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A 2017 federal tax deduction for prepaying anticipated 2018 state income taxes? Not likely!

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In anticipation of enactment of the House and Senate proposed federal tax legislation, some commentators and tax practitioners are suggesting that — in view of the likely elimination of the state income tax deduction for 2018 and subsequent years — individual taxpayers prepay their 2018 state income tax liability and claim the deduction on their 2017 federal income tax returns. Aside from the problem that many high-income taxpayers will find benefits significantly limited because they will face the alternative minimum tax, we believe there is scant authority, if any, in federal tax law to support the position of deductibility of a prepayment of tax for a year that has not yet arrived.

Prior revenue rulings

Commentators have cited Rev. Rul. 71-190 and Rev. Rul. 82-208 as the basis for claiming a 2017 deduction for payments made in 2017 to be applied to a tax liability in 2018 — notably, a year that has not even arrived at the time of payment, let alone produced any income, deductions, credits, or other items to support a tax calculation. Any payment might be in the form of an estimated tax — to be credited against the 2018 tax liability when it is determined. Some states (e.g., Wisconsin) have a form for receiving a payment in advance. However, neither of those rulings addresses this type of situation. They both address a payment of taxes very late in a given tax year — for example in 2017 — with respect to that tax year (i.e., 2017 in this example). In fact, the latter ruling was adverse to the taxpayer (the payment was held not deductible) because the taxpayer had *no reasonable basis* to believe he owed additional state taxes and was apparently only attempting to reduce his federal tax for the year at issue.

Other tax professionals have cited the capitalization regulations — Regs. Sec. 1.263(a)-4(f) — as authority, as the regulations allow the deduction of expenses paid in advance where the tax benefit does not extend beyond 12 months. This is an exception to those regulations' general requirement at Regs. Sec. 1.263(a)-4(d)(3) that prepaid expenses must be capitalized. However, not only is there no direct reference or example of a deduction for taxes paid in advance for a year that has not yet arrived, but the purpose of the regulations is to govern business-related expenditures "paid to acquire or create intangibles," a very different situation from an advance payment of personal income taxes for a subsequent year. In fact, we believe the regulations have no applicability to the issue discussed here.

In addition, Regs. Sec. 1.263(a)-4(f)(4) provides that Regs. Sec. 1.263(a)-4(f)(1) does not apply to amounts paid to create (or facilitate the creation of) an intangible of indefinite duration. Where there is no liability yet in existence, the payment of an excessive 2017 estimated tax payment would apply against a future liability that is not limited in duration. There is no certainty, for example, as to whether the taxpayer would exist in order to recognize the income. The taxpayer may die in an accident early in 2018 before recognizing any income. It cannot be said that there is a liability for state income tax beyond Dec. 31, 2017.

Professional standards

Any deduction in 2017 for a payment of anticipated 2018 state income taxes is clearly a *tax position* that requires the CPA adviser-tax preparer to comply with AICPA Statements on Standards for Tax Services (SSTS) No. 1, *Tax Return Positions*, for preparation of a return and SSTS No. 7, *Form and Content of Advice to Taxpayers*, for advising on the position. In addition, tax preparers must comply with the preparer penalty provisions of Sec. 6694 (and the regulations thereunder) and Circular 230, Section 10.34, standards with respect to tax returns and documents, affidavits, and other papers, and Section 10.37 if the advice is provided in writing.

Basically, these professional standards with regard to taking and advising on a tax position are quite similar and consistent in that they require a tax preparer or tax adviser to identify *substantial authority* for any non-tax shelter position that he or she recommends or takes on a tax return that is not disclosed in some fashion. Lacking substantial authority, the tax preparer or tax adviser may recommend a tax position for which he or she believes there is a *reasonable basis*, provided disclosure is made in the return.

Disclosure is generally made by the taxpayer on either a Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement* (where the taxpayer takes a position contrary to a regulation). Substantial authority has often been described by respected commentators as a 40% to 45% chance of prevailing administratively or judicially on the merits if challenged by the government. Reasonable basis has been similarly described as a 25% chance of prevailing. Both confidence thresholds are based on authorities set forth in Regs. Sec. 1.6662-4.

In interpreting authorities, the IRS and the courts have given significant weight to direct reference with respect to the tax treatment of an item in a return, and far less weight is given when a taxpayer argues the tax treatment should be based on analogous authority applicable to tax treatment of another item, however arguably similar. This would be particularly true with regard to attempting to assert analogous treatment of an item if Congress did not intend for the item to be in fact treated in a similar manner.

It is noted that Rev. Proc. 2016-13 does provide that the reasonable-basis and disclosure standard is satisfied for certain items entered on a tax return if the item is reflected on the proper line in the return and is entered in accordance with the form's instructions. Among those items are state income taxes entered on Schedule A, *Itemized Deductions*. However, the procedure specifically states that it does not reflect law changes after Dec. 31, 2015. It does not insulate a taxpayer from penalties for claiming a deduction for which there is no liability. Therefore, we believe that the procedure would not insulate a taxpayer (and preparer or adviser) from the disclosure requirements with regard to a 2017 payment of 2018 taxes if the tax reform legislation is enacted. We believe this is particularly true as it would appear to attempt to secure a tax deduction for an amount that Congress does not intend to allow as a deduction.

Consequently, CPAs should advise clients that payments in 2017 of state tax liabilities projected for 2018 are not deductible on their 2017 federal income tax returns. There is simply no authority for that position, and Rev. Rul. 82-208 is authority against that position. The payment sent to a state or local government before 2018 to apply against 2018 tax liability is a mere deposit. Tax deductions are not available for deposits (Rev. Rul. 79-229).

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