Current Federal Tax Developments

Week of May 3, 2021

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CURRENT FEDERAL TAX DEVELOPMENTS
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SECTION: 85
IRS CONFIRMS MARRIED COUPLES IN COMMUNITY PROPERTY STATES MAY GAIN UNEMPLOYMENT EXCLUSION BENEFIT ON SEPARATE 2020 INCOME TAX RETURNS

Citation: "2020 Unemployment Compensation Exclusion FAQs — Topic A: Eligibility," IRS webpage, Q&A4, 4/29/21

The IRS has updated its online FAQ[1] on the unemployment compensation exclusion for 2020 and its application in community property states.

State law generally determines ownership of property and income, thus defining what is each spouse's income when filing separate returns. In a community property state, community income (which is the default income in a community property state) is considered to be equally the income of each spouse, even if the income arises from the services of one spouse to the exclusion of the other.

When Congress in the American Rescue Plan Act added IRC §85(c), it excluded up to $10,200 of unemployment compensation from a taxpayer's income as long as the taxpayer's modified adjusted gross income is less than $150,000. Unusually, Congress did not provide for a lower modified adjusted gross income limit if married taxpayers file separate returns. Rather, each of the taxpayers gets his/her own $150,000 income limit.

Advisers who have taxpayers in one of the community property states (Arizona, California, Idaho, Louisiana, Nevada, Texas, Washington and Wisconsin) began speculating that, due to the division that will take place for much of the couple's income as community income, married couples in such states could have income of up to $300,000 and still get the exclusion if the taxpayers filed separate returns.

As well, even if total unemployment received by one spouse was more than $10,200, filing separate could also serve to increase the amount deductible in total between the spouses if the other spouse did not also have $10,200 of unemployment compensation.

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[1] "2020 Unemployment Compensation Exclusion FAQs — Topic A: Eligibility," IRS webpage, Q&A4, April 29, 2021, https://www.irs.gov/newsroom/2020-unemployment-compensation-exclusion-faqs-topic-a-eligibility#:~:text=Q4,7 (retrieved April 30, 2021)

On April 29, 2021, the IRS confirmed this thinking in Q&A 4 in Section A of the FAQ. The FAQ provides:

> **Q4. I'm married and don't file a joint return with my spouse. We live in a community property state. Are we eligible for the exclusion? (added April 29, 2021)**
>
> A4. Yes. Because you live in a community property state, you report half of your unemployment compensation and half of your spouse's unemployment compensation on your tax return and your spouse reports the other half of your unemployment compensation and half of his or her unemployment compensation on his or her tax return. You should exclude up to $10,200 on your tax return if your modified AGI is less than $150,000. Your spouse should exclude up to another $10,200 on his or her tax return if your spouse's modified AGI is less than $150,000. Neither of you should exclude more than the amount of unemployment compensation you report on your Schedule 1, Line 7.[2]

SECTION: 162
IRS FINDS RENT PAID TO RELATED PARTY UNREASONABLY HIGH FOR TWO YEARS, DENIES DEDUCTION

Citation: Plentywood Drug Inc. et al. v. Commissioner, TC Memo 2021-45, 4/26/2021

In the case of *Plentywood Drug Inc. et al. v. Commissioner*, TC Memo 2021-45,[3] the IRS and the taxpayer were disputing whether rents paid by a C corporation to its shareholders were excessive. While the Tax Court did not agree with the IRS's determination of what amount was reasonable, the Court did find a portion of the rent paid was above a reasonable amount and denied that amount of the deduction.

The corporation in question ran a drug store in a very small town in Montana. The Court described the operations of the store as follows:

> Plentywood Drug has a single store on Main Street near the center of town. Its building has 8,125 square feet of retail space on the main level and 5,250 square feet of support area below. The store is a full-line pharmacy, but is also stocked as a convenience store for the community — it sells everything from groceries to toys. It uses the basement to store both inventory and business records. Robert Mann

[2] "2020 Unemployment Compensation Exclusion FAQs — Topic A: Eligibility," IRS webpage, Q&A4, April 29, 2021

[3] *Plentywood Drug Inc. et al. v. Commissioner*, TC Memo 2021-45, April 26, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/tax-court-determines-fair-market-rent-for-pharmacy/59npq (retrieved May 1, 2021)

> bought the building around 1978, and it is now co-owned in four equal shares by the Manns and the Eberlings.[4]

The corporation set the rent to the shareholders each year by oral agreement at the beginning of year. The rents for the years in question were as follows:

Year	Amount
2011	$83,584
2012	192,000
2013	192,000

The IRS argued that the rents over these years did not represent a reasonable amount to have paid for this space in this small town. If that were the case, the excess rent would not be allowed as a deduction paid by the corporation, with those excess funds treated as a dividend. The dividend would not be deductible to the corporation while the shareholders would have to pick these amounts up as dividend income.

Both the taxpayer and the IRS introduced experts to testify regarding the appropriateness of the rents charged for the drug store. Normally the experts would try to find comparable properties and then compare those market rents with the amounts charged on this related party rental, with key disputes revolving most often around differences between the comparables and the lease being analyzed, as well as appropriate adjustments that should be made to take those differences into account.

However the Court noted that this case posed a number of special problems for finding such comparables given where the building was located:

> The parties in these cases quickly realized that finding comparable properties in a town of 1,700 people in frontier Montana and then using them to come up with a fair market rent would be difficult. One problem right out of the chute is that Montana is a nondisclosure state. This means that real-estate data such as sales prices that appraisers can typically find in other states is legally confidential and simply not available. This issue is magnified in a town the size of Plentywood, which already has a limited number of even potentially comparable buildings. We heard entirely credible testimony that

[4] Plentywood Drug Inc. et al. v. Commissioner, TC Memo 2021-45, pp. 3-4

> Montanans — perhaps especially Montanans in small communities — don't commonly share details of their financial lives very readily with strangers.[5]

The Court found flaws with the methods that each expert used to account for these differences. The IRS used three government buildings in the town for which rental data was available, plus one other rental where data was available. These included:

- Two government-subsidized multifamily residential buildings,
- The local post office, and
- A 625-square-foot commercial retail property.[6]

The government's expert then attempted to adjust the rents for each property to take into account its different nature. However, the Court found that the very different nature of rentals of government-subsidized multifamily residential buildings made them alike only in the fact that both they and the drugstore were rented--and the Court found the rents charged on those residential properties were not helpful in determining a proper rent for the retail business building. The commercial rental property was also far smaller than the drugstore in question, and again the Court rejected using information from its rental to help determine a reasonable rental amount for the drugstore.

The taxpayer's expert had decided to look for comparable properties in Williston, North Dakota, a town about one hour away from Plentywood, as well as in Plentywood due to the lack of available information on comparable rentals in Plentywood. He found a number of properties for which he could obtain data in Williston, both because the location was not in Montana (and thus more data was considered public information) and the town was much larger than Plentywood, resulting in more buildings to choose from and what appears to be a more cooperative population that was less apt to worry about the outsider's curiosity.

But the Court didn't find this approach helpful either, noting that Williston was a much larger community. The opinion notes:

> Although the properties McIvor found are very similar to Plentywood Drug's retail space, we also find that the difference in market areas is very great. Williston has a larger population than Plentywood and rents there have been much affected by the oil boom. It's possible that the boom also affected Plentywood, but neither party put in any solid proof of that — for example, evidence of a surge in population or business formation — into the record of these cases. We therefore do not accept the Williston properties as being reasonable comparables.[7]

The Court did note that both experts had used the Plentywood Post Office as a comparable, and the Court found that property both was located in the right place (in

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[5] *Plentywood Drug Inc. et al. v. Commissioner*, TC Memo 2021-45, p. 8

[6] *Plentywood Drug Inc. et al. v. Commissioner*, TC Memo 2021-45, p. 11

[7] *Plentywood Drug Inc. et al. v. Commissioner*, TC Memo 2021-45, p. 18

the small town, not in the much larger one) and the property itself was roughly comparable in use to the drug store.

After a discussion of that property and the one being rented, the Court concluded that a proper rent would be $15.90 per square foot for the main retail space and $8 per square foot for the basement storage space in the building. This resulted in a total fair market value rent for each year of $171,187.50.

Thus the Court denied a deduction for just less than $20,000 for the rents paid in 2012 and 2013.

SECTION: PROPOSD LEGISLATION
FACT SHEET ISSUED FOR PROPOSALS FOR THE AMERICA FAMILIES PLAN

Citation: Fact Sheet: The American Family Tax Plan, White House website, 4/27/21

President Biden released a fact sheet on his just proposed changes to the tax system early on April 28.[8] We've seen quite a bit of discussion in the popular, financial and tax press about items in this proposal since its release, so we'll summarize some of the key items here.

The 15-page document details more than just tax proposals, with the major tax proposals that have gotten a lot of notice found on the last two pages of the fact sheet. Some other tax-related items are found elsewhere in the document.

Warning – The Devil Will Be in the Details, and We Have None

It's easy to overreact to such proposals, as many parties forget (or have a vested interest in ignoring) that this remains merely a proposal at this point in time. It's not clear how much Congressional support would exist for passing this proposal "as is" and history suggests that there will be modifications, many likely significant, made to any bill if it becomes law—another thing that is far from a certainty.

While this does not mean we should ignore the proposals, it seems likely that time spent on understanding the nuances of a number of the items will turn out to be as valuable as time spent working out the details of the border adjusted tax that was a key proposal late in 2016, just as Republicans took control of the Presidency and both chambers of Congress. And right now we don't have any bill text upon which you can even attempt to understand such nuances.

Considering *possible* actions should specific proposals become law is an appropriate step to take. But advising that clients take actions based on the proposals is far riskier,

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[8] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, https://www.whitehouse.gov/wp-content/uploads/2021/04/American-Families-Plan-Fact-Sheet-FINAL.pdf (retrieved May 1, 2021)

especially for any action that might bring regret if the laws are not enacted as you expect or fear.

So with those warnings in place, let's look at what is in the President's fact sheet.

Key Proposals

A summary of some of the key proposals is found below.

- **Reporting of cash inflows/flows for accounts by financial institutions**: As part of a focus on increasing tax enforcement activities against higher income taxpayers, the law would add a provision that "would require financial institutions to report information on account flows so that earnings from investments and business activity are subject to reporting more like wages already are."[9] Presumably that information would be used to identify audit candidates, and would likely require explanation of things such as the sources of funds coming into accounts in excess of reported income. The increased enforcement on higher income individuals is claimed to "raise $700 billion over 10 years."[10]

- **The top marginal federal tax rate would go up to 39.6% from 37% for individuals:** The proposal would restore the top marginal individual income tax rate to 39.6%. The fact sheet states: "The President's plan restores the top tax bracket to what it was before the 2017 law, returning the rate to 39.6 percent, applying only to those within the top one percent."[11]

- **The special capital gain rates will go away for "households making over $1 million":** One of the items that got immediate notice was the elimination of the lower rate on long term capital gains for certain taxpayers. While we are told that is for households making over $1,000,000, we don't know if that's adjusted gross income, taxable income, or some other measure. The fact sheet states "[h]ouseholds making over $1 million—the top 0.3 percent of all households—will pay the same 39.6 percent rate on all their income, equalizing the rate paid on investment returns and wages."[12]

- **Significant reduction in step-up of basis on inherited assets.** Potentially far more significant is the apparent taxation of excess appreciation in assets held when a person dies. The fact sheet provides: "Today, our tax laws allow these accumulated gains to be passed down across generations untaxed, exacerbating inequality. The President's plan will close this loophole, ending the practice of "stepping-up" the basis for gains in excess of $1 million ($2.5 million per couple when combined with existing real estate exemptions) and making sure the gains are taxed if the property is not donated to charity."[13]

  While not fully clear, it is possible that those gains in excess of $1,000,000 will be taxed under a mark-to-market system upon death. But note that the statement

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[9] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 14

[10] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 14

[11] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

[12] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

[13] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

never explicitly says that. Arguably, if the gain is immediately subjected to tax it seems the basis would be stepped up, yet the sentence refers to ending the practice of "stepping up" basis. So the proposal could simply be to restore EGTRRA's limited basis step-up at death—but, this time, without eliminating the estate tax in exchange for the loss of basis step-up

Obviously, details will be very important for this provision, including how and whether this will apply to assets passed to a surviving spouse. As well, since it comes in with gains in excess of $1,000,000, it would seem that if enacted it would bring back to estate planners individuals who had seen "death taxes" removed as a threat to heir's future wealth.

The fact sheet also notes that some form of protection for family-owned businesses will be part of the proposed bill, noting: "The reform will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business."[14]

- **Elimination of capital gains treatment on carried interests:** An issue that was heavily discussed during the process of passing the Tax Cuts and Jobs Act is also raised in the fact sheet. While it had been proposed originally as part of TCJA to force income from *carried interests* to be taxed as ordinary income, the provision was watered down substantially in the final version of TCJA. Now the new Administration apparently wants to try again to change the tax treatment of such income. The fact sheet states: "The President is also calling on Congress to close the carried interest loophole so that hedge fund partners will pay ordinary income rates on their income just like every other worker. While equalizing tax rates on wages and capital gains will address this disparity, permanently eliminating carried interest is an important structural change that is necessary to ensure that we have a tax code that treats all workers fairly."[15]

- **Elimination of like-kind exchange deferral for real estate gains in excess of $500,000.** The Tax Cuts and Jobs Act eliminated like-kind exchange treatment for any assets aside from real estate held for income producing or business purposes. The new proposal would again reduce the number of transactions eligible for like-kind exchange deferral treatment, providing: "The President would also end the special real estate tax break—that allows real estate investors to defer taxation when they exchange property—for gains greater than $500,000..."[16]

- **Tax Cuts and Jobs Act limitation on the deduction of excess business losses for individuals made permanent**. The fact sheet provides "…the President would also permanently extend the current limitation in place that restricts large, excess business losses, 80 percent of which benefits those making over $1 million."[17]

- **Broaden the net investment income tax of 3.8% to apply the taxes consistently to "those making over $400,000."** The fact sheet provides that

[14] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

[15] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

[16] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

[17] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

"Finally, high-income workers and investors generally pay a 3.8 percent Medicare tax on their earnings, but the application is inconsistent across taxpayers due to holes in the law. The President's tax reform would apply the taxes consistently to those making over $400,000, ensuring that all high-income Americans pay the same Medicare taxes."[18] It appears this is meant to insure that income in excess of $400,000 would be either subjected to Medicare taxes or the net investment income tax. Currently if a person is actively involved in an S corporation, any flow-through income the person receives from the S corporation is not subject to either Medicare taxes or the net investment income tax.

- **The IRS would be able to regulate paid preparers.** The fact sheet also provides that the IRS would be able to regulate paid tax return preparers. The sheet states: "Tax returns prepared by certain types of preparers have high error rates. These preparers charge taxpayers large fees while exposing them to costly audits. As preparers play a crucial role in tax administration, and will be key to helping many taxpayers claim the newly-expanded credits, IRS oversight of tax preparers is needed. The President is calling on Congress to pass bipartisan legislation that will give the IRS that authority."[19]

- **Make permanent or extend a number of individual tax credits added in the American Rescue Plan Act.** The proposal looks to make permanent or significantly extend a number of new individual tax credits that were added on a temporary basis in the American Rescue Plan Act of 2021. These provisions include:

  – Extend expanded ACA premiums tax credits in the American Rescue Plan

  – Extend the Child Tax Credit increases in the American Rescue Plan through 2025 and make the Child Tax Credit permanently fully refundable.

  – Permanently increase tax credits to support families with child care needs (the credit for child care).

  – Make the Earned Income Tax Credit Expansion for childless workers permanent.[20]

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[18] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 15

[19] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, p. 13

[20] Fact Sheet: The American Family Tax Plan, White House website, April 27, 2021, pp. 12-13