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# Tax Talk

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Kent Bridges, Managing Partner

Dear Clients and Friends,

The traditional "busy season" is well under way at Bridges & Dunn-Rankin. It comes as a surprise to most people that September 15 (extended due date for most entity returns) and October 15 (extended due date for individual returns) are probably bigger deadlines for us than March 15 and April 15. Nevertheless, this is clearly a busy time of the year for us as we try to get out audited financial statements and Schedule K-1s, along with structuring transactions, handling IRS and DOR matters, and doing ongoing planning for our clients.

2020 is a Presidential election year, and so we are hearing a lot about potential tax legislation; with the Democratic candidates proposing new taxes on wealth and financial transactions, higher tax rates and the repeal or limitation of various deductions, while the Republicans talk of another potential tax cut.

The Tax Court has issued rulings in four conservation easement cases since the last issue of our newsletter, so we will summarize those in this issue, along with discussing how to properly structure S-corp shareholder loans to get basis, the recent SECURE Act legislation, TCJA interest expense limitations and a roundup of other tax items of general interest.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

*Kent Bridges*

## Tax Court Issues Rulings in Four Conservation Easement Cases

If you have been a reader of this newsletter for a while, then you know that "syndicated conservation easements" have been the tax shelter du jour (especially amongst Georgia residents) for more than a decade now (in fact, we were first approached about these at least 18 years ago). Their popularity really seemed to take off after a big taxpayer win at the Tax Court in 2009 (*Kiva Dunes Conservation*) in a case involving a developer who granted a perpetual conservation easement, keeping property as a public golf course which otherwise could have been developed as residential lots. In the *Kiva Dunes* case (for which the tax year was 2002), the taxpayer claimed a deduction of $30.6 million, the IRS sought to disallow the deduction entirely, and the Tax Court allowed a deduction of $28.7 million.

Since the *Kiva Dunes* decision in 2009, the conservation easement cases have largely gone against taxpayers, and we note that it takes quite some time for a case to make its way to the Tax Court (e.g. the four cases in which the Tax Court just issued rulings involve tax years 2010 – 2013, and there are cases docketed with the Tax Court for even earlier years than that).

Below is a brief synopsis of each of the four cases for which rulings have been issued by the Tax Court since the last issue of our newsletter.

- ***TOT Property Holdings, LLC v Commissioner*** – In its December decision in *TOT Property Holdings*, the Tax Court disallowed the deduction entirely because it found that the "perpetuity requirement" was not met because of how proceeds from sale of the property would be shared if the easement were ever extinguished judicially. The Tax Court could have stopped there, without giving consideration to whether the highest and best use value claimed by the taxpayer was reasonable, but the court went on to consider value because if the value were found to have been significantly overstated then the 40% gross valuation misstatement penalty would apply, rather than the general 20% accuracy-related penalty. The Court found that the value of the conservation easement was $486k, not the $6.9M claimed, and, accordingly, asserted the 20% accuracy-related penalty on the $486k and the 40% valuation penalty on the next $6.4M. The taxpayer had claimed that the highest and best use of the property was as a residential development for mountain resort homes, and the taxpayer's appraiser used as comparable sales properties which had mountain and lake views. However, the subject property was not in the mountains and had no lakes, and nearby residential developments had failed. The Court also noted that the property was at least 32 miles from any interstate highway, had no public access water, and no hospital in the county. Accordingly, the Court agreed with the IRS' appraiser that the highest and best use was recreational and hunting. The Court noted that the conservation easement syndicate had paid only a little over $1M for a 99% interest in the property, and thought that was likely the best measure of the land's value (rather than the $7M+ claimed). The Tax Court felt there was no reasonable cause exception to penalties applicable here, even though the taxpayer hired a qualified appraiser and accountant, because the taxpayer should have known that it was not reasonable to claim a value so much greater than the value just paid to acquire the partnership interests. Immediately following the Tax Court's decision, the IRS issued a News Release (IR-2019-213) quoting IRS Commissioner Chuck Rettig as saying, in part, "If you engaged in any questionable syndicated conservation easement transaction, you should immediately consult an independent, competent tax advisor to consider your best available options".

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## Tax Court Issues Rulings in Four Conservation Easement Cases — continued

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- ***Carter v Commissioner*** – In its February 3 decision in *Carter*, the Tax Court disallowed the deduction because the LLC retained the right to build some single-family residences on the property, with the location of such to be determined later, subject to the approval of North American Land Trust. The one bright spot for the taxpayers in this case was that the Tax Court ruled the IRS could not assess the almost $2M in penalties it sought, because the IRS could not prove that the agent first properly obtained written supervisory approval for such.

- ***Railroad Holdings, LLC v Commissioner*** – Similar to its rulings in *TOT Property Holdings* and *Carter*, in its February 5 ruling in *Railroad Holdings*, the Tax Court disallowed the deduction based solely on failure to adhere to the perpetuity rule. The deed provided that if the conservation easement was set aside by judicial proceeding, then the charitable organization holding the easement would receive an amount equal to the value of the conservation easement deduction claimed. Off-hand, that certainly seems fair enough, and if the value being assigned to the conservation easement was in fact grossly overstated, then that would mean that the charitable organization would likely receive all of the sale proceeds. However, the Tax Court said that strict compliance with the regulations is required, and the regulations require that the amount going to the charitable organization be determined at the time of a subsequent sale based on a formula, the numerator of which is the value assigned to the conservation easement and the denominator of which is the total value (i.e. highest and best use value used), and failure to adhere strictly to this formula means no deduction.

- ***Oakhill Woods, LLC v Commissioner*** – In *Oakhill Woods*, both the IRS and the taxpayer sought summary judgment on the issue as to whether failure to disclose cost basis on Form 8283 means automatic loss of the deduction. The taxpayer wanted the Tax Court to either rule that it substantially complied with the disclosure requirements or that the regulation requiring such was invalid. The IRS wanted the Tax Court to rule that the regulation is valid and that taxpayer automatically loses (regardless of whether or not the valuation was correct) due to failure to comply. The Tax Court denied taxpayer's motion for partial summary judgment, and granted the IRS motion in part, ruling that the regulation is valid (i.e. you can lose deduction for failure to disclose basis) and that taxpayer did not substantially comply with the requirements. However, the Tax Court acknowledged that it was conceivable the taxpayer might have a reasonable cause defense for not complying, if the taxpayer can demonstrate that it received advice from a competent tax professional (who was independent of the transaction) that it did not need to provide the basis information, and that it relied in good faith on the advice so received. We note, however, that the Tax Court appears to be skeptical that the taxpayer can demonstrate this, and the Court also expressed skepticism as to the value placed on the easement, stating "Oakhill thus took the position that the 379 acres had appreciated by more than 800% during the previous 3 ½ years amid the worst real estate crisis since the Great Depression." We note further that the taxpayer here did not just inadvertently forget to disclose the cost basis, but instead attached a statement saying "a declaration of taxpayer's basis in the property is not included in the attached Form 8283 because of the fact that the basis of the property is not taken into consideration when computing the amount of the deduction". The IRS and the judge were not impressed with this statement.

There is an old adage that "bad facts make bad law".

In the 2009 *Kiva Dunes* case, the taxpayer had good facts, and the IRS, perhaps overly confident that they would win based solely on the amount of the deduction relative to the taxpayer's cost basis in the property, appeared to put on a poor case. More than 10 years had lapsed between the time of purchase of the property and the granting of the conservation easement. This helped to avoid any issue with the fact the conservation easement deduction being claimed was many multiples of (52 times) the original purchase price paid. The taxpayer had already sold most of the property he owned around the golf course (limiting any value enhancement he was gaining by virtue of granting the conservation easement). Both parties agreed that the highest and best use of the golf course property was as residential lots, the property was zoned for such, and the market demand for such at the time was sufficient to absorb the hypothetical number of lots over a reasonable period of time. And, perhaps most importantly, the taxpayer had used an appraiser who was very familiar with the local market and who appeared to have done a very thorough appraisal, whereas the IRS used an appraiser who was not familiar with the local market and who appeared to have made a number of mistakes.

Since its big loss in the *Kiva Dunes* case, the IRS appears to have been a bit more careful with the cases it takes to Tax Court, and the Tax Court judges, perhaps perceiving that conservation easements have become an area of taxpayer abuse, appear to be quick to give the IRS a win based on what many might perceive as technical foot faults, rather than dealing with the more difficult and subjective issue of valuation.

Most people have seen nature documentaries of the African wildebeests gathering on the banks of the Mara River in Kenya, preparing to attempt a crossing, while the river teems with crocodiles preparing for a feast. An estimated over 1,000,000 wildebeests attempt the crossing each year, with all but about 6,000 making it safely across (although surely it must be a terrifying experience; even for those who do make it across safely). Syndicated conservation easements may prove to be similar, with the number of taxpayers who have participated in them exceeding the IRS' capacity to pursue all of the cases (even though the IRS almost certainly knows who has participated due to the disclosures on Forms 8283 and 8886). This may particularly be the case once the IRS gets beyond the relative lay-ups it has been getting from technical foot faults, like failure to disclose cost basis and failure to adhere to the perpetuity clause, and has to pursue cases on the more substantive, time-consuming, and subjective issue of valuation. With this in mind, it will be interesting to see whether the IRS offers a broad-based settlement program.

## The Secure Act

In late 2019, the *Setting Every Community Up for Retirement Enhancement* (SECURE) *Act* was enacted. Below is a summary of the highlights.

***Elimination of the "Stretch IRA"*** – For persons who passed away prior to 2020, it was possible to stretch out over a very long period of time their RMDs (required minimum distributions) by naming a very young beneficiary, on whose life expectancy the RMDs could be based. Going forward, however, the inherited IRA will generally have to be paid out over a period not to exceed 10 years. There is a limited exception for beneficiaries under the age of 21 who inherit IRA from a parent (but not a grandparent), whereby the required time period may be stretched to age 31. Individuals who have previously named a trust as their IRA beneficiary should have these trust agreements reviewed by an attorney, as trust provisions which were favorable under prior law may be very unfavorable under the new law (e.g. a "Conduit Trust" might now not permit any distributions until the 10th year, with required full distribution in that year, or a "Discretionary Trust" might have to receive and retain distributions each year at the trust level at the high trust tax rates).

***RMDs not required until age 72*** – In the past, you had to begin taking your required minimum distributions (RMDs) in the year you attained age 70 ½ (with a grace period to April 1 of the next year for your first year's RMD). For those who did not reach the age of 70 ½ before 2020, the required starting date is now the year in which you attain age 72. The April 1 of next year grace period for first year's RMD continues to apply (although availing yourself of the grace period means doubling up the RMD in that year).

***QCDs still okay at age 70 ½*** - Although the required date for starting RMDs has been pushed back to age 72, you can still make a qualifying charitable distribution (QCD) from your IRAs at age 70 ½ (up to $100,000 per year).

***IRA contributions after the age of 70 ½ now okay*** – The prohibition on making traditional IRA contributions after age 70 ½ is repealed (provided you or your spouse are still working and have sufficient compensation to support the deduction).

***Exception to early distribution penalty for birth or adoption*** – Generally, a 10% penalty applies if you take a distribution from IRA or 401(k) prior to attaining the age of 59 ½. However, a new rule permits you to take up to $5,000 during the one-year period beginning on the date of a birth or adoption, and not incur the penalty. This $5,000 amount is per child and per parent, so if both parents have qualified plan assets they could potentially have up to $10,000 of distributions free from the penalty following the birth or adoption of a child. The amount is, however, still subject to income tax.

***Kiddie tax reverts to pre-TCJA rule*** – Prior to the *Tax Cuts and Jobs Act* (TCJA) legislation enacted in late 2017, unearned income of minor children (or students up through the age of 23) was subject to tax at their parents' marginal tax rate. TCJA changed that to provide that the children's unearned income was taxed at trust rates. However, trusts move into the highest rate bracket at a fairly low level of income, which meant that this rule was very punitive for families of modest income. Accordingly, for 2020 and beyond, the SECURE Act changes back to the old rule of taxing the child's income at the parents' rate, and provides that for 2018 and 2019 you can elect whichever of the two sets of rules you prefer.

Michael A. Sudduth, CPA

***Use of 529 plan funds for apprenticeships and loan repayments*** – 529 plan funds may now be used for certain qualified apprenticeship programs and up to $10,000 (per person lifetime limit) may be used to repay qualified student loans.

***Ability to adopt retirement plan up to extended due date of return*** – Prior to the SECURE Act, generally for an employer to adopt a retirement plan such had to be done by the end of the tax year. Now, effective for 2020, the employer has up until the extended due date of its tax return to adopt a plan that is entirely employer funded.

***Fiduciary safe harbor for selection of annuity provider for 401 (k) plan*** – Although nothing under prior law prevented a 401(k) plan from offering an annuity option, it was estimated that fewer than 10% did because of concerns about fiduciary liability if the annuity provider ran into financial trouble and could not meet its obligations. The legislation alleviates this concern by providing a safe harbor for the selection of an annuity provider.

***Increased tax credit for adoption of retirement plan by small business*** – Prior to 2020, small businesses could receive a tax credit of up to $500 per year for up to 3 years for establishing a retirement plan. For 2020 and beyond, the credit is increased to up to $5,000 per year for up to 3 years (with the amount being $250 for each non-highly compensated employee eligible to participate).

***Tax credit for adoption of auto-enrollment*** – A small business which adopts an auto-enrollment feature for its 401(k) plan can receive a tax credit of $500.

***Long-term part-time employees must be eligible for plan*** – Historically, employers have been able to exclude from their retirement plans employees who work less than 1,000 hours per year. The new rule (essentially first effective for 2024) is that employers will have to offer participation to employees who have worked at least 500 hours in at least three consecutive years.

***Easier to establish multiple employer retirement plan*** – The new rules make it easier for two or more unrelated employers to establish a single retirement plan (which, in theory, may result in economies of scale and lower costs).

***Penalty increased for late filing of 5500*** – The general penalty for late filing of a Form 5500 (annual report for a retirement plan) is increased from $25 per day to $250 per day.

## Properly Structuring S-Corp Shareholder Loans to Get Tax Basis

An S-corp shareholder's ability to deduct for income tax purposes K-1 losses from the S-corp is limited to his or her "basis" in the S-corp. "Basis" for these purposes is the amount the shareholder paid for his or her shares, plus capital contributions to the company, loans made to the company by the shareholder and K-1 income, minus K-1 losses and distributions.

So, can an S-corp shareholder count in his S-corp basis loans made to the S-corp by another company he owns, since, in substance, that is the same as his having made the loan himself? No, according to the Tax Court and the Ninth Circuit Court of Appeals. In the recent *Messina* and *Kirkland* cases, the courts ruled that the S-corp shareholder must make the loans directly in order to obtain basis in the S-corp.

## Watch Out for the TCJA Interest Expense Limitations

The *Tax Cuts and Jobs Act* (TCJA) legislation enacted in late 2017 reduced tax rates and added new deductions like the qualified business income deduction. However, to help pay for those goodies, other changes were enacted which restrict deductions. One example of such is the limitation on business interest expense.

For 2018 – 2021, the general rule is that the deduction for business interest expense is limited to 30% of "adjusted taxable income", which is basically EBITDA. For 2022 and thereafter, the limitation becomes even more punitive, as the definition of "adjusted taxable income" basically changes to EBIT.

There are exceptions to the general rule for companies with average annual revenue (computed over 3 years) of $25 million or less (as computed aggregating related entities, and indexed for inflation) and also certain industries (most notably real estate if a proper election is made to accept slower depreciation, and also floor plan financing of auto dealers and regulated utilities). However, there are some potential gotchas in the exceptions. A "tax shelter" does not qualify for the small business exception; and the definition of tax shelter for these purposes would likely surprise most people, as it includes any flow-through entity where more than 35% of the losses are allocated to members who do not actively participate in management of the business.

It may be possible to plan around the interest expense limitation by using leasing arrangements or priority returns in lieu of loans from members. The key is to be aware of the potential limitation, as these rules can be a trap for the unwary.

### Quick Notes

- Tax extenders legislation enacted in late 2019 reinstated (retroactively to 2018 and effective through 2020) certain tax benefits for individuals, including the exclusion from income for the discharge of qualified principal residence indebtedness, the mortgage insurance premium deduction, the deduction for qualified tuition and related expenses, and the 7.5% of AGI floor for medical expenses (rather than the 10% which was scheduled to apply).
- In a Chief Counsel Advice (CCA 202009024) which comes as no surprise, the IRS has indicated that the basis limitation rules and at-risk rules apply for purposes of computing self-employment tax in the same manner that they apply for income tax purposes.
- In a Program Manager Technical Advice (2020-001), the IRS has indicated that the Rev Proc 84-35 exception to the partnership late filing penalty for small partnerships (generally those with 10 or fewer partners) continues to apply, even though the code section referenced in the definition of small partnership has been repealed.
- Georgia has enacted new legislation which provides that, effective April 1, 2020, "marketplace facilitators" are required to collect and remit sales tax on behalf of their marketplace sellers if the total amount of Georgia sales across all of their marketplace sellers and the marketplace facilitator itself is $100,000 or more for the previous or current calendar year.
- Form BE-10 (survey taken every 5 years by the Bureau of Economic Analysis) for the current 5-year cycle is due by May 29, 2020 (or June 30, for those filing 50 or more such forms). This form must be filed by any individual, trust, estate, nonprofit organization or company which owns 10% or more of a foreign corporation or business. Penalties for failure to file range from $2,500 to $25,000.

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