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Baby Out With the Bathwater?

Tax Reform Update

Has Congress (Inadvertently?) Repealed All Deductions Previously Allowed Under IRC 212, Not Just the De Minimis Deductions Identified in the Legislative History and Most Summaries of the TCJA? If So, What Does That Mean for Shareholders and Real Estate Investors?[1]

I. Quick Explanation and History of IRC 212

IRC Section 212 provides, in its entirety and unchanged since its inclusion in the 1954 Code:

§ 212 Expenses for production of income.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

The predecessor to section 212 was adopted in 1942 because courts were denying "ordinary and necessary" deductions for taxpayers who could not establish that they were engaged in a *trade or business* and therefore who were unable to satisfy that prerequisite for deducting expenses under IRC 162.[2] Indeed, Reg. 1.212-1(o) explicitly provides that: "The provisions of section 212 are not intended in any way to disallow expenses which would

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otherwise be allowable under section 162 and the regulations thereunder."

Treas. Reg. 1.212-1(b) elaborates the scope of 212 (2): "Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired."

II. Quick Explanation and History of IRC 67

In the last major recodification of the Internal Revenue Code in 1986, Congress enacted IRC 67 to limit certain "miscellaneous itemized deductions," to 2 percent of an individual taxpayer's adjusted gross income (AGI). The legislative history suggests that the logic for such limitation was to reduce record keeping burdens for nominal expenses and perceived confusion about precisely which expenses might be deductible. IRC 67(c) directed the Secretary (of the Treasury and thus the IRS) to extend the disallowance to expenses incurred by pass-through entities and the IRS did so in 1988 in Treas. Reg. 1.67-2T.

IRC 67(b) defined "miscellaneous itemized deductions" as all "itemized deductions" [presumably of the type normally deducted on Schedule A of Form 1040 and comparable schedules on Forms 1065 and 1041] except for certain specifically authorized exceptions. The deductions authorized by either IRC 162 or 212 are not listed among the exceptions, making basically all deductions allowed by reason of those provisions subject to the 2 percent floor. Indeed, temporary regulations issued in 1988 identified all IRC 212 expenses as subject to the 2 percent floor of IRC 67 but hardly touch upon trade or business deductions covered by IRC 162. Reg. 1.67-1T(a)(1)(ii) and (iii). The same regulation, at paragraph -1T(b), defines miscellaneous itemized deduction largely by reiterating the definition in IRC 67(b). Paragraph (c) of that regulation explains that expenses covered under both IRC 162 and 212 should be properly allocated between the two sections on a reasonable basis. Thus, this reader of the section 67 regulations is left with the impression that all deductions allowed under IRC 212 were subject to the 2 percent floor but

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no expense incurred in a trade or business on IRC 162 would be limited except for employee business expenses.

III. TCJA: If Only Congress Had the Benefit of the Above History Lessons

Comes now the so-called Tax Cuts and Jobs Act (TCJA) enacted on December 22, 2017. That legislation enacted new paragraph (g) of IRC 67 that provides in its entity: “Notwithstanding subsection (a) [subjecting certain miscellaneous itemized deductions to the 2 percent floor], no miscellaneous itemized deductions shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.”

The scant legislative history suggests that House bill was again trying to “simplify” the tax code by expressly denying (at least until 2026) two specific categories of miscellaneous itemized expenses in particular:

1. All employee business expenses (e.g., job searching, uniforms, subscriptions to trade journals), and
2. Expenses covered by 212(3) — i.e., the cost of individual taxpayers to determine or dispute their income tax liability.[3]

The Senate Amendment, followed by the Conference Agreement, was far broader and expressly suspended *all* miscellaneous itemized deductions subject to the two-percent floor.

The legislative history is instructive of the types of expenses that Congress thought it was now denying in the name of simplicity. A copy of the relevant legislative history is appended to this article as Appendix A. A quick review of the list of expenses identified in the legislative history suggests that Congress may have thought the types of expenses subject to IRC 67 limitation was far narrower than it became when the temporary regulations promulgated under IRC 67 swept up virtually all IRC 212 expenses. Stated differently, it is not clear to us that Congress fully appreciated the scope of expenses described under the penumbra of “miscellaneous itemized deductions” when it prohibited miscellaneous itemized deductions. Such confusion may be the result of congressional staffers relying on IRS Publication 529, "Miscellaneous Deductions” instead of looking at the actual law, to determine the type of expenses Congress may have thought they were now rendering non-deductible. Most of us in private tax practice know that looking to IRS publications for guidance is no substitute for real research. In any event, given that cited

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regulatory definition of expenses within the scope of IRC 67(a) seems to include *all* IRC 212 expenses, it seems that Congress may have (inadvertently?) tossed the baby out with the bathwater when denying all miscellaneous itemized deductions in IRC 67(g), other than the two significant exceptions noted in Section V. below.

IV. What the Legislative History Ignored

If we're correct that the largely *de minimis* expenses identified in IRS Publication 529 and the legislative history constitute the scope of miscellaneous itemized deductions that Congress intentionally intended to preclude in the TCJA, then the question becomes what kind of material expenses were *inadvertently* included on that list when Congress enacted IRC 67(g)?[4] Turns out that there are many categories of expenses — often quite material — that may no longer be deductible, including:

1. **Individual shareholder-specific investment advice in connection with corporate transactions**. For example, payments by stockholders for advice on contemplated corporate action in connection with their ownership of shares has traditionally been considered an IRC 212 expense.[5] Note that shareholders are regularly denied a current deduction (in favor of an increase to tax basis) where a company expense was paid by a stockholder even though proximately related to corporate business.[6]

2. **Payments for investment advice**. Until the TCJA, investment fees and expenses were generally deductible under IRC 212 (and subject to the 2 percent floor after 1988) only to the extent they related to (1) periodic planning sessions and (2) the evaluation of potential investments to the extent needed to formulate an opinion regarding such investments were investment advice.[7] Conversely, fees for services and expenses incurred in the "process of acquisition or disposition" including, but not limited to, negotiating the purchase and creating the investment vehicle were capital in nature, were generally supposed to be capitalized.[8]

3. **Family investment offices**. Family office expenses are often deductible by reason of Reg. 1.212-1(g), which provides:

Fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in

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connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard of the type of investment and to the relation of the taxpayer to such investment.

Hopefully the cost of maintaining some family offices or employees providing some of the functions of a family office can also fit under IRC 162 or be treated as attributable to rental property to avoid the scope of new IRC 67(g).

4. Expenses attributable to serving as Board Director. Consider the interesting situation of an individual serving as a director of a corporation in which the individual is an investor. A corporate director who serves for compensation on the board is engaged in a trade or business and such earnings are self-employment income. Rev. Rul. 72-86, 1972-1 CB 273. If the individual is also an investor in the same corporation, then the expenses from the business of serving as a director must be distinguished from investment expenses of a shareholder. See e.g., Charles Nichols TC Memo 1963-148.

5. Legal fees to protect or secure an income right or property. Taxpayers regularly incur material expenses to protect their interest to an income stream or in property. Thus, Reg. 1.212-1(k) provides:

Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents.

See also Reg. 1.263(a)-2(e).

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V. Expenses That Seem to Have Escaped the Chopping Block

Fortunately, there are two categories of IRC 212 expenses that Congress seems to have (inadvertently?) missed in its pruning exercise.

1. **Expenses to manage real estate**. IRC 212 expenses attributable to property held for the production of rental and royalty income are expressly deductible in computing adjusted gross income under IRC 62(a)(4), and consequently escape the IRC 67(a) 2 percent floor limit under prior law and now complete disallowance pursuant to IRC 67(g) .[9] Thus, ordinary and necessary expenses paid or incurred in the management, conservation or maintenance of a building devoted to rental purposes continue to be deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in, or the purpose for, which the property in question was acquired. Reg. 1.212-1(b). Although deductions defined by IRC 212 are generally classified as itemized deductions in certain regulations, the term "itemized deductions" does not include any deductions "allowable in arriving at adjusted gross income" including IRC 212 expenses attributable to rental and royalty property. IRC 63(d); IRC 62(4).

2. **Trusts and estates expenses**. Pursuant to IRC 67(e) the adjusted gross income of an estate or trust is computed in the same manner as that of an individual except for several exceptions that are deductible against gross income for a trust or estate including:

1. Trust distribution deductions allowed by IRC 651 and 661,
2. The personal exemption for trusts and estates authorized by IRC 642(b),
3. The charitable contribution deduction allowed to trusts and estates governed by IRC 642(c), and
4. Pursuant to IRC 67(c)(3) and 67(e), deductions permitted to trusts and estates as provided in regulations.

The operative rules for these statutes are located at Reg. 1.67-4. These regulations, in general, provide that trusts and estate can deduct only administration expenses (including legal and accounting fees; costs of owning property such as insurance, maintenance, etc.; investment advisory fees; and fiduciary expenses) against adjusted gross income that would not have been incurred if the property were not held in such trust

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or estate. Any other administration expenses — i.e., expenses that would have been incurred if the trust assets were owned by an individual — are treated as miscellaneous itemized deductions. Reg. 1.67-4 consequently classifies trust and estate administration expenses as miscellaneous itemized deductions unless the fiduciary establishes that the expenses would not have been incurred "but for" the existence of the trust or estate. The regulations also require a reasonable allocation of "bundled" fees, such as a trustee fee that includes an investment advisory component and legal fees that pertain to pure trust legal issues and general legal issues to qualify any portion of the bundled administration fee as a deduction against adjusted gross income. The rules regarding capitalization of certain costs and other limits on deductions also apply to trusts and estates. It is also necessary to recognize that trust administration costs attributable to grantor trusts, electing small business trusts (ESBTs), qualified subchapter S Trusts (QSSTs) and other common types of trusts may be subject to different or additional rules. Finally, trusts and estates can deduct expenses attributable to property producing rental or royalty income against adjusted gross income to the same extent as individuals.

As noted above, IRC 67(g) provides that no miscellaneous itemized deduction shall be allowed between 2017 and 2026 notwithstanding IRC 67(a) — the allowance of a deduction for miscellaneous deductions that exceed the 2 percent limit. It seems clear to us that trust and estate administration expenses allowed under IRC 67(e) to determine adjusted gross income are not itemized deductions subject to IRC 67(a), and thus should still be allowed notwithstanding the recent addition of IRC 67(g).

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[1] Allow us to begin with an apology. Most of the articles posted here are designed to be understood by non-tax professionals. Time constraints and the nature of this article simply do not allow such accommodation.

[2] Before 1942, there was no statutory provision for the deduction of non-business expenses. If the expenditure in question was not incurred in conducting a business activity, it was not deductible. This rule was strictly applied in the case of *Higgins v. Commissioner*, 312 U.S. 212 (1941). In

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Higgins, the Supreme Court held that expenses incurred by a taxpayer in managing his income-producing property were not deductible because the taxpayer's investment activity did not constitute the carrying on of a trade or business. Thus, while the income derived from investment and other forms of non-business activity would be taxable, expenses incurred in carrying on such activities were not deductible. Congress acknowledged this inequity and responded by enacting former §23(a)(2) of the Code (now §212(2)). Section 212(3) was enacted by Congress in 1954 to nullify the Supreme Court's decision in *Lykes v. United States*, 343 U.S. 118 (1952). In that case, the Supreme Court held that legal expenses of a contest over federal gift tax liability were not deductible under the predecessor of §212(2). Although the legal expenses incurred with respect to controversies over income or estate tax liability were considered deductible under that provision, the Court held that a determination of gift tax liability did not have a sufficient connection with income-producing property of the taxpayer to support a deduction. Congress then acted to remove the inequity created by the *Lykes* decision, adding subsection (3) to provide specifically for the deduction of expenses in connection with the determination of any tax without regard to whether they related to property held by the taxpayer for the production of income. This historical footnote is taken from *Bloomberg BNA's* portfolio 523 T.M. I.C.1.

[3] H.R. Rep. No. 115-466, Conference Committee Report to Accompany H.R. 1, Tax Cuts and Jobs Act (Pub. L. No. 115-97). Copy attached hereto as Appendix A. Whether it is sound tax policy to deny taxpayers deductions for expense incurred to determine their tax liability is a question best left for another day, and possibly a beer.

[4] Query whether material expenses historically deductible under IRC 212, even if subject to the 2 percent AGI floor of IRC 67, could/should/will now be included in the asset's tax basis.

[5] Deductions have been allowed in a variety of contexts under the penumbra of this classification. The following list is taken from *Thomson Reuters'* Tax & Accounting publication online at Paragraph 2125.05(5) via Checkpoint.

Other examples include: Attorney fees for advice on making interest-bearing loans to corporate officers for purpose of protecting

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investment in corp.'s stock. *Nancy Reynolds Bagley,* 8 TC 130 (1947), acq 1947-1 CB 5.

Fees paid to investment counsel service for advice as to plan for merger of corp. of which taxpayer was substantial stockholder, so as to preserve taxpayer's controlling interest. *Andrew Jergens v. Commissioner*, PH TC Memo ¶43,322, appeal dismissed for lack of prosecution, 33 AFTR 1653 (5th Cir. 1943).

Legal fees paid by stockholders for advice in preserving interest in corp. Advice led to purchase of more stock to give them control of corp. *Straub v. Granger* 143 F Supp. 250 (D. PA, 1956).

Attorney fees in connection with sale of stock by taxpayer where attorneys rendered services of "research and advice relating to taxpayers' rights arising from status as preferred stockholders" and also services in effecting disposition of stock held allowable to extent of advice as to taxpayers' rights. Case rem'd to Tax Court for allocation of fees. *Dykema v Commissioner*, 218 F.2d 535 (1954, 6th Cir.).

[6] *E.g.*, Rev. Rul. 67-411, 1967-2 CB 124.

[7] *Honodel v. Commissioner*, 76 TC 351 (1981).

[8] *See Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), affg. 410 F.2d 313 (8th Cir. 1969); *Kimmelman v. Commissioner*, 72 T.C. 294, 304-305 (1979).

[9] *See, e.g.*, Schedule E, Form 1040, *Supplemental Income and Loss*. In contrast, costs of defending an interest in rents or royalties under a lease have only been allowed recovery via amortization over the term of the lease. *Porter Royalty Pool, Inc. v. Commissioner*, 165 F.2d 933 (6th Cir. 1948), *cert. denied*, 334 U.S. 833 (1948).

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