Tax Planning Ideas in Light of Tax Cuts and Jobs Act of 2017

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In addition to serving on the Editorial Advisory Committee for *Trusts & Estates* magazine, Mr. Blum volunteers his time with several non-profit organizations. He is Treasurer of the Fort Worth Symphony, the Multicultural Alliance, and the Texas Cultural Trust. He also serves as Secretary/Treasurer of the Pat & Emmitt Smith Charities and as a member of the Board of Directors of B Sharp Youth Music Program, Inc.

Mr. Blum earned his BBA (Highest Honors) in Accounting from The University of Texas and received his law degree (High Honors) from The University of Texas School of Law.

- The Tax Cuts and Jobs Act of 2017 is the biggest tax reform in over 30 years (1939, 1954, 1986, 2017).
- What survived the chopping block is going to be around a long time.
- The big news in the business tax arena is the 21% C corp income tax rate.
- The initial estimated cost of the legislation was $1.4 – $1.5 trillion. It's likely to cost even more than anticipated.
- Some of the provisions of the Tax Act sunset at the end of 2025 including the increased estate tax exemption and the Section 199A deduction for pass-through income. The new 21% C corp tax rate does not sunset.
- In August, the IRS issued proposed regulations on the new Section 199A deduction for pass-through income. Final regulations are expected before year-end.

Section 199A Deduction for Pass-Through Income

- Deduction of 20% of "Qualified Business Income" from domestic pass-through businesses.
- To be Qualified Business Income ("QBI") , the income cannot be from a Specified Service Trade or Business ("SSTB"), meaning from the fields of health; law; accounting; actuarial science; performing arts; consulting; athletics; financial services; brokerage services; investing and investment management; trading; dealing in securities, partnership interests or commodities; or any trade or business where the principal asset is the reputation or skill of one or more employees.
- The fields of engineering and architecture are excepted.

Taxpayer's Total Income	Income from Specified Service Trade or Business (NOT Qualified Business Income)	Income NOT from Specified Service Trade or Business (Qualified Business Income)
< $157,500 (single) < $315,000 (married)	Full 20% deduction available	Full 20% deduction available
$157,500-$207,500 (single) $315,000-$415,000 (married)	Sliding scale to determine amount of deduction available, then part of deduction subject to Wage/Qualified Property Cap	Sliding scale to determine amount of deduction available, then part of deduction subject to Wage/Qualified Property Cap
> $207,500 (single) > $415,000 (married)	No deduction available	Full 20% deduction available but subject to Wage/Qualified Property Cap

- The Wage/Qualified Property cap is the greater of: (i) 50% of W-2 wages, or (ii) 25% of W-2 wages plus 2.5% of unadjusted basis immediately after acquisition ("UBIA") of qualified property.
- Threshold amounts will be indexed for inflation.
- Bottom Line: The Section 199A deduction is designed to help non-service businesses who have a good-sized payroll or who own a capital-intensive business (a company with a lot of fixed assets, like real estate or manufacturing equipment).

Qualified Property

- Qualified Property is tangible property being depreciated, calculated as the Unadjusted Basis Immediately After Acquisition (“UBIA”).
- Land is excluded.
- Fully-depreciated property doesn’t count, but recent improvements to the property that are being depreciated do count.

Overall Limit on Individual's Section 199A Deduction

- The total amount of an individual's Section 199A deductions has an overall limit.
  - To calculate the overall limit, first compute the sum of 20% of the combined Section 199A deductions for each trade or business, 20% of qualified real estate investment trust (REIT) dividends, and 20% of qualified publicly-traded partnership (PTP) income.
  - Next, calculate 20% of the amount that the individual's taxable income exceeds the net capital gain.
  - The lesser of these two amounts is the individual's Section 199A deduction.
- The proposed regulations include rules for how to calculate an individual's overall Section 199A deduction for situations in which a trade or business has negative QBI. Essentially, if you have some pass-throughs with gains and some with losses, you have to net the losers against the winners, and you only get the 20% deduction against the net.

Reduce Taxable Income to Qualify

- If the taxable income is slightly over the $207,500/$415,000 threshold, consider ways to reduce it.
- Note: Reducing income from $415,000 to $315,000 (married filing jointly) saves the tax on $163,000, not just $100,000. When income hits $415,000, you lose the entire 20% deduction. If income is $315,000, you qualify for a full $63,000 deduction.

1) Adopt a qualified retirement plan such as a defined benefit plan or cash balance plan. Contributions to the plan reduce the taxable income. (In this context, these are tax-reduction techniques as well as tax-deferral techniques.)

2) Put the kids on the payroll. If the kids do legitimate work for the business, pay them a reasonable wage. This reduces the parents' taxable income.

3) Make charitable gifts. Consider "bunching" multiple years of charitable gifts into a single year to maximize the charitable income tax deduction. Contribute the bunched amount to a donor-advised fund and then make grants from it over time.

4) If a sale of assets will spike your income, consider contributing the assets to a Charitable Remainder Trust prior to the sale, and you not only defer income tax but you salvage the 20% deduction.

5) Spouses file separately.

- Assume Husband earns $150,000 as a doctor, and Wife earns $300,000 of income from her separate property.
- Together, their income is above the $415,000 threshold, so the pass-through income is ineligible for the Section 199A deduction.
- If they file separately, Husband could qualify for the Section 199A deduction.
- <u>Note</u>: This should work in a non-community property state or in California, where income from separate property is separate property. It may not work in Texas, where income from separate property is community property. It's not clear if a partition making Husband's income his separate property would be respected by the IRS. [See Lucas v. Earl, 281 U.S. 111 (1930) and Commissioner v. Harmon, 323 U.S. 44 (1944).]

6) Utilize multiple trusts.

- Consider creating complex (non-grantor) trusts and gifting pieces of the business to the trusts. Each trust can receive up to the $157,500 threshold in qualified business income without being subject to the Wage/Qualified Property Cap. The maximum tax savings per trust is $11,655. (If $157,500 of income is allocated to each trust, then $157,500 x 20% x 37% = $11,655.)
- Note: Creating multiple trusts to circumvent the threshold amount will not work if the beneficiaries are substantially the same. Proposed Regulations Section §1.643(f)-1 confirms the applicability of IRC Section 643(f):

> "Multiple trusts will be treated as one trust if (1) such trusts have substantially the same grantors and substantially the same primary beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter. For the purposes of the preceding sentence, a husband and wife shall be treated as 1 person."

The proposed regulations include an example where a trust for the benefit of A, B, and C was found to be "substantially the same" primary beneficiaries as a trust for the benefit of A, B, and D.

Proposed Regulations

- The proposed regulations give specific guidance on what services are Specified Service Trades or Businesses ("SSTBs").
  - Health
    - The proposed regulations provide that specified services in the field of health means "medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient)."
    - It does not include services "not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices."

- Brokerage Services
  - The proposed regulations provide that specified services in the field of brokerage services means "services in which a person arranges transactions between a buyer and seller with respect to securities for a commission or fee," including services provided by stock brokers.
  - It does not include "services provided by real estate agents or brokers, or insurance agents or brokers."
- Athletics
  - The proposed regulations provide that specified services in the field of athletics means "the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing."
  - It does not include services "that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events" and does not include "services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public."

- Consulting
  - The proposed regulations provide that specified services in the field of consulting means "professional advice and counsel to clients to assist the client in achieving goals and solving problems" including providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such."
  - It does not include "services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses" and does not include "consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services."

- Performing Arts
  - The proposed regulations provide that specified services in the field of performing arts means “the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such.”
  - It does not include services “that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts” and does not include services “by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.”
- Similar clarification is provided for specified services in the fields of law; accounting; actuarial science; financial services; investing and investment management; trading; dealing in securities, partnership interests, or commodities; and any trade or business where the principal asset is the reputation or skill of one or more employees.

- Cracking and Packing
  - Before the proposed regulations, “Cracking and Packing” strategies—altering how gross income and expenses are packaged—offered opportunities to maximize tax benefits. However, the proposed regulations limit the effectiveness of Cracking and Packing. They also limit the need for Cracking and Packing.
    - <u>Example</u>: An immigration law firm has a large team of clerical staff that fills out forms. The attorneys take the forms and provide legal services.

      Can the clerical services be treated as a business line separate from the legal services, allowing a Section 199A deduction for the profits related to the clerical services? No. Because the business lines have common ownership and are functionally connected, they would both be considered part of the same specified service trade or business.

- The proposed regulations introduce the following concepts:
  - Aggregation
  - De Minimus Rule
  - Common Ownership Rule
  - Incidental Rule

Aggregation Under Proposed Regulations

› If you elect to aggregate trades or businesses, you must combine the qualified business income, W-2 wages, and the UBIA of qualified property.

› Conditions to be able to aggregate trades or businesses (all conditions are required):

- The same person or group of persons, directly or indirectly, owns 50% or more of each trade or business. (An individual's spouse, children, grandchildren, and parents are considered as the individual.)
- The ownership described above exists for a majority of the taxable year in which the items attributable to each trade or business are included in income.
- All of the items attributable to each trade or business are reported on returns with the same taxable year, not taking into account short taxable years.
- None of the trades or businesses is an SSTB.

- The trades or businesses satisfy at least two of the following factors (based on all of the facts and circumstances):
  - › The trades or businesses provide products and services that are the same or customarily offered together.
  - › The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
  - › The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

› Once an individual chooses to aggregate, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years.

- A newly-created or newly-acquired trade or business can be added to an existing aggregated trade or business.
- If there is a change in facts and circumstances such that an individual’s prior aggregation no longer qualifies for aggregation, then the trades or businesses will no longer be aggregated, and the individual must reapply the rules to determine a new permissible aggregation (if any).

- To elect aggregation, individuals must attach a statement to their returns identifying each trade or business aggregated. The statement must contain:
  - A description of each trade or business.
  - The name and EIN of each entity in which a trade or business is operated.
  - Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year.
  - Such other information as the Commissioner may require in forms, instructions, or other published guidance.

- Example: John owns three businesses—Business A, Business B, and Business C.
    - Assumptions:
        - None of the businesses are an SSTB.
        - None of the businesses have any qualified property.
        - Business A generates $1 million of income and pays $500,000 of W-2 wages.
        - Business B generates $1 million of income but pays no W-2 wages.
        - Business C generates $2,000 of income and pays $500,000 of W-2 wages.
        - John also has $750,000 of wages income from employment with an unrelated company.
        - John's total taxable income is $2,722,000.
    - Because John's taxable income is above the $207,500/$415,000 threshold, the Section 199A deduction available for each business is limited by the Wage/Qualified Property Cap.
- First, let's assume John **doesn't** elect to aggregate.

- Business A:
  - A full 20% deduction would be 20% x $1,000,000 = $200,000.
  - The Wage/Qualified Property Cap is the greater of: (i) 50% of W-2 wages (50% x $500,000 = $250,000), or (ii) 25% of W-2 wages (25% x $500,000 = $125,000) plus 2.5% of UBIA of qualified property (2.5% x $0 = $0).
  - John's Section 199A deduction for Business A income is $200,000.

- Business B:
  - A full 20% deduction would be 20% x $1,000,000 = $200,000.
  - The Wage/Qualified Property Cap is $0 since Business B paid no wages and has no qualified property.
  - John's Section 199A deduction for Business B income is $0.

- Business C:
  - A full 20% deduction would be 20% x $2,000 = $400.
  - The Wage/Qualified Property Cap is the greater of: (i) 50% of W-2 wages (50% x $500,000 = $250,000), or (ii) 25% of W-2 wages (25% x $500,000 = $125,000) plus 2.5% of UBIA of qualified property (2.5% x $0 = $0).
  - John's Section 199A deduction for Business C income is $400.

- Calculate John's total Section 199A deduction:

Business A Deduction	$200,000
Business B Deduction	0
Business C Deduction	400
20% Qualified REIT Dividends	0
20% Qualified PTP Income	0
	$200,400

Taxable Income less Net Gain	$2,722,000
	x 20%
	$544,400

  - The lesser of these two amounts, $200,400, is John's Section 199A deduction.

- Now assume the same facts for John who owns Business A, Business B, and Business C, except that John **elects to aggregate** the three businesses.
  - When aggregating, the Wage/Qualified Property Cap is applied after the businesses are aggregated.
  - The aggregated businesses generate $2,002,000 of taxable income and pay $1,000,000 of W-2 wages.
  - A full 20% deduction would be 20% x $2,002,000 = $400,400.
  - The Wage/Qualified Property Cap is the greater of: (i) 50% of W-2 wages (50% x $1,000,000 = $500,000), or (ii) 25% of W-2 wages (25% x $1,000,000 = $250,000) plus 2.5% of UBIA of qualified property (2.5% x $0 = $0).
  - So the aggregate Wage/Qualified Property Cap is $500,000.
  - John's Section 199A deduction for the aggregated businesses is $400,400 (compared to $200,400 if he didn't elect to aggregate).

De Minimus Rule Under Proposed Regulations

- Gross receipts of $25 million or less:
  - When gross receipts of the trade or business are $25 million or less, none of the trade or business income is considered SSTB income if less than 10% of the gross receipts are attributable to a specified service.
- Gross receipts over $25 million:
  - When gross receipts of the trade or business are in excess of $25 million, none of the trade or business income is considered SSTB income if less than 5% of gross receipts are attributable to a specified service.
- Watch out when gross receipts start to approach $25 million, because if you go slightly over, the de minimus test drops from 10% to 5%.

- Example: An optometrist owns and operates a large facility to manufacture and assemble lenses, glasses, and contacts.

  The optometrist also practices optometry in an office adjoining the manufacturing facility.

  The facility generates receipts of $5 million per year. The optometry practice has receipts of $200,000 per year.

  Because less than 10% of the gross receipts are from the optometry practice, the profits from the optometry practice are not considered SSTB income.

Common Ownership Rule Under Proposed Regulations

› An SSTB includes any trade or business that provides 80% or more of its property or services to the SSTB if there is 50% or more common ownership of the trades or businesses.

› If the business provides less than 80% of its property or services to the SSTB and there is 50% or more common ownership, then only the portion of business providing property or services to the commonly-owned SSTB is considered part of the SSTB. A deduction may be taken relating to the remaining portion of the business.

- <u>Example 1</u>: A dentist has an entity that owns the building which leases space to his dentistry practice. His dentistry practice is the sole tenant of the building. The dentist owns more than 50% of the building entity and of the dentistry practice.

  Because the building entity and the dentistry practice have common ownership and more than 80% of the building entity's property is provided to the dentistry practice, the building entity is considered an SSTB and no deduction is available.

- Example 2: A dentist has an entity that owns the building which leases space to his dentistry practice. The dentist owns more than 50% of the building entity and of the dentistry practice. BUT, the building entity leases only 70% of its space to the dentistry practice.

  Because the building entity and the dentistry practice have common ownership and less than 80% of the building entity's property is provided to the dentistry practice, the dentist can take a deduction on the income earned from the other 30% of building.

› If there is less than 50% common ownership between the SSTB and the non-SSTB, then a deduction may be taken regardless of how much of the property is provided to the SSTB. Family attribution rules apply.

Incidental Rule Under Proposed Regulations

- If an SSTB and a trade or business that is not an SSTB share expenses (such as shared wage or overhead expenses) and have 50% or more common ownership

  and if the receipts of the non-SSTB business represent less than 5% of the combined gross receipts of both businesses,

  then the non-SSTB business loses the ability to take the Section 199A deduction. In this situation, the smaller, non-SSTB business is considered incidental to and, therefore, part of the SSTB.

- Example 1: An optometrist owns his optometry practice and also owns a business that sells eye glasses. The optometry practice and the product sales business have common ownership and share expenses. Receipts from the product sales business account for less than 5% of the gross receipts of both businesses. The income from the product sales business would not be eligible for the Section 199A deduction.

- Example 2: Same scenario except the receipts from the product sales business account for 6% of the gross receipts of both businesses. Now, the income from the product sales business would be eligible for the Section 199A deduction.

Income as K-1 Distribution Instead of Wages

- If you own an S corporation, consider reducing your salary and taking more of your income as a K-1 distribution.
- Because wages are subject to a 37% tax but K-1 income is taxed at 29.6% (37%, minus 20%), there's an incentive to shrink wages and take more income on a K-1, but be careful not to drop wages so low that the Wage/Qualified Property Cap reduces the deduction.
- <u>Example</u>: With business income of $10 million and W-2 wages of $4 million, the Section 199A deduction would be $2 million. The Wage/Qualified Property Cap is $2 million, so you can take the full deduction. BUT, if you drop wages to $1 million, the deduction is now limited to $500,000.

Independent Contractors Instead of Employees

- If you're a W-2 employee, your wages don't qualify for the Section 199A deduction. Consider trying to become an independent contractor instead. Independent contractors report on Schedule C and qualify for the Section 199A deduction on net income.

- The business owner may oppose converting you to an independent contractor because it could drop the company's wages so low that the Wage/Qualified Property Cap reduces his Section 199A deduction.

- A potential problem with this is the IRS often challenges independent contractor status, which is a facts and circumstances determination, not an election.

- Note that the proposed regulations state that a W-2 employee who subsequently begins to work as an independent contractor will be presumed to be an employee until proven otherwise in accordance with the traditional rules for determining whether an individual is an employee or independent contractor. This is true even if the formerly-employed individual forms an S corporation and payments are made to the S corporation.

Deleverage Qualified Property and Leverage Non-Qualified Property (Move the Debt Around)

› Example: Sam purchases a new medical office building for $30 million.

The medical office building is fully-leased and has $20 million of debt.

Sam expects rental income of $2,000,000, a depreciation deduction of $1,100,000, and an interest deduction of $900,000, resulting in $0 net income.

What is Sam's Section 199A deduction? Sam's income from the medical office building is not eligible for the Section 199A deduction because it does not generate taxable pass-through income.

› Example, Part 2: Sam and his father have a partnership which owns an apartment complex.

The apartment complex is appraised at $50 million and no longer has any debt.

The original cost basis of the apartment complex has been fully-depreciated, and the apartment complex has only $4 million of qualified property. Sam expects $3 million of taxable income this year.

What is Sam's Section 199A deduction? The deduction for the apartment complex is $100,000. His deduction is limited because of the low amount of qualified property.

- 20% of the taxable income is 20% x $3,000,000 = $600,000.
- The Wage/Qualified Property Cap is the greater of: (i) 50% of W-2 wages, or (ii) 25% of W-2 wages plus 2.5% of UBIA of qualified property is 2.5% x $4,000,000 = $100,000.

- Example, Part 3: Sam could pay down the note on the medical office building by borrowing against the apartment complex.

  The partnership takes out a $20 million loan against the apartment complex and makes a distribution from the partnership to Sam. Sam then uses this to pay off the debt on the note secured by the medical office building.

  The medical office building has taxable income of $1,100,000 and now pays no interest.

  The deduction for the medical office building goes from $0 to $220,000.

  - 20% of the taxable income is 20% x $1,100,000 = $220,000.
  - The Wage/Qualified Property Cap of 25% of W-2 wages plus 2.5% of UBIA of qualified property is 2.5% x $30,000,000 = $750,000.

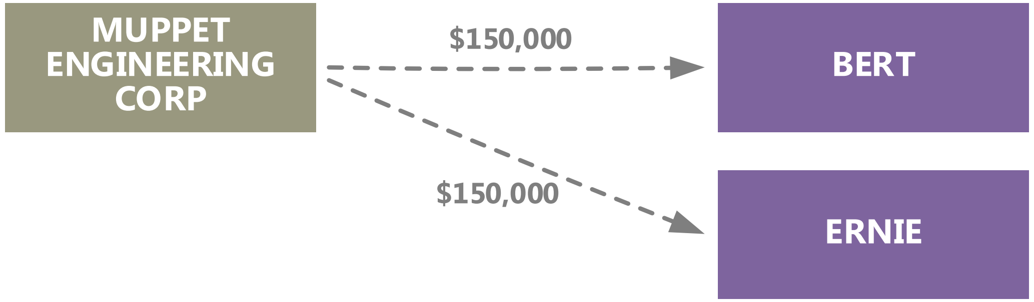
  The deduction for the apartment complex remains $100,000.

  - 20% of the taxable income is 20% x $2,100,000 (after $900,000 interest deduction) = $420,000.
  - The Wage/Qualified Property Cap of 25% of W-2 wages plus 2.5% of UBIA of qualified property is 2.5% x $4,000,000 = $100,000.

Team Up for Partnerships

- Instead of employees becoming independent contractors, an alternative is for two or more employees to team up and form a partnership that contracts with the company to provide services for a contracted amount of pay. (This is very common with "teams" of financial advisors.)

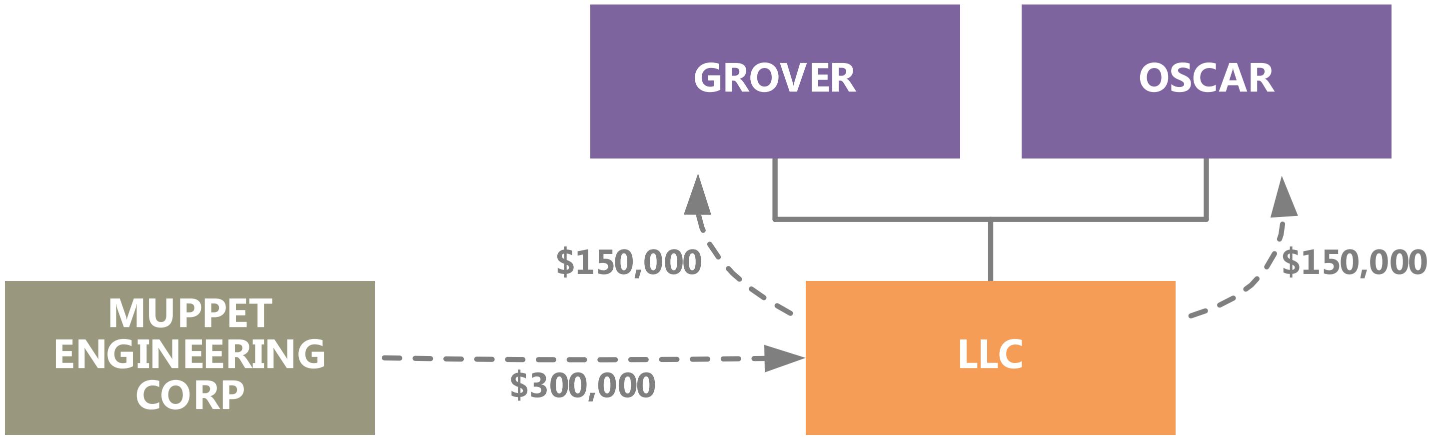
- Example 1: Bert and Ernie each earn $150,000 in W-2 wages as employees of Muppet Engineering Corp. Each of Bert's and Ernie's total income is below the $157,500/$315,000 threshold.



  Although the income is not from a specified service business, they do not qualify for the Section 199A deduction. Why? Because the definition of a qualified business does not include the business of performing services as an employee.

- Example 2: Grover and Oscar provide similar services to Muppet Engineering Corp through their LLC, which is classified as a partnership for tax purposes.

  The LLC earns $300,000 from Muppet Engineering Corp and allocates the income equally between Grover and Oscar. Each of Grover's and Oscar's distributive share of the income qualifies for the Section 199A deduction.



- The IRS is less likely to challenge a partnership structure than independent contractor status. And, any IRS challenge is less likely to succeed.
- Efforts may be made to "dress up" this argument by having the LLC pay joint expenses or earn income from other sources, etc.
- Be aware that the owner of Muppet Engineering Corp now has lower wages, so if Muppet Engineering is a pass-through entity, this will impact the owner's Wage/Qualified Property Cap. (This is not a concern if the corporation is a service business that doesn't qualify for the Section 199A deduction or if is a C corporation instead of a pass-through.)
- Also, if the "sales team" is comprised of service providers (like lawyers or accountants), this only provides them with the Section 199A deduction if their taxable income is under the $207,500/$415,000 threshold.

Partnership with No W-2 Wages or Qualified Property: Convert Partnership to S Corporation

› Piggy and Kermit form Muppet Partnership which is not a service business. Muppet Partnership has no employees and owns no qualified property.

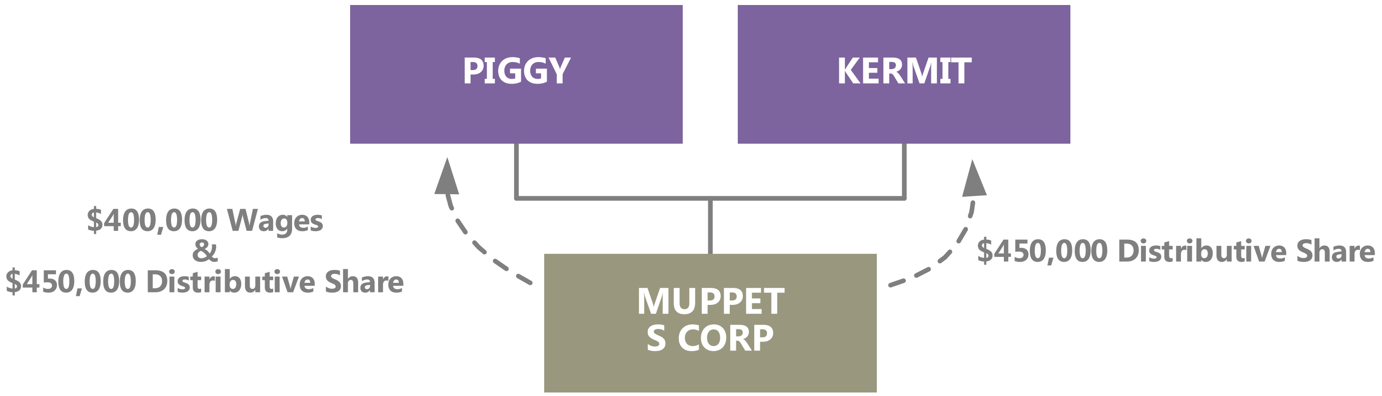
› Each of Piggy's and Kermit's total taxable income exceeds the $207,500/$415,000 threshold.

› Muppet Partnership earns $1.3 million of qualified business income and makes a guaranteed payment to Piggy in the amount of $400,000 for services rendered by Piggy (which doesn't count as wages). Piggy's allocable share of qualified business income from Muppet Partnership is $450,000. Kermit's allocable share of qualified business income from Muppet Partnership is $450,000.

› Because Muppet Partnership does not have any employees and does not own any qualified property, the Wage/Qualified Property Cap is $0.

› Piggy and Kermit will not be entitled to any deduction with respect to their allocable shares of qualified business income from Muppet Partnership.

› Remedy: Convert Muppet Partnership to an S corporation.



- If Muppet Partnership is an S corporation, the $400,000 payment to Piggy is wages.
- Because of the $200,000 Wage/Qualified Property Cap, $200,000 of the income would qualify for the Section 199A deduction, providing total annual tax savings of about $74,000.
- Each owner is allocated 50% of the Wage/Qualified Property Cap ($100,000 per owner), so each owner gets a $100,000 deduction and each saves $37,000.

Special Rule for Section 754 Election Basis Adjustments

› Basis adjustments that result from a Section 754 election are not taken into consideration when calculating the UBIA of qualified property portion of the Wage/Qualified Property Cap.

- Example 1: Father dies owning an interest in a partnership (that owns an appreciated asset).

  At his death, the basis of his partnership interest is stepped-up to fair market value, and the partnership will make a Section 754 election.

  Because of the Section 754 election, the portion of the assets inside the partnership with respect to Father will receive a corresponding step-up in basis.

  This corresponding step-up in basis **is not taken into consideration** for purposes of calculating the UBIA of qualified property portion of the Wage/Qualified Property Cap. It will only be used for depreciation and sales purposes.

- Unlike basis adjustments resulting from a Section 754 election, a Section 1014(a) basis step-up at death is taken into consideration for purposes of calculating the UBIA of qualified property portion of the Wage/Qualified Property Cap.
  - Example 2: Father dies owning an appreciated asset in a disregarded entity.

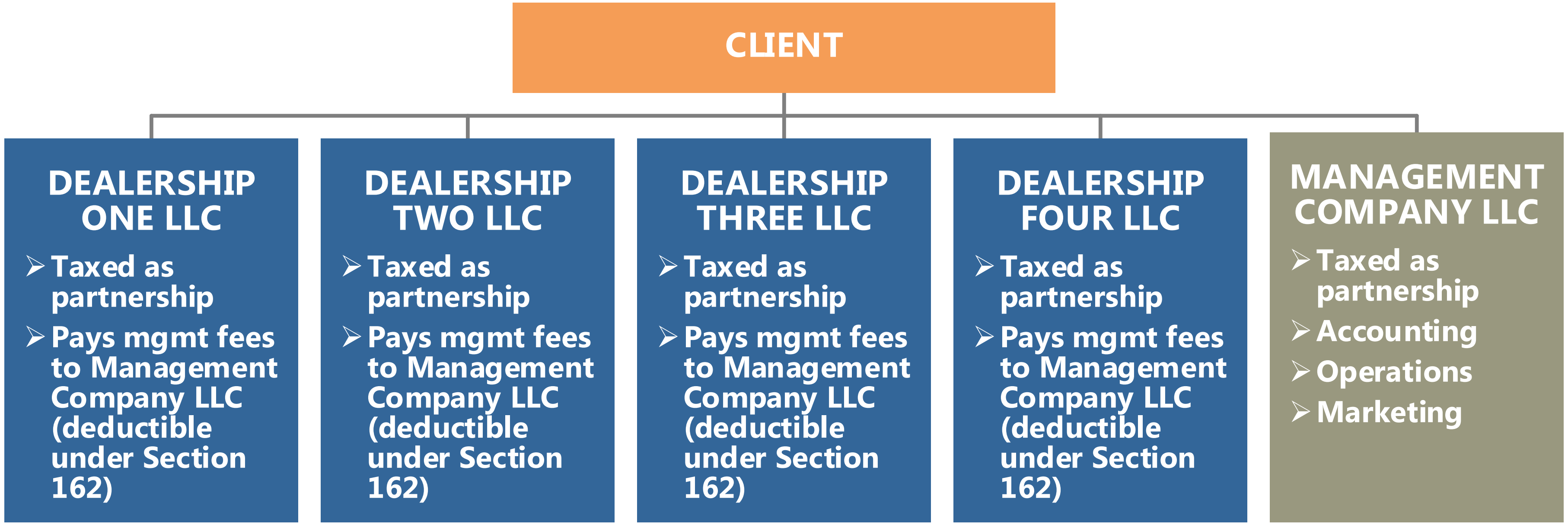
    At his death, the basis in the asset is stepped-up to fair market value.

    This step-up in basis is taken into consideration for purposes of calculating the UBIA of qualified property portion of the Wage/Qualified Property Cap.

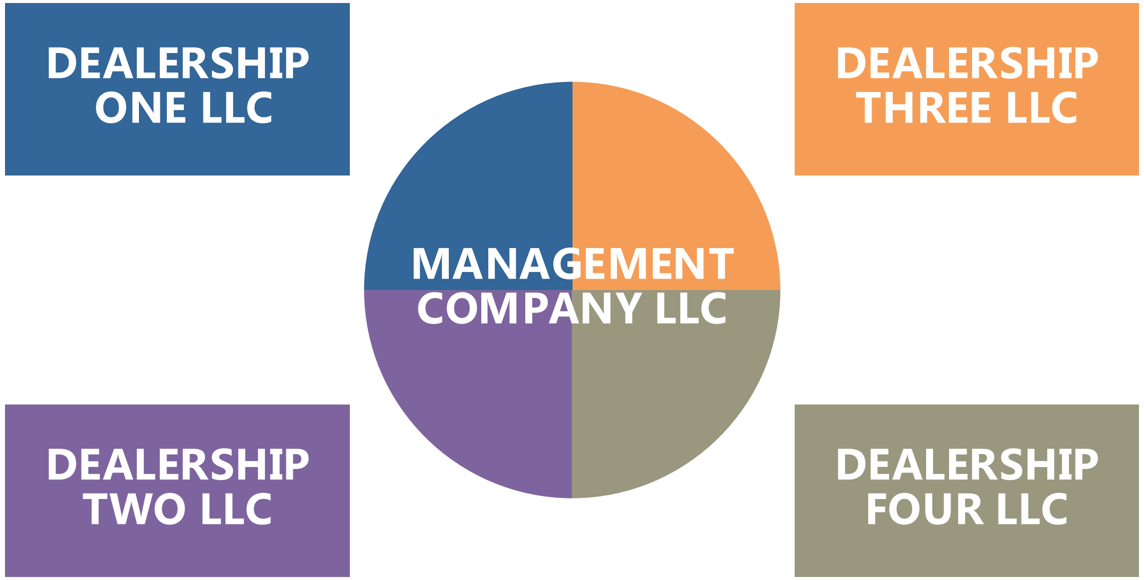
    Therefore, it can be used for depreciation, sales purposes, and for purposes of calculating the UBIA of qualified property portion of the Wage/Qualified Property Cap.

What Constitutes a Trade or Business?

- Following is a fairly-common structure. The client owns five entities. Four of the entities own and operate automobile dealerships. The fifth entity provides management services. Most of the employees work for only a single dealership and are paid wages from that dealership entity. A few employees perform work for all four dealerships and are paid wages from the management company.



- There are two ways that the client could benefit by combining the management company operations with the dealership operations: (i) for purposes of increasing the Wage/Qualified Property Cap, and (ii) for utilizing the 20% deduction for any management company profits.
- Remember, in order to aggregate two or more businesses, none of the trades or businesses may be a specified service trade or business.
- <u>Question</u>: Does the management company constitute a specified service trade or business because it provides specified services to all four dealerships?
- Let's look at this a different way.
  - There is no requirement that a trade or business be housed in only one entity. (For example, when a building leases space to a bunch of CPAs, it is considered to be part of the accounting service business.)
  - The real business here is selling automobiles, parts, and labor. The accounting and management is in a supporting role.



- A stated goal of the proposed regulations is to ignore the entity wrappers. When seen this way, all of the blue area is a single trade or business. We believe that the management company income and expenses should be incorporated into those of the dealerships. The results would be: (i) the W-2 wages paid by the management company would increase the Wage/Qualified Property Cap; and (ii) the profits enjoyed by the management company would give rise to the Section 199A deduction.

Should Everyone Elect C Corporation Status?

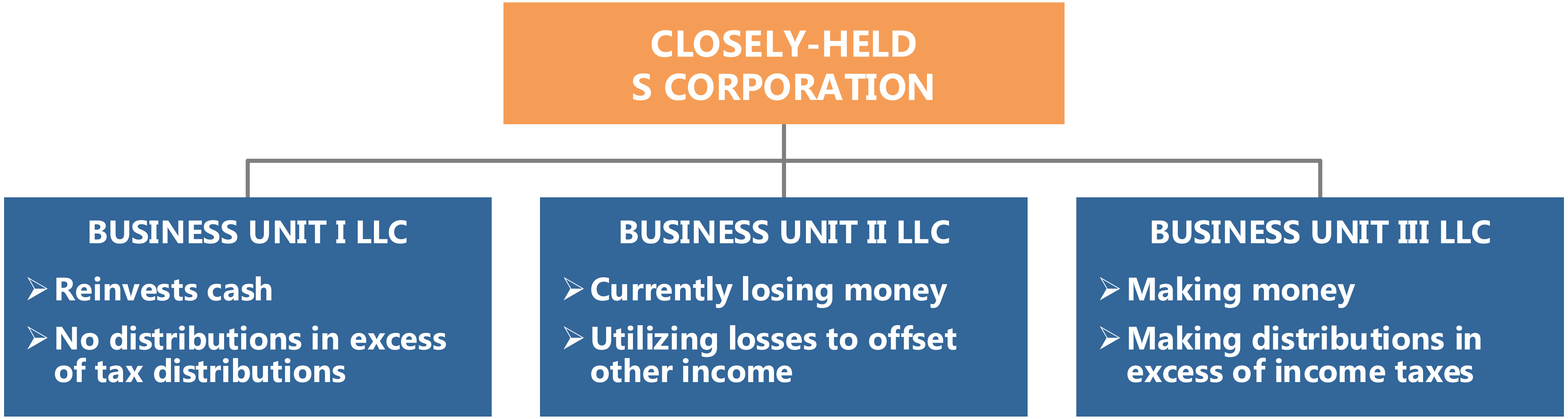
Assumptions: Annual income of $5 million, the business generates a 5% rate of return on invested capital, and a 0% dividend rate.

Total After 20 Years		
1.	Pass-through, no deduction (37% rate)	$85.9 M
2.	Pass-through with deduction (29.6% rate)	$99.7 M
3.	C corp (21% rate), pays out accumulated assets after 20 years as dividend taxed at 23.8%	$89.2 M
4.	C corp (21% rate), owner dies, family gets step-up and dissolves corporation	$117.0 M

Considerations Before Converting to C Corporation

- Double-Level Taxation – Converting to a C corp works best if the corporation doesn't pay dividends.
- Conversion Costs – The amount of debt above basis is taxed as gain; some states also have a conversion tax.
- Accumulated Earnings Tax – The IRS might seek to assert if a closely-held C corporation accumulates excess earnings.
- Personal Holding Company Tax – This applies if investment income is too high.
- Intended Exit Strategy – A business sale structured as a sale of assets instead of a sale of stock would be subject to double taxation (taxed when you sell the assets and taxed again when you distribute the proceeds to shareholders).
- Individualized modeling is needed to determine the best solution.
- Bottom Line: Not "one size fits all."

Closely-held company with multiple business units:



- Client's knee-jerk reaction was to convert the S corporation to a C corporation.

After more thought, more subtle ideas emerge:

CLOSELY-HELD S CORPORATION

BUSINESS UNIT I LLC

- **Reinvests cash**
- **No distributions in excess of tax distributions**

- Client has chosen C corp to utilize 21% rate since there is no double taxation in foreseeable future.
- Put in only profits interest. (See next slide).

BUSINESS UNIT II LLC

- **Currently losing money**
- **Utilizing losses to offset other income**

- No benefit of stand-alone C corp. Remain pass-through entity.
- What about excess business losses (461(l))? Depending upon answer, may want to merge with profitable C corp. (See slide after next).

BUSINESS UNIT III LLC

- **Making money**
- **Making distributions in excess of income taxes**

- Probably remain disregarded entity. Run numbers before deciding.
- If we leave Unit II as a stand alone pass-through, do we need to leave Unit III as a pass-through to utilize Unit II's loss?

Contribute Profits Interest

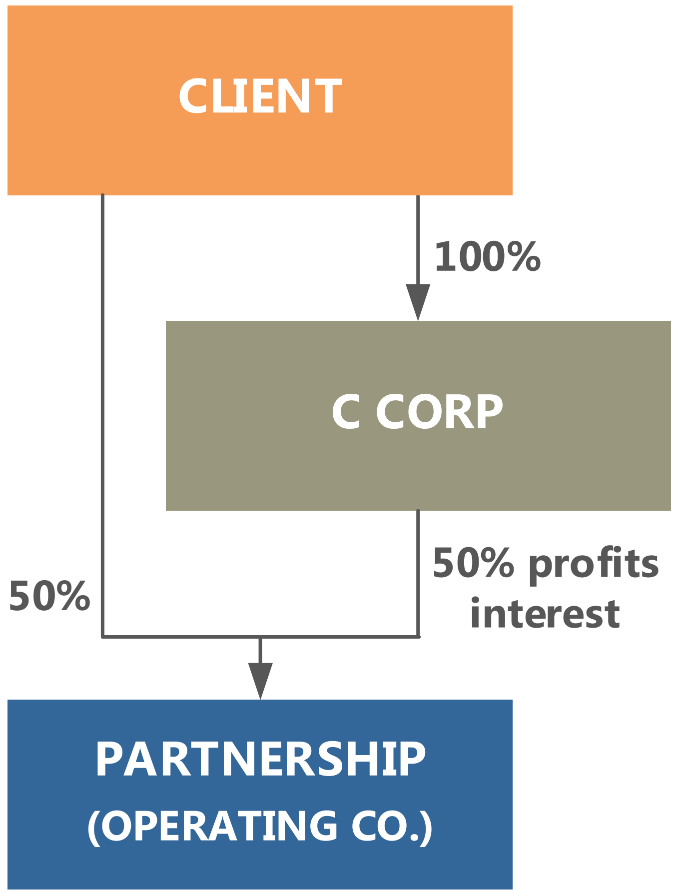
- Note that when we are converting any profitable business into a C corporation, we form a new C corporation and only contribute a profits interest. That way we can eliminate a second layer of tax on the pre-existing goodwill upon a subsequent asset sale.
- Consider a growing business owned by a pass-through entity with $10 million of goodwill. If we place the business into a C corporation, there will be both a corporate level tax and a shareholder level tax upon a future asset sale. If instead, we place only a profits interest in the C corporation and keep the assets in the pass-though entity, then upon sale of the business by the pass-through entity, we will have only a shareholder level tax.
- Each year, as profits are allocated to the C corporation, they will be taxed at 21%.

Excess Business Losses

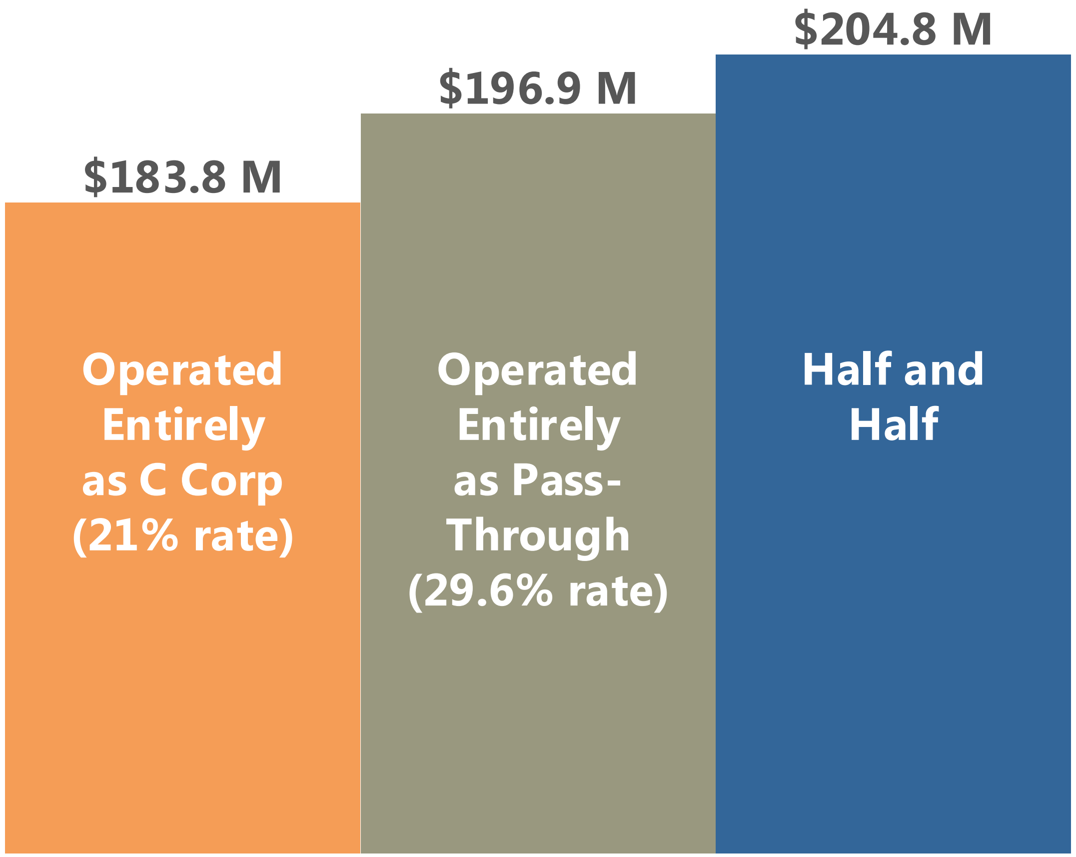
- In our previous chart, if Business Unit I and Business Unit III are both placed inside C corporations and Business Unit II has a $1 million loss, the shareholder can only deduct $500,000 against next year's other income because of Section 461(l). The other $500,000 loss may be carried over. It might be better to contribute Business Unit II into one of the C corporations which can fully-utilize the loss.
- Alternatively, you could leave Business Unit III as a pass-through so that Unit II's loss can be utilized against Unit III's income.

Half and Half Might Be Most Beneficial

- For some situations, part C corporation and part pass-through may work best. Assume client needs half of the profits to live on and will reinvest the rest.
- Assign a 50% profits interest to the C corporation, and allow the other 50% of the profits to pass through.
- Each year, the operating company distributes half of the profits to the C corporation and passes-through the other half to the owner.
- The C corporation profits are reinvested in the partnership, so the C corporation's ownership interest in the partnership will grow over time.



Assumptions: Annual income of $5 million, the business generates a 20% rate of return on invested capital, and the client liquidates after 20 years.



Partnership vs. S Corporation

- Partnerships are generally better.
  - A Section 754 election can step-up inside basis. This increased basis may result in increased depreciation deductions. Also, the increased inside basis is helpful even if the partnership is not liquidated, whereas with an S corporation, the corporation has to be liquidated to benefit from the outside basis step-up.
  - Partnerships can often distribute assets to partners without generating a taxable event.
  - Special allocations may be used.
  - Partnership interests may be owned by corporations, partnerships, trusts of any type, and non-resident aliens.
  - Unlike with an S corporation, when the partnership borrows money, the resulting loan increases the outside basis of the partners.

Deduction for State and Local Taxes Capped at $10,000

- The deduction for state and local taxes, including property taxes, is now capped at $10,000 for married couples ($5,000 for single).
- Consider doubling the deduction by utilizing a complex trust which gets its own $10,000 limitation. Buy a house for a child, and put half in the complex trust and half in the child's name. The trust can deduct $10,000 of property taxes, and the child can deduct $10,000 of property taxes. Note this does not work for your own residence (would be a grantor trust, not a complex trust).
- A C corporation does not have a state and local income tax deduction limit. In some instances that fact may tip the scale in favor of a C corporation. If a client lives in a state with a state income tax but their business is in a state with no income tax, by owning their business as a pass-through structure and passing the income through to the client, they're exposing the income to state income tax of which the client can only deduct $10,000. If the business were instead a C corporation, no income would pass through to the client, and state income tax would be avoided.

Section 1202 Qualified Small Business Stock Exclusion

- If there is a compelling reason to use a C corporation, it may lie in Section 1202. Simply put, the long-term capital gain from the sale of Section 1202 stock is reduced by 50%-100%. The reduction is 100% for Section 1202 stock acquired in 2018.
- If a client believes he can sell the stock upon exit, a C corporation must be considered.
- Think about it—a 21% gain on operations, followed by a 0% capital gain upon exit. Pretty compelling!
- Note that an existing business owned as a partnership, sole proprietorship, or disregarded entity can be contributed to a C corporation, giving the contributor Section 1202 stock.
- Before 2018, the excluded gain was an AMT add-back, so the client wound up paying AMT on the sale of stock. Under the Tax Act, it isn't, so now a sale of stock is truly tax-free.

- For several reasons, Section 1202 isn’t for everyone.
  - Must be a C corporation.
  - Never have been an S corporation.
  - Must have acquired the stock newly-issued from the corporation.
  - Must have held the stock for at least 5 years.
  - The aggregate gross assets immediately after issuance (and before) cannot be more than $50 million.
  - Cannot ever take assets out of a corporation without a taxable event.
  - If the company pays out dividends, there’s a double layer of taxation (at company level and at shareholder level.)
  - Generally, Section 1202 doesn’t apply to service businesses.

Section 1202 Mathematics

Business in Partnership		Section 1202 Stock Sale		Section 1202 Assets Sale	
Asset Sale Price	$10M	Stock Sale Price	$10M	Asset Sale Price	$10M
Basis[1]	(4M)	Stock Basis[2]	(1M)	Asset Basis	(4M)
Gain	6M	Gain	9M	Gain	6M
Tax on Gain	x 20%	Tax on Gain	x 0%	Tax on Gain	x 21%
Tax on Sale	**$1.2M**	**Tax on Sale**	**$0**	**Tax on Sale**	**$1.26M**
				Net Distribution	$8.74M
				Stock Basis	(1M)
				Stock Gain	7.74M
				Tax on Gain	x 0%
				Tax on Distribution	**$0**
				Total Tax	**$1.26M**

[1] Assumes inside and outside basis are equal

[2] Assumes $1M initial investment

Bonus: Use It or Lose It

› The extra estate and gift tax exemption vanishes at the end of 2025. To lock in the benefit, a couple has to transfer $22 million out of their estate.

› Gifting to Spousal Lifetime Access Trusts ("SLATs") will be a popular approach because spouses will still have access to all of their assets, even after making gifts to the SLATs. Utilizing SLATs doesn't mean the survivor has to live on half the assets.

- Each spouse creates a SLAT for the benefit of the other; each SLAT buys life insurance on the other spouse.
- Example: Husband creates a SLAT for the benefit of Wife and funds it with $11 million. Wife's SLAT buys a life insurance policy on Husband's life. At Husband's death, Wife continues to benefit from her SLAT, plus her SLAT collects $11 million on Husband's life, so Wife's access to the full $22 million isn't diminished when Husband dies.
- The two SLATs cannot be identical or will violate the reciprocal trust doctrine.

Bonus: The New “FAST” Trust

› With the Tax Act’s higher exemption and more wealth passing to heirs, it’s more important than ever to consider the impact of large inheritances on heirs.

› Studies show that successful families (those that thrive and stay connected for generations) engage in best practices like family retreats, preparing heirs, educating heirs on finances, philanthropy, entrepreneurship, preserving family heritage and values, family enrichment activities and travel, etc.

› FAST (Family Advancement Sustainability Trust):

- Provides Funds – A FAST provides the funds to pay for family education, family retreats, enrichment, etc. An efficient way to fund a FAST is with life insurance (special GST-exempt dynasty ILIT dedicated to this purpose).
- Provides Leadership to Ensure It Happens – A FAST assigns leadership to trustees and committee members who are charged with the responsibility of planning the retreats/education activities, and the FAST trust pays them for their work. My experience is that, if G-1 dies without setting up a FAST, G-2 drops the ball on paying for this and doing the work.

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