible by an employer under Code Section 162, the amount must be reasonable, and the payment must be purely for services rendered. Courts have

considered various factors in assessing the reasonableness of compensation, such as: employee qualifications; the nature, extent, and scope of the employee's work; the shareholder-employees' compensation compared with that paid to non-shareholder-employees; prevailing rates of compensation for comparable positions in comparable concerns; and comparison of compensation paid to a particular shareholder-employee in previous years where the corporation has a limited number of officers. No single factor is considered dispositive, and additional scrutiny is given in situations where a corporation is controlled by the employees to whom the compensation is paid because there is a lack of arm's-length bargaining. (Charles Schneider & Co., CA 8 1974; 34 AFTR 2d 74-5422).

A taxpayer's income from selling goods is calculated by taking the income generated by selling goods and subtracting the amount that the taxpayer paid for those goods, which is also known as the "cost of goods sold." (Treas. Reg. § 1.61-3(a)). The cost of goods sold for a given tax year only includes the cost of the goods that the taxpayer sold in that tax year. Consequently, the cost of goods sold for a given tax year usually equals the beginning inventory (at cost), plus inventory purchases and inventory costs, minus the ending inventory (at cost). *See,* (Huffman, (2006) 126 TC 322).

Taxpayer used the gross profit method to determine its cost of goods sold. Instead of calculating the cost of goods sold by tracking changes in its inventory, Taxpayer selected a percent profit that it claimed to make on the sale of goods and used that figure to generate its cost of goods sold, as well as estimates of its beginning and ending inventory. Taxpayer's cost of goods sold "varied without explanation" from year to year, and Taxpayer kept no records indicating how it selected its gross profit percentage. Taxpayer paid each of Founder's sons $575,000.00 in 2006, $675,000.00 in 2007, and $720,000.00 in 2008. Founder made the compensation decisions alone, without consulting his accountant. The only apparent factors considered in determining annual compensation were reduction of reported taxable income, equal treatment of each son, and share ownership. After audit, the IRS issued deficiency notices to Taxpayer for 2006, 2007, and 2008. The Tax Court upheld such deficiency notices, and the First Circuit Court of Appeals affirmed the Tax Court's decision. *See*, Transupport, Inc. v. Comm., (CA1 02/14/2018) 121 AFTR 2d ¶ 2018-454.

*Transfers of Life Estates Under Split Purchase Agreement Does Not Void Chapter 14 Protection*

The IRS has issued three Private Letter Rulings related to split-purchase agreements wherein the Service stated that transfers by the life tenants of their interests in a geographically-defined section of real property held in a split-purchase arrangement would not void the exemption from Chapter 14 of the split-purchase ownership of the remaining property where the original acquisition was entered into before October 8, 1990. The original transaction involved the purchase of a life estate by wife, a successor life estate by husband, and remainder interests as tenants-in-common by six children, in certain real properties, each participant paying the actuarial value of his or her purchased interest using independent funds. The parents now wanted to transfer their life estates in a geographically-defined portion of the property to the children. In addition to stating that the transfer would not subject the remaining property to Chapter 14, the IRS also stated that husband's and wife's gifts, to the extent made without adequate consideration, would be taxable gifts, and that the value of husband's and wife's remaining interests in the property would not be included in their gross estates for estate tax purposes. *See*, PLR 201808001, PLR 201808002, and PLR 201808003 (Feb. 23, 2018).

*IRS Notice States that Carried Interest Rules Cannot be Avoided by Using S Corps.*

Effective for tax years beginning after December 31, 2017, the Tax Cuts and Jobs Act added a new Code section which imposes a three year holding period requirement in order for "applicable partnership interests" received in connection with the performance of services to be taxed as long-term capital gain. (Code Sec. 1061). These interests are often referred to as "carried interests." Code Sec. 1061(c)(1) generally defines the term "applicable partnership interest" as meaning any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. Code Sec. 1061(c)(4)(A) provides that the term "applicable partnership interest" does not include any interest in a partnership directly or indirectly held by a corporation. Code Sec. 1361(a)(1) provides in general that the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under Code Sec. 1362(a) is in effect for such year.

The IRS has now announced that it intends to issue regulations providing guidance on the application of Code Sec. 1061 and that those regulations will provide that the term "corporation" for purposes of Code Sec. 1061(c)(4)(A) does not include an S corporation. Thus, "taxpayers

will not be able to circumvent the three-year rule by using S corporations." *See*, Notice 2018-18; 2018-12.

*New Jersey Division of Taxation Provides Guidance Regarding New Jersey Estate Tax*

In a statement provided to the New Jersey State Bar Association, the New Jersey Division of Taxation has provided guidance to practitioners regarding changes to the imposition of the New Jersey Estate Tax. The Division's statement is as follows:

"New Jersey estate tax has gone through another change for 2018 as a result of Bill A-12. The Division of Taxation has been receiving a lot of communications requesting clarification on the new requirements. Most notably have been calls from financial institutions stating that estates and their attorneys have been telling the banks that the tax has been repealed and waivers are no longer required. **This is incorrect**.

The division wishes to pass on the following information:

1. Bill A-12 did not repeal the Estate Tax law. It provided that for 2018 the tax rate is zero, but made no other amendments to the existing law.
2. New Jersey Inheritance Tax has not changed and remains in effect.
3. The statutory lien on decedent's assets remains for both taxes. Therefore, the waiver requirement remains.

By way of explanation, even had the estate tax been fully repealed, the inheritance tax waiver requirements would still have remained. Waivers, as before, come in two forms. One of these must be presented to financial institutions or transfer agents in order to release assets:

1. Form 0-1, which is the formal release issued by the division. This is obtained by filing a return with the division.
2. Form L-8, which is the self-executing waiver completed by the estate. This may only be used by Class "A" beneficiaries (when assets do not pass into a trust and no disclaimer has been filed).

The only difference now is that the size of the estate no longer matters for decedents who die on or after January 1, 2018. An updated L-8 is being posted which reflects this change.

All filing requirements for inheritance tax remain in effect. The director has waived any return filing requirements for New Jersey estate tax for decedents who die on or after January 1, 2018 (so long as the current law remains in effect). An updated L-9 (for real estate waivers) will be posted shortly as well.

As always, the Division of Taxation would be happy to answer any questions or address any concerns you may have. Please contact our Inheritance and Estate Tax Hotline at 609-292-5033 and an auditor will assist you." (**emphasis added**)

There are several interesting portions of the statement to note. First, the specific clarification that the New Jersey estate tax is not repealed; rather, the estate tax rate has simply been reduced to zero, but no other changes have been made to the law. Moreover, the Director has waived the filing requirement for estate tax for decedents who die on or after January 1, 2018 "(so long as the current law remains in effect)". This pointed clarification regarding the continued existence of the New Jersey estate tax, albeit at a current zero tax rate, and the waiver of filing requirement only so long as the current law remains in effect, may give credence to speculation that the New Jersey estate tax may not be "repealed" for long. Second, the statutory lien on decedent's assets remains; thus, the waiver requirement remains. Consequently, wherever assets pass into a Trust, or by qualified disclaimer, a New Jersey inheritance tax return must be filed and Form 0-1 waivers obtained. Form L-8 waivers may not be used where assets pass into Trusts or by disclaimer, even if all beneficiaries of such Trust or disclaimer are Class "A" beneficiaries exempt from New Jersey Inheritance Tax.

The above reflects just some of the recent tax developments of which you should be aware. Please contact us if we may be of assistance to you in any way.

Very truly yours,
GENOVA BURNS LLC
Judson M. Stein, Esq.
Lauren M. Ahern, Esq.

For more information, please contact Judson M. Stein, Esq., at jstein@genovaburns.com, or Lauren M. Ahern, Esq., at lahern@genovaburns.com.