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NEWS ANALYSIS

Analyzing Trump's Tax Returns

by Lee A. Sheppard

Gosh darn it, he must have done something!

Those who are familiar with the broad outlines of former president Donald Trump's business life found little new information in his recently released tax returns. Giant loss carryovers washed out income. Business deductions were claimed for expenses that other real estate professionals couldn't deduct. The difference is that Trump was president — not a television host or full-time real estate professional — during much of the period for which we have new tax return information.

The House Ways and Means Committee released parts of Trump's individual and business returns covering six years. The committee released a narrative that unsubtly accused Trump of acting like an autocrat and selected redacted pieces of his tax returns for much of the period he was president. (Related coverage: p. 276.)

Trump reported little or no income tax for four of those years. The Joint Committee on Taxation wrote a longer report for tax professionals. The Ways and Means Committee's asserted justification for seeking this information was evaluation of IRS auditing of partnerships and presidents. Trump's Treasury secretary refused to supply the returns, in violation of statute (section 6103(f)). Trump lost in the Supreme Court (*Trump v. Committee on Ways and Means*, No. 21-5289). (Prior coverage: *Tax Notes Federal*, Nov. 28, 2022, p. 1308.)

But the committee promptly vitiated its arguments before the courts by releasing parts of the returns. This came after a leak of a bunch of prominent rich people's returns, including those of Carl Icahn and Elon Musk, exquisitely timed to coincide with tax increase proposals. (Prior coverage: *Tax Notes Federal*, June 14, 2021, p. 1792.) Hedge fund manager Kenneth C. Griffin of Citadel, a large Republican donor, is suing the government for leaking his tax return (*Griffin v. IRS*, No. 1:22-cv-24023-RNS (S.D. Fla.)). (Prior coverage: *Tax Notes Federal*, Dec. 19, 2022, p. 1760.)

This release might be part of an ongoing, multifaceted campaign by the bipartisan political class to dirty up the former president so he can't run again. As dirtying up goes, this was a damp squib. There were so few surprises in the Trump returns that the chattering class was reduced to throwing a hissy fit about the IRS's failure to begin to audit his 2017, 2018, and 2019 returns until he left office. While he was in office, only his 2016 return was audited. The Internal Revenue Manual includes no prescribed start date for a presidential audit.

The requirement that the president's return be audited is in the IRM (IRM sections 3.28.3.4.3, 3.28.3.5.3, and 4.2.1.1.5). Ways and Means wants to codify it and add a disclosure requirement. A bill to do that, the Presidential Tax Filings and Audit Transparency Act of 2022 (H.R. 9640), was passed by the House. The disclosure bill would have the effect of further discouraging anyone with a business background — including Michael Bloomberg — from seeking the presidency, which would be just fine with the bipartisan nomenklatura.

Ways and Means argued that the IRS should put five specialists on a presidential audit instead of the usual one agent (what, no forensic accountant?). Ways and Means fretted that a single agent could be intimidated by a president's representatives. But Trump's issues are not complicated. There's a large volume of filings and a lot of messy factual questions, but we're not talking complex, sophisticated, unresolved questions of law here. The law is clear — the facts aren't. Despite the boxcar numbers, Trump's audit could have been readily handled by IRS examiners used to dealing with real estate partnerships and closely held businesses.

"These returns do not deviate from standard closely held business practice," Steven Bankler, a San Antonio CPA who specializes in closely held businesses, commented. "Businessmen regularly lose money. They are entrepreneurs. They accept

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Can't go back to picking windows. (Associated Press)

risk. They take risks every day. They have more wins than losses."

Ways and Means argued that access to the former president's returns would help them design a fairer tax law without loopholes. How's that again? Jay Starkman, an Atlanta accountant writing in *The Wall Street Journal,* pointed out that Trump, as a real estate developer, didn't pay a lot of taxes because of laws Congress enacted. "These are legal and proper deductions even if they seem unfair," Starkman wrote. "His tax preparers may have to explain why they signed returns with so many issues" (*The Wall Street Journal*, Dec. 28, 2022).

> ***Trump's issues are not complicated. The law is clear — the facts aren't.***

"It is difficult to see any meaningful substantive tax reform coming out of this public disclosure effort (excluding any changes to IRS presidential audits), considering that the Wyden partnership reform proposals from September 2021 did not get much public attention before being retracted and partnerships enable many of the tax-reducing or -avoiding structures existing today," Monte Jackel of Jackel Tax law commented. (Prior analysis: *Tax Notes Federal*, Dec. 20, 2021, p. 1709.)

Business Structure

Trump's structure is typical in the real estate business.

Trump holds his assets through a Florida revocable trust, the Donald J. Trump Revocable Trust, which is treated as a grantor trust, so that trust income is taxable to him (section 671 et seq.). Ways and Means fretted that Trump didn't use a blind trust to hold his assets. Under Florida law, that trust is not a separate entity.

> ***Trump's structure is typical in the real estate business.***

The trust owns various partnerships, which own interests in other partnerships. Trump's entire return for any given year would include more than 400 Forms K-1 and 27 Schedules C for business expenses. Based on his Federal Election Commission filings, Trump appears to have a single-member LLC holding his interest in each project. He uses a holding partnership rather than Schedule E to consolidate partnership items. Ways and Means complained that the IRS had not been given a complete picture of all Trump's business entities.

His vehicle for equity ownership in his domestic real estate investments and some other deals is Florida-based DJT Holdings LLC. The trust owns 99 percent of DJT Holdings. The managing member, DJT Holdings Managing Member LLC, which owns 1 percent, is an S corporation owned by Trump individually. Weirdly, that managing member also reports separate gross receipts and expenses, which become quite large in the years after 2016. This managing member owns managing member interests in numerous Trump projects. There appears to have been some restructuring using this S corporation when Trump became president, most likely to get all those managing member interests under one umbrella instead of Trump as an individual owner.

A similar structure is in place for the two other operating entities, DTTM Operations LLC and LFB Acquisition LLC, both of which are owned 99 percent by DJT Holdings LLC and 1 percent by managing single-member LLCs owned by Trump individually. DTTM Operations LLC holds 99-percent interests in more than 50 partnerships that hold Trump trademarks. Its income and loss bounce around. LFB is the vehicle for Lamington Farm Club LLC d/b/a Trump National Golf Club-Bedminster. The club has large gross receipts but is expensive to run and depreciation is wearing

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off. The partnership antiabuse rule accepts this structure (reg. section 1.701-2(d), Example 1).

Trump contributed a Trump brand and image license agreement to his licensing partnerships in which he participates in lieu of a capital contribution. The license is held by the partnership in which a special-purpose LLC is an equity partner. These numerous LLCs were reorganized under DJT Holdings Managing Member LLC. He may also enter a marketing and promotional services agreement with a licensee partnership. There appears to be a partnership for each licensing deal, which would explain why there are hundreds of them. Presumably Trump would have a zero basis in his self-created intangible, giving him a tax basis of zero in his partnership interest, regardless of its option value (section 722). Royalties and fees are ordinary income. (Prior analysis: *Tax Notes*, Aug. 31, 2015, p. 907.)

Trump uses S corporations as holding vehicles to minimize the hit for self-employment taxes. Here the assumption is that Trump provides services to the LLC and so would be subject to Self-Employment Contributions Act (SECA) tax as a general partner (section 1402(a)(13); *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011)). Proposed section 1402 regulations would require that the limited partner's authority to bind the partnership be truly limited to be excused from SECA tax (prop. reg. section 1.1402(a)-2(h)). The IRS has refused to finalize those regulations, instead waiting for Congress to change the law (REG-209824-96).

"The structure of the DJT group of entities in the House report shows a fairly typical structure to greatly minimize the imposition of self-employment tax. The current president did some of the same," Jackel noted.

Debt Cancellation Income

Debt cancellation income is a verifiable number.

The JCT questioned the schedule for carryover of losses and deferral of deferred cancellation of indebtedness (COD) income under a special temporary provision enacted for reacquisition of real estate debt (section 108(i)). The deferral, for 2009 and 2010 reacquisition of debt, was only for five or four years, respectively, so by 2015, Trump's deferral had already crossed over and he was having to recapture COD income from that point forward. The JCT estimated that he deferred $141 million of COD income. The forgiveness appears to have been because of modifications by the lender.

"This was a one-time explicit deferral of COD income," said Jackel. Large bank loans on large commercial real estate projects are often syndicated and sold to investors as commercial mortgage bonds. So the special exception allowed a debtor to go into the market and acquire beaten-down bonds holding its own mortgage. The exclusion was accompanied by deferral of the deduction of market discount that would be created. But there was no interest charge on the deferral. Where did the debtors get the cash? They could issue new debt to reacquire their old debt or modify their old debt (reg. section 1.1001-3). (Prior analysis: *Tax Notes*, Feb. 16, 2009, p. 823.)

Is it time for Congress to cut back on real estate goodies? Nothing will get done in this Congress because the two bodies are controlled by different parties. Commercial real estate is in deep trouble; buildings are not worth loan value. Work from home has made office buildings nearly obsolete, and occupancy in major markets is uneconomically low (*The Wall Street Journal*, Jan. 3, 2023). Nothing new will be built in these circumstances, making it an ideal time for forward-thinking legislators to reduce depreciation deductions. But they won't do that because they don't think beyond the next election. They are more likely to revive the special exemption for debt cancellation income.

Trump does not have a lot of debt on his aggregate real estate holdings of roughly $3 billion. New York state brought a $250 million civil case against the Trump Organization, accusing it of deceiving lenders, chiefly Deutsche Bank, on the value of real properties. We're supposed to be shocked that loan values didn't match tax assessed values for Trump properties (*People of the State of New York v. Donald J. Trump*, No. 452564-2022).

Trump is accused of fooling one of the world's largest too-big-to-fail banks for a decade! When you owe the bank $1 billion and you can't pay it, the bank is in trouble. Lenders are fully capable of

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appraising properties and making their own decisions. What's more likely is that the lenders cooperated with lofty valuations so Trump's loans didn't require reserves on their books. That would be a matter for bank directors and shareholders. The case is scheduled for trial in October. Although it was one of the remedies the state sought, state Judge Arthur Engoron effectively confiscated the Trump properties when he appointed a monitor and made an order preventing asset dispositions.

Passive Activity Losses

Could a sitting president be treated as active in real estate under the passive activity loss limitation rules?

The United States is on a scheduler system called the passive activity loss limitation rules (section 469). For rental properties, losses are per se passive (section 469(c)(2)). Rental real estate includes the obvious, like rental apartments. It does not include hotels (because of the services) unless the hotel building is subject to a lease (reg. section 1.469-1T(e)(3)).

But a real estate professional enjoys an exception to the rule that a rental activity is per se passive (section 469(c)(7)). To qualify for the exception, a real estate professional must work 750 hours per year and devote half of all personal services rendered to trades or businesses during the year to real property trades or businesses in which he materially participates. Participation in other non-rental real estate activities is counted toward establishing that half (section 469(c)(7)(B)(i) and (ii)). That professional must still satisfy the material participation test for the rental activity (section 469(c)(1), reg. section 1.469-9(e)(1)).

"Material participation" is required to be considered active, meaning regular, continuous, and substantial involvement in operations (section 469(h)(1)). Any type of work done in connection with a project, in any capacity, is considered "participation" for purposes of the tax law (reg. section 1.469-5(f)). The question becomes whether the individual has done enough work so that it is "material." Real estate professionals have to show how much they worked during the year in question, but they need not track each property, and can elect to combine properties (reg. section 1.469-9).

But rental real estate activity cannot be combined with other real estate activities to establish material participation. The hotel business doesn't mix with rental real estate. If a hotelier met the 750 hours and half of personal services test for hotel business participation, he would still have to demonstrate separately that he materially participated in his unrelated rental real estate activity.

As a real estate developer, Trump was able to argue that he was active in his projects, so real estate losses produced by interest deductions and depreciation could offset his other active or portfolio income. If Trump were sufficiently active in real estate, he could take all real estate depreciation and interest deductions against his non-real-estate income. If he did not materially participate in his real estate projects, the associated tax deductions would be unavailable for use against his licensing income (section 469(c)(1)(B), (c)(7)).

Even before Trump became president, the IRS raised a question whether he could have materially participated in all of his projects. He spent 2016 campaigning. But the examining agent determined that he met the material participation test for 2016 because he devoted more than 100 hours to the activity, which was not less than the participation of any other individual involved, and devoted 500 hours to all such activities (section 469(h), reg. section 1.469-5T(a)(3), (4)). The agent was apparently impressed that Trump was represented by prominent practitioners, which bothered Ways and Means. There is no final revenue agent's report for 2016. (Prior analysis: *Tax Notes*, Aug. 22, 2016, p. 1053.)

This test can be difficult to satisfy without good recordkeeping. The Tax Court held that a real estate developer wasn't active in a trade or business and imposed accuracy-related penalties. Although a taxpayer can demonstrate material participation by any reasonable means, the developer constructed a daily activity narrative during the examination. The court didn't accept the taxpayer's oral testimony in the absence of contemporaneous documentation or proof of the extent of his participation relative to that of his employees and contractors (reg. section 1.469-

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5T(f)(4); *Schumann v. Commissioner*, T.C. Memo. 2014-138).

While Trump was president, he probably couldn't devote 750 hours to real estate. But there is a set of alternative material participation tests in grandfathered temporary rules designed to weed out mere investors with no involvement in the business (reg. section 1.469-5T(a)). Managers don't get a free pass for the mere status of being managers (reg. section 1.469-5T(b)(2)(ii)). Moreover, monitoring the finances or operations in a non-managerial capacity is not considered material participation, but rather investor behavior (reg. section 1.469-5T(f)(2)(ii)).

Except for 2015 and 2016, Trump was serving as president during the years the JCT looked at. Could a busy sitting president be treated as active in real estate? Potentially yes, under one of the alternative material participation tests (reg. section 1.469-5T(a)(5)). This is a rule that the IRS drafted to keep profitable developers on the hook for income that their projects earned after they stopped materially participating. It is called the five-out-of-10-year rule, and it applies to any five years out of the preceding 10 years. So if Trump materially participated through the years 2011 to 2016, which he probably did, he would be deemed to materially participate from 2017 through 2021 without regard to whether he put in a single hour.

Now, Trump could not qualify as a real estate professional while president. That would put him back under the rule that rental real estate is per se passive. The five-out-of-10-year rule does not supply an exception to that, so his rental real estate income and loss would be walled off on the passive schedule. The significant activities that are taken into account for purposes of the five-out-of-10-year rule have to be in substantially the same business for the whole decade (reg. section 1.469-5(j)(1)). But the five-out-of-10-year rule would cover losses generated by hotels and golf courses, so Trump could take those losses against other income on his individual return.

"An IRS rule that was intended to hurt taxpayers comes back and bites them in the butt!" Richard Lipton of Baker McKenzie commented. "But it is a very clear rule, that was intended to catch people who materially participated in an activity that was profitable and then wanted to claim that future income was passive when they ceased participating — you cannot do that. But it applies to losses, too, so Donald Trump would get the benefit. Black-and-white rule."

> ***'An IRS rule that was intended to hurt taxpayers comes back and bites them in the butt!' Lipton said.***

Trump's own public statements on the subject would indicate that he wasn't actively participating in his real estate projects while president. He said that he waited to run for president until his adult children were ready to run the business. His son Eric is the executive vice president of development and acquisitions of the Trump Organization. Donald Jr. is also an executive vice president. After having been president, Trump remained active in politics and remarked that it would be impossible to go back to picking windows.

As of 2015, Trump's loss carryover was $105 million. Not all of the loss carryover represents losses subject to the passive activity loss rules. His properties generated fresh losses subject to these rules every year from depreciation deductions. The JCT flagged the material participation issue without explaining it. Real estate development is internally sheltered. Rent is for paying interest. Only the net losses flow through the partnerships to the holding partnership and onto Trump's individual return.

In 2016 Trump had $9 million of interest, $9 million of Schedule C income, and an $11 million capital gain offset by a $16 million Schedule E loss and $45 million of losses passed through by DJT Holdings LLC (which showed a $65 million loss), for an overall $32 million loss. For the year, the IRS examiner agreed that Trump actively participated in his real estate projects, so the $32 million loss was sustained. In those years, Trump was spending $200 million rebuilding the Old Post Office as a hotel, where he planned to live while he was president (security concerns nixed that). So there are Form 3800 rehabilitation credits coming through at $2 million per year in 2015 and 2016.

What would Trump's individual returns look like without the monster loss carryovers? He earns about $9 million of interest every year. He earns other income in the millions. In 2018, a year

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in which he paid $2 million of tax after credits, he had a $22 million capital gain offset by $12 million of Schedule E losses. Rehabilitation credits were $7 million per year in 2017 and 2018.

There are other basis rules that apply before the passive loss limitation rules apply (reg. section 1.469-2T(d)(6)(i)). The JCT asked whether Trump had sufficient basis in his real estate holdings to absorb the losses being generated (section 465). Nonrecourse debt is not included in basis for this purpose (section 465(b)(2)).

But the statute allows an exception for certain qualified nonrecourse financing (section 465(b)(6), reg. section 1.465-27). This exception is for real property used in the activity of holding real property, which has several requirements (section 465(b)(6)(E)). There must be no one with personal liability on the loan (reg. section 1.465-27(b)(3)). A partnership is treated as a person for this purpose, but its liability is disregarded when the lender can only grab the property (reg. section 1.465-27(b)(4)).

"It would not be uncommon for this exception to be used to allow nonrecourse debt of real estate owners to increase the NOL," Jackel said. "The use of nonrecourse debt can boost the amount of losses, but the use of those losses with nonrecourse debt basis is supposed to be recaptured when the debt is paid off, cancelled, etc. If you can borrow to refinance current debt, you can defer recapture in many cases."

There are also subchapter K basis restrictions on the use of losses. A partner's distributive share of partnership loss (including capital loss) is limited to his adjusted basis in his partnership interest at the end of the partnership year in which the loss occurred (section 704(d)).

But the so-called value-equals-basis rule — which presumes that property depreciates in value — allows transitory special allocations of depreciation provided the partnership agreement calls for a later offsetting gain allocation (reg. section 1.704-1(b)(2)(iii)(c)). Because the value of the depreciable real property rarely declines, the value-equals-basis rule effectively permits allocations that will never be offset by gain chargebacks (reg. section 1.704-1(b)(5), Example (1)(xi)). Thus, the value-equals-basis rule can produce tax results that don't properly reflect income.

Inventory

Trump treats condominiums and hotel rooms as inventory.

DJT Holdings deducted $127 million for cost of goods sold over the period of the returns. Red hats? No, the JCT concluded from surrounding documents that were also disclosed to Ways and Means that the goods in question were condominiums and hotel rooms, and that half the costs were labor costs. On DJT Holdings LLC's 2017 and 2018 returns, COGS represented nearly half of its $50 million gross receipts. In each of those years, roughly $50 million of losses roll in from lower-tier partnerships. On its 2018 return, some units were reclassified as depreciable property, with basis adjustments (section 743(b)).

Although condominiums and hotel rooms can be fungible, the IRS view is that they should not be treated as inventory because of the land component. Gain on the sale is ordinary for a dealer. Real property is not eligible for inventory accounting, according to the IRS, which is empowered to say when inventory accounting is appropriate (section 471(a)). Acquisition and construction are subject to capitalization rules (section 263A, Rev. Rul. 66-247, 1966-2 C.B. 198).

The JCT suggested that the percentage of completion method might be more appropriate (section 460). Developers are statutorily permitted to use the percentage of completion method for residential real estate, over the occasional objections of the IRS. Accrual of income and expense is not required for home construction contracts (section 460(e)(1)(A), (6)(A)). Larger homebuilders must capitalize costs (section 263A, reg. section 1.460-5(d)(3)). Gain can be deferred until 95 percent of the project is completed because developers are allowed to use this method of accounting at the partnership level for residential buildings.

The IRS unsuccessfully contested a family-run developer's right to use this method. The developer built planned communities, including infrastructure on raw land and formation of homeowners' associations. It delayed recognition of income until these contracts came out of escrow, even though it accepted deposits that could be as large as the entire purchase price when infrastructure was in place but before houses were completed (reg. section 1.460-

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1(e)(3)(ii)). The IRS argued that the completed contract method did not clearly reflect the developer's income (section 446(b)). The case was about whether the improvements were separate or part of a package (*Shea Homes v. Commissioner*, 142 T.C. No. 3 (2014)).

The Tax Court concluded that the developer was not selling just a house, but an entire development with amenities and common facilities (reg. section 1.460-3(b)(2)(iii)). Therefore, the taxpayer should be allowed to defer income from the contracts until 95 percent of the total contract costs were incurred, or the development (or a promised phase) was completed (reg. section 1.460-1(c)(3)(i)). Moreover, common improvements were not secondary items subject to separate accounting (reg. section 1.460-1(c)(3)(ii)). So the IRS could not change the taxpayer's method.

Some of Trump's products are not eligible for the percentage of completion method. Hotel rooms are not eligible residential real estate because a dwelling unit is defined as "a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis" (sections 168(e)(2)(A)(ii), 460(e)(5)(A)(i); reg. section 1.460-3(b)(2)(i)(A)). Indeed, transient use could be ascribed to a lot of investor-owned big-city condominiums.

An inventory method would produce tax deferral comparable to the percentage of completion method. So Trump's preparers appear to have chosen inventory accounting as the next best result for ineligible but fungible hotel rooms and condos. If costs are capitalized to each individual unit, the result may approximate specific identification inventory accounting. Indeed, last-in, first-out could accelerate deduction of capitalized costs by creating a unit cost exceeding the costs attributable to it, as the IRS recognized in disallowing its use for real estate (Rev. Rul. 86-149, 1986-2 C.B. 67).

Conservation Easement

Overvaluation of conservation easements is endemic, and Congress just acted to put a lid on it.

Trump gave an easement for three-quarters of the land on his Westchester estate, Seven Springs, to the North American Land Trust in 2015. He can still put that land to a variety of noncommercial uses — windmills, solar panels, picnic shelters, and hunting stands. He really wanted to develop the 212-acre estate as a golf course and housing, but his wealthy neighbors predictably threw hissy fits.

Here's a short lesson in golf course economics. Golf courses per se don't make money. Housing developments near them make money. Golf courses are always built on flood plains because there is no other productive use for that kind of land. Many golf courses have conservation easements because there will inevitably be unusable swamp on the edges, which is suitable for conservation purposes. Swamps happen to be where beavers and birds and other wildlife like to congregate and feed themselves.

Trump has owned Seven Springs since 1995, when he bought it for $7.5 million. The Cushman & Wakefield appraisal said the property was worth $57 million at the time of the 2015 easement gift, which was challenged by New York state, and then valued at four times as much for lenders, which the state also challenged (*The Wall Street Journal*, Dec. 21, 2022).

Overvaluation of conservation easements is endemic, and Congress just acted to put a lid on it.

In 2019, when it was auditing the 2015 return, the IRS decided not to challenge the Seven Springs easement. No charitable contribution deduction was allowable in 2015 because of Trump's taxable income limit, so the deduction was carried forward (section 170(b), (d)). But the JCT reported that the agent's notes mentioned disallowance of the entire $21 million deduction based on an unqualified appraisal, or reduction of the value to $9 million. Either of these might be the subject of a gross valuation misstatement penalty for the preparer (section 6695A).

"We think that failure to audit donations in the year of contribution may result in an unallowable charitable contribution being deducted in a future year," the JCT stated.

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"Appraisals are always subject to scrutiny by the IRS," Bankler noted.

In the much-maligned bipartisan omnibus budget bill just signed into law (the Consolidated Appropriations Act, 2023, H.R. 2617), Congress acted to limit the amount of conservation easement values relative to acquisition cost on contributions by partnerships (new section 170(h)(7)). A contribution of an easement by a partnership (whether directly or as a distributive share of a contribution of another partnership) is not treated as a qualified conservation contribution if the amount of the contribution exceeds 2.5 times the sum of each partner's share of the partnership's basis in the real property, net of liabilities (section 752). The entire deduction is disallowed if the valuation exceeds that, even if the taxpayer can prove that value. (Prior analysis: *Tax Notes Federal*, Jan. 2, 2023, p. 87.)

The new statute seems to have been aimed at the most egregious cases of overvaluation. The partnership angle in the new statute is aimed at syndications, but it doesn't say that. Seven Springs, which was the subject of Trump's easement, is in its own little LLC owned by DJT Holdings LLC. If Trump were to make the same contribution today, the new law would disallow the entire deduction, even if the appraiser was correct. But a single owner could put a conservation easement property in some other entity, like an S corporation, and take a big deduction if the large value could be justified.

Personal Expenses

Trump puts a lot of unreimbursed business expenses in special-purpose entities.

Ways and Means was fussed about $27 million of unreimbursed expenses over the period of the returns. These were showing up on Schedule C, and behind every Schedule C is a disregarded entity. Is this common? Very, as any reader who has represented the proprietors of any closely held business knows. Operating businesses often put specific tasks in a separate special-purpose entity, like one entity to employ shared staff who are lent out or charged to other entities. This special-purpose entity doesn't ever show a profit. These entities flow into the owner's individual return on Schedule C.

"Just because a Schedule C entity doesn't make money doesn't mean it isn't doing anything. It's a parasite on an operating entity. You do it for nontax reasons," Bankler said.

The New York Times identified Trump family personal expenses for hair, makeup, gasoline, meals, and other personal things that subsequently caught the IRS's attention (*The New York Times,* Sept. 27, 2020). "Audits of closely-held entities often find personal expenditures being improperly deducted as business expenses," the JCT deadpanned. It fretted that some Schedules C listed nothing but expenses, potentially triggering the hobby loss rules (sections 162, 183, and 263).

Trump was in two businesses — real estate development/management and licensing of his personal brand. Branding might encompass expenses for otherwise personal stuff like appearances. Even the success of the casinos was, at one time, dependent on Trump's personal brand, as former Commerce Secretary Wilbur Ross, then at Rothschild, recognized when he persuaded Trump's creditors to let him continue to live large in public during the debt workouts. Like Ralph Lauren, Trump sells a dream of copying his own lifestyle. So an examining agent would have a situation in which some otherwise personal expenses could be characterized as expenses of maintaining a personal brand.

"There are independent third-party business transactions that would be hard to refute. Trump's lifestyle is the core of the business," Bankler commented. "No one knew or cared what Trammel Crow looked like." Fred Trammel Crow was a prominent Texas real estate developer who died in 2015.

> ***Trump was in two businesses — real estate development/management and licensing of his personal brand.***

DJT Holdings LLC owns a single-family residence that had considerable running expenses and no rental income, leaving the JCT to wonder whether it was a personal residence. The LLC also deducted $10 million of hotel expenses in 2020. The residence in question might be Seven Springs, the estate that Trump treated as a personal residence until 2014 and then reclassified as a business (*Los Angeles Times*, Dec. 30, 2022).

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"There is commingling in small-business ownership. No doubt about it. Closely held businesses are moderately aggressive on defining what a business expense is," said Bankler.

"It is not unlikely that, similar to many high-net-worth individuals and corporate taxpayers as well, when the law is not crystal clear on an issue, taxpayer positions were taken ranging from slightly aggressive to very aggressive, some safely within those parameters and some outside of those parameters," Jackel commented. "These types of well-advised taxpayers do not, as a rule of thumb, 'cheat,' meaning not reporting something that is clearly income or claiming a deduction when the facts do not at all support them."

In 2017 Trump settled the Trump University litigation for $21 million. The IRS wanted to know whether the entire amount was properly treated and whether insurance reimbursed any of it. Certain costs of settlement, like legal fees, are nondeductible (section 162(f)). The IRS also wondered whether Trump's basis in Trump Entrepreneur Initiative LLC, formerly known as Trump University LLC, was sufficient to absorb the deduction.

"Unreimbursed expenses need to be substantiated and its connection to business or investment activity looked into," said Jackel. "In order to do a thorough, fair, and objective evaluation of the returns, one would need to see the key underlying documents, such as the partnership agreements, and copies of contracts and agreements. Without the underlying data, it is just speculation."

"No one except the IRS is in any position to determine whether these deductions are valid or not," Bankler concurred. "A tax return is the tip of the pyramid. You see 1 percent of what is going on. Until you get the underlying documents, you can't get into the commingling discussion."

"There were many items where deductions were claimed that apparently were not audited for substantiation and business connection. That type of lack of basic review is not a good look for the IRS audit team," Jackel noted. The IRS would need access to the partnership agreement to determine whether a partner was required to pay these expenses without reimbursement. It is likely that the agreements say so. For an S corporation, an unreimbursed expense is treated as a contribution to capital by the owner.

Airplanes

Rich people typically put their airplanes in entities to isolate liabilities.

"We always put an airplane into a separate entity. They're an attractive nuisance, like a pool. They have to be isolated from liability in a separate entity. We try to keep good assets away from bad liabilities," said Bankler.

Trump files Schedule C for each of the two LLCs, each holding an airplane, that reported expenses equal to gross receipts. He has the famous Boeing 757, which has been refurbished for another campaign. He also owns a smaller Cessna Citation X jet and three Sikorsky helicopters. While he was president, he wasn't allowed to fly in his own planes. But if he were nonetheless treated as active in a real estate trade or business during that period, he could justify deduction of aircraft expenses on Schedule C (reg. section 1.469-4).

> ***Rich people typically put their airplanes in entities to isolate liabilities.***

The IRS uses a primary purpose test for aircraft expenses for a sole proprietor. In a recent memorandum, the agency ruled that a sole proprietor didn't have to use the travel expense allocation method for his own plane because he is not an employee but is self-employed (reg. section 1.274-10(e)). That is, because he does not earn compensation, but is taxed directly on business earnings, there is no imputed income that could be treated as wages (section 274(e)(2)). Thus, he would have to proceed under regular business expense rules (section 162). Personal use is not deductible (section 262(a)). Mixed business and personal use is a primary purpose question (ILM 202117012).

The estate of an insolvent developer recently contested the IRS disallowance of business expenses for his aircraft. He founded a homebuilding empire that built 26,000 houses. The enterprise went belly up in 2009, owing $75 million, and a receiver was appointed. The builder's jet was in its own partnership and taxed

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as a disregarded entity. The builder reported large losses from it and a successor to his lost building business — Schedule C airplane losses, Schedule E losses, and loss carryovers. The IRS argued that he was not engaged in any trade or business after his building empire went into receivership and was shut down (*Estate of Morgan v. Commissioner*, T.C. Memo. 2021-104).

The Tax Court held that he was not engaged in a trade or business and was unable to substantiate his basis in his interest in the airplane partnership. The taxpayer argued that his foray into a new business was exploratory (section 195). He didn't build or sell any new houses during the years at issue (section 162). He made one loan to a friend for another business. He was unsure whether he would go back to building. The court wasn't buying it. He couldn't use loss carryovers because he was not actively participating in any new business. Ergo, the airplane was not a part of any trade or business. But the court did not sustain a substantial understatement penalty because the builder reasonably relied on his long-standing, competent preparer.

Politicians typically get in trouble spending campaign funds — other people's money — while Trump spent a lot of his own. His plane was instrumental in winning the primaries in 2016 because he could make multiple campaign stops in a day and go places other candidates couldn't reach. Trump's planes could still have been used in his real estate business. Campaign expenses are nondeductible, so he would have to allocate costs between deductible real estate business and nondeductible campaigning. He would have to have documentation, which would be readily available for the big jet because it has to obtain landing slots at airports, for which there are records.

Federal election law allows candidates to spend as much as they want on their own campaigns, but political spending is not deductible (section 162(e)). Campaign expenses are specifically nondeductible (section 162(e)(1)(B)). Politicians and lobbyists have unsuccessfully tested this rule, arguing that spending was factually ordinary and necessary to their careers. But courts give the statute a purposive legal interpretation, severing the connection between spending and function (*Cloud v. Commissioner*, 97 T.C. 613 (1991); *Cammarano v. United States*, 358 U.S. 498 (1959); *Textile Mills Securities Corporation v. Commissioner*, 314 U.S. 272 (1941)).

Gift Loans to Children

The JCT wondered whether Trump should reclassify the loans to his kids as gifts.

Trump reported $51,000 or less of interest income each year, attributable to loans to his adult children. The JCT wondered whether the loans were disguised gifts and whether the children's interest deductions should be disallowed. Gift loans have to bear interest at the applicable federal rate (section 7872). Extrapolating from the interest charged, the total loan principal would have been roughly $2.6 million (*The Wall Street Journal,* Dec. 22, 2022).

As any reader who has represented the rich knows, it is very common for adult children to borrow from their parents for various purposes, including to finance individual lifestyles duplicating their parents' lifestyle. Many an adult child is eyeball-deep in debt and waiting for the last parent to die. Those parents also regularly make gifts and loans to their children to shift wealth. Loan proceeds can be invested to earn more than the AFR. Advisers recommend that children pay interest in cash, but many loans accrue interest that is due at maturity.

Trump's adult children have day jobs, but there are loans described in his tax returns. Although *The New York Times* groused about the children's salaries, it may be that they are being paid market salaries and that loans make up the difference to sustain their lifestyles. The total principal amount, derived from the interest charged, seems small for the loans to be part of a wealth transfer plan.

"These are estate planning loans," Bankler explained. "Most want the remainder of the estate to be divided equally among the children. By doing loans, these funds are then returned to the estate so that all of the children share equally and the child with the loan hasn't received an 'extra' amount." ■

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