TAX PLANNING IDEAS IN LIGHT OF TAX CUTS AND JOBS ACT OF 2017

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- Biggest tax reform in over 30 years (1939, 1954, 1986, 2017).
- 2017 planning paralysis while tax law was in limbo is over.
- What survived chopping block going to be around long time.
- In spite of the 21% corporate income tax rate, we still prefer the limited partnership structure for operating businesses the vast majority of the time.
- Initial estimated cost of the legislation was $1.4 – $1.5 trillion. Likely to cost more than anticipated.

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Strategies to Maximize 20% Pass-Through Deduction (Section 199A)

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- Section 199A 20% Deduction for Pass-Through Income
  - To be "Qualified Business Income," the income **cannot** be from fields of health; law; accounting; actuarial science; performing arts; consulting; athletics; financial services; brokerage services; any trade or business where the principal asset is the reputation or skill of one or more employees; or investing, trading, dealing in securities, partnership interests or commodities. Engineering and architecture are exceptions.

Taxpayer's Total Income	Income from Specified Service Business (NOT Qualified Business Income)	Income NOT from Specified Service 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 W-2 wage cap*	Sliding scale to determine amount of deduction available, then part of deduction subject to W-2 wage cap*
> $207,500 (single) > $415,000 (married)	No deduction available	Full 20% deduction available but subject to W-2 wage cap*

**W-2 wage cap is greater of: (i) 50% of W-2 wages, and (ii) 25% of W-2 wages plus 2.5% of unadjusted basis of business assets.*

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- W-2 wage cap is greater of: (i) 50% of W-2 wages, and (ii) 25% of W-2 wages plus 2.5% of unadjusted basis of business assets.
- Because wages are subject to 37% tax but K-1 income is taxed at 29.6%, there's an incentive to shrink wages. BUT, be careful not to drop wages so low that W-2 wage cap reduces deduction.
  - With business income of $10 million and W-2 wages of $4 million, 20% deduction would be $2 million.
  - If wages are $1 million, deduction is limited to $500,000.

Bottom Line: The pass-through 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).

Convert Wages to Deductible Income

- Employee's W-2 wages don't qualify for 20% pass-through deduction (still subject to 37% individual tax rate). Conversely, an independent contractor reports on Schedule C and qualifies for 20% pass-through deduction on net income.
- Knee-jerk reaction might be to convert employees to independent contractors, thinking more income will pass through and get 20% deduction.
- Potential problems with independent contractor approach:
  - Must be careful not to drop wages so low that W-2 wage cap reduces deduction.
  - The IRS often challenges independent contractor status, which is a facts and circumstances determination, not an election.
- An alternative would be for two or more employees to form a partnership which is paid a contracted amount.

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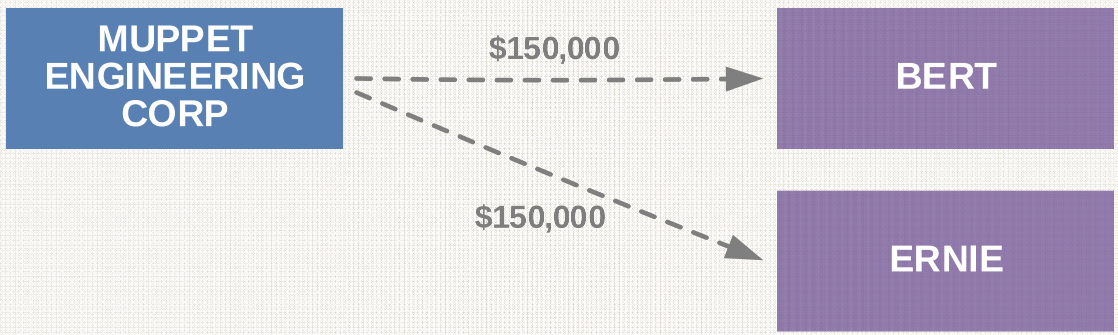
Muppet Engineering Corp

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 20% deduction. Why? Because the definition of a qualified business does not include the business of performing services as an employee.



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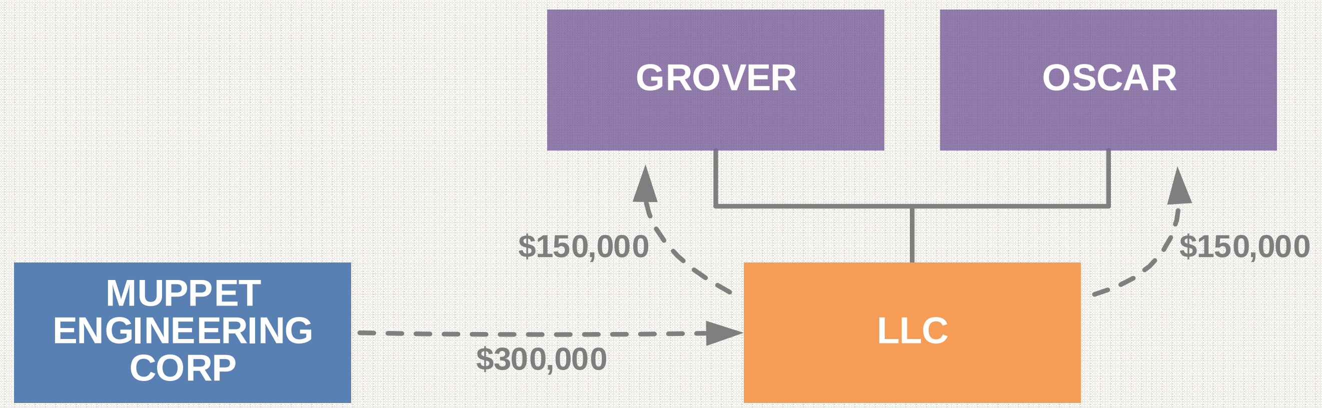
Example 2:

- Grover and Oscar on the other hand provide similar services to Muppet Engineering Corp through their LLC (which is classified as a partnership for tax purposes).
- 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 income qualifies for the 20% deduction.



- The partnership structure is less likely to be challenged by the IRS.
- 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.
- Note: If the corporation were a flow-through entity, changing Bert and Ernie from being W-2 employees would reduce the W-2 wage cap.
- This structure could work well for companies that create profit center sales “teams.”

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Reduce Taxable Income to Qualify

- Qualified Retirement Plan
  - Adopt qualified retirement plan.
  - Contributions to plan reduce taxable income.
- Put Kids on Payroll
  - If kids do legitimate work for the business, pay them reasonable wage.
  - Reduces parents’ taxable income.
- Make Charitable Gifts

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- Husband and Wife File Separately
  - Assume husband earns $150,000 as doctor, and wife earns $300,000 of income from her separate property.
  - Together, income is above $415,000, so pass-through income is ineligible for 20% deduction.
  - If they file separately, husband can qualify for 20% pass-through deduction.
  - Note: 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.

    [See Lucas v. Earl, 281 U.S. 111 (1930) and Commissioner v. Harmon, 323 U.S. 44 (1944).]

Utilize Multiple Trusts

- Each trust can receive up to the $157,500 threshold in qualified business income without being subject to the W-2 wage cap.
- Maximum tax benefit per trust is $11,655 ($157,500 x 20% x 37%).
- Note: 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. [Code Section 643(f)]

Partnership with No W-2 Wages or Qualified Property

- Piggy and Kermit form Muppet Partnership. Muppet Partnership is not a specified 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. 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.
- Each of Piggy's and Kermit's total taxable income exceeds the $207,500/$415,000 threshold.
- Because Muppet Partnership does not have any employees and does not own any qualified property, the W-2 wage cap is $0.

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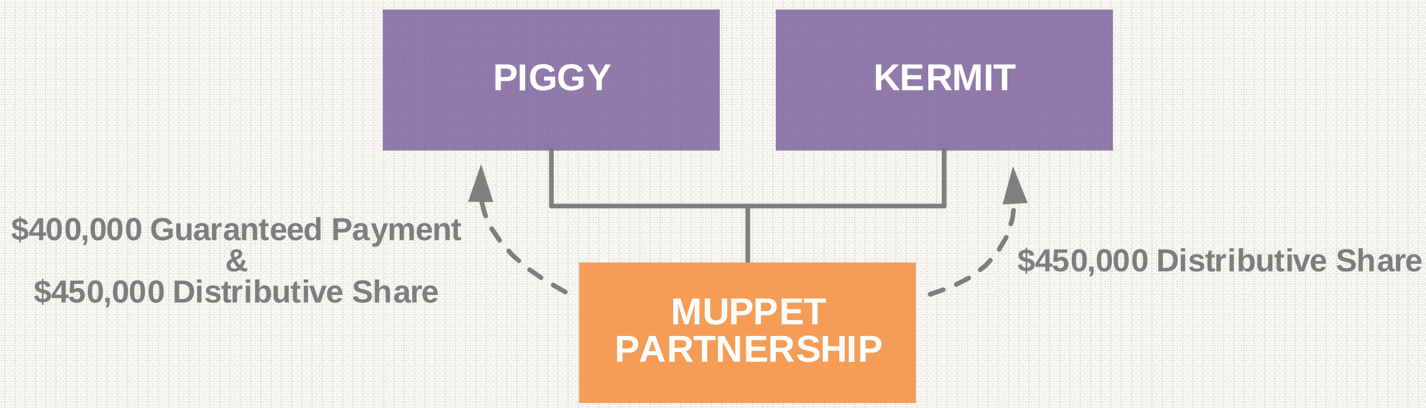
- Piggy and Kermit will not be entitled to any deduction with respect to their allocable shares of qualified business income from Muppet Partnership.



- If Muppet Partnership were an S Corporation, $200,000 of the income would qualify for the 20% deduction because of Piggy's W-2 compensation, providing annual tax savings of about $74,000.

Choice of Entity Issues

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Should Everyone Elect C Corporation Status?

Assumptions: $5 million annual income, business generates 5% rate of return on invested capital, 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 – so works best if corporation doesn’t pay dividends.
- Conversion Costs – amount of debt above basis is taxed as gain; some states also have conversion tax.
- Accumulated Earnings Tax – IRS might seek to assert if closely-held C corporation accumulates excess earnings.
- Personal Holding Company Tax – applies if investment income is too high.
- Intended Exit Strategy – business sale structured as sale of assets instead of 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).
- Need individualized modeling to determine best solution.

Bottom Line: **Not “one size fits all.”**

Cracking and Packing

- Under the new rules, maximum tax benefits may sometimes be achieved by altering how gross income and expenses are packaged. The terms of art for this process are “Cracking” and “Packing.”
- If specified service business owns real estate, separate out real estate into separate entity which will qualify for 20% pass-through deduction. Pay market-level rent (on high side of scale of reasonableness) to separate real estate entity to **push as much income as possible** to entity that will qualify for 20% pass-through deduction.
- An immigration law firm has a large team of clerical staff that fills out forms. The attorneys take the forms and provide legal services. Presumably, the clerical services could be treated as a business line separate from the legal services, allowing a 20% deduction for profits related to the clerical services.

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- Similarly, an optometrist might sell glasses or contacts in addition to providing medical services. Profits from the sale of products should be eligible for the 20% deduction, subject to the W-2 wage cap.

- These results are consistent with PLR 201717010 which held that a medical testing laboratory was not in the field of health for purposes of Section 1202(e)(3).

Closely-held company with multiple business units:

CLOSELY-HELD S CORPORATION

BUSINESS UNIT I LLC
- Reinvests cash
- No distributions in excess of tax distributions

BUSINESS UNIT II LLC
- Currently losing money
- Utilizing losses to offset other income

BUSINESS UNIT III LLC
- Making money
- Making annual distributions in excess of income taxes

- 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 Corporation 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 Corporation. Remain pass-through entity.
- What about excess business losses (461(l))? Depending upon answer, may want to merge with profitable C Corporation. (See slide after next).

BUSINESS UNIT III LLC

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

- Probably remain dis-regarded 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?

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Contribute Profits Interest

- Note that when we are contributing any profitable business into a C corporation, we **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, 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%.

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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.

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Section 199A W-2 Limitation:

CLIENT

BUSINESS ONE LLC
- Taxed as partnership
- No W-2 expenses
- Pays management fees to Management Company LLC (deductible under Section 162)

BUSINESS TWO LLC
- Taxed as partnership
- No W-2 expenses
- Pays management fees to Management Company LLC (deductible under Section 162)

BUSINESS THREE LLC
- Taxed as partnership
- No W-2 expenses
- Pays management fees to Management Company LLC (deductible under Section 162)

MANAGEMENT COMPANY LLC
- Taxed as partnership
- W-2 expenses
- Accounting
- Operations
- Marketing

- Fairly-common scenario for clients with many entities.
- Businesses One, Two, and Three each use personnel from Management Company to operate the businesses, and they pay Management Company for these personnel. This is because all of the employees perform services for each business in various proportions.

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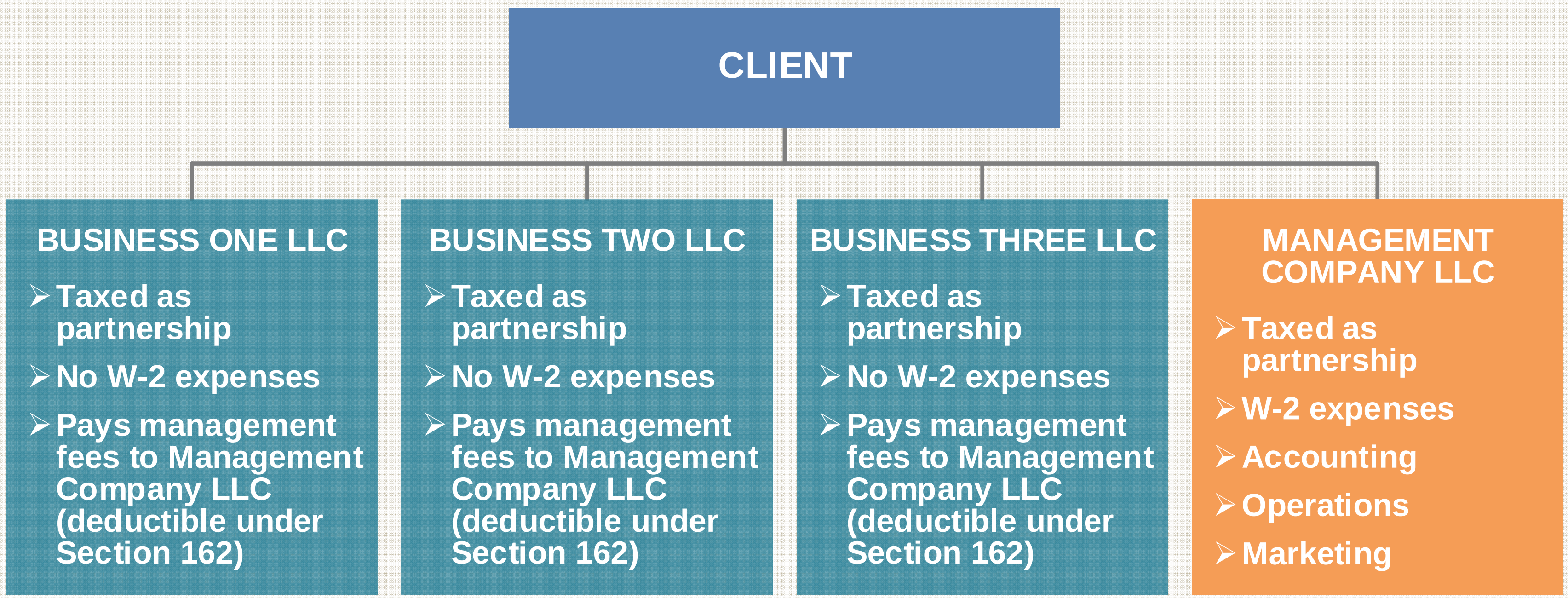

- Question: Do the W-2 expenses incurred by Management Company allow the client to utilize the Section 199A deduction for Businesses One, Two, and Three?

  Answer: Probably, but we do not know for sure.

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- Here is the argument for allowing the W-2 expense to be used this way. Let's look at the language of the statute.

> *(i) 50 percent of the W-2 wages <u>with respect to the qualified trade or business</u>, or (ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5% percent of the unadjusted basis immediately after acquisition of all qualified property*.
> [Section 199A(b)(2)(B)]

- The language "with respect to the qualified trade or business" would seem to give us the argument that the W-2 wages of one entity could be used to support the deduction of income generated in another entity as long as the W-2 wages were related to that other entity's trade or business and they both landed on the same taxpayer's return.

- Furthermore, Section 199(A)(f) provides that the section shall be applied at the partner or S corporation shareholder level and that each partner/shareholder “shall be treated for purposes of subsection (b) as having W-2 wages…equal to the partner/shareholder’s allocable share.”

- This appears to be a strong argument for utilizing W-2 wages paid by the Management Company to increase the Section 199A deduction for the three businesses.

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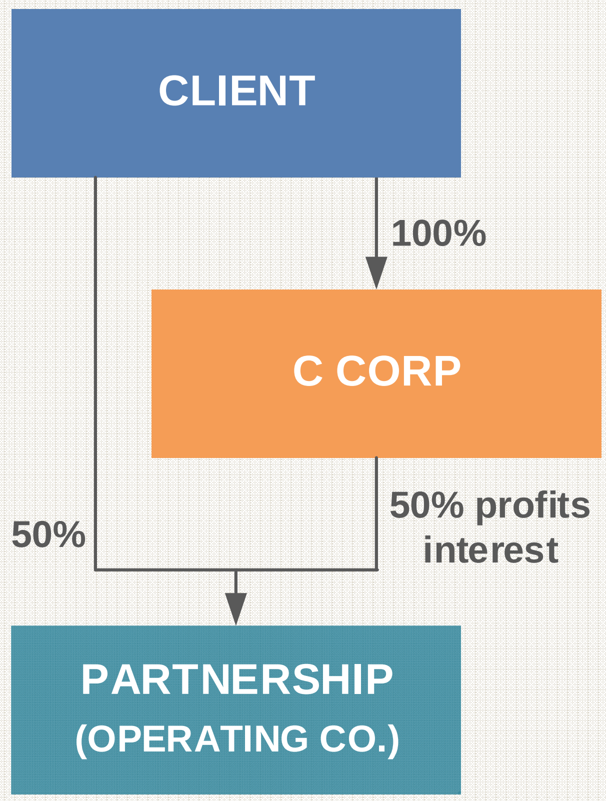
Optically, however, this structure is superior:

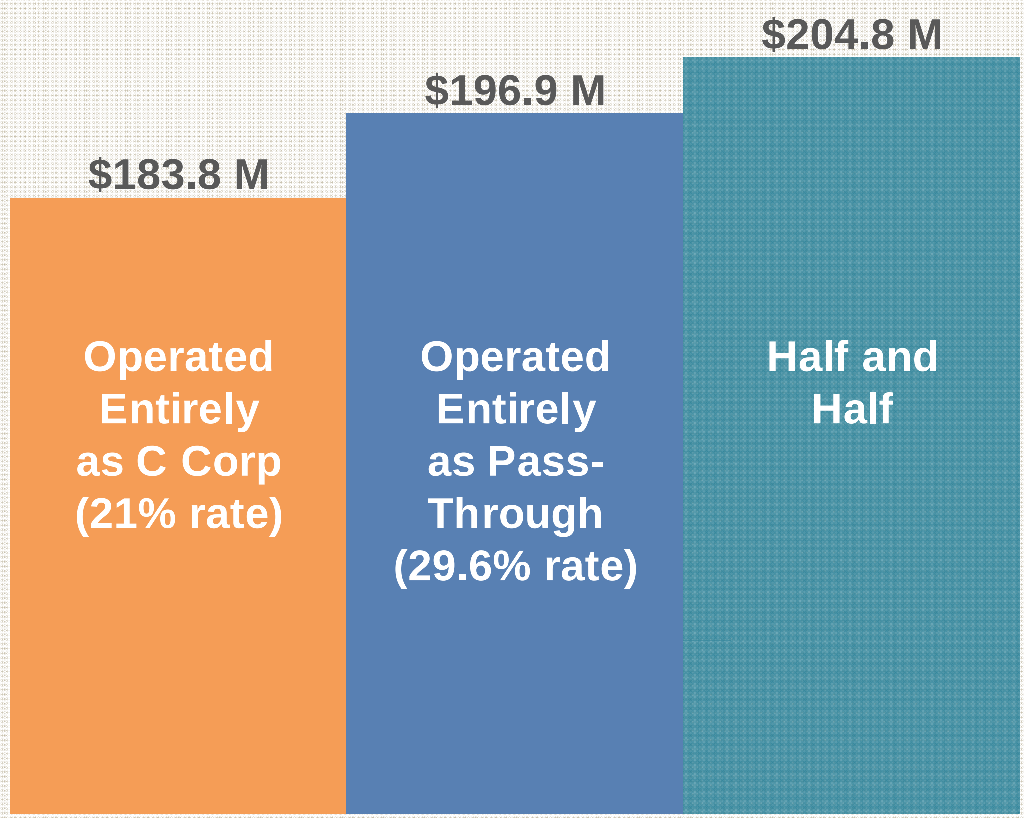
- With this structure, it would be more difficult for the IRS to argue that the W-2 wages of Management Company is separate from the operations of Businesses One, Two, or Three because the income and the W-2 expense flow through to the client on the same K-1.

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, and the C Corporation's ownership interest in the partnership will grow over time.



Assuming $5 million income and 20% rate of return, total received when client liquidates after 20 years:



Partnership vs. S Corporation?

- Partnerships are Generally Better
  - 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.
  - Assets may often be distributed 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.

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

- Deduction for state and local taxes (“SALT”), including property taxes, now capped at $10,000 for married couple ($5,000 for single or married filing separately).
- Consider doubling the deduction by utilizing a complex trust. Each complex trust 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 grantor trust, not complex).
- Also, 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.

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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 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.

For Everybody?

- Why doesn’t everybody do this? Lots of reasons:
  - Must be a C corporation.
  - Never have been an S corporation.
  - Must have acquired stock newly-issued from the corporation.
  - Must have held the stock for at least 5 years.
  - Aggregate gross assets immediately after issuance (and before) not more than $50 million.
  - Cannot ever take assets out of a corporation without a taxable event.

- Drawbacks:
  - What if the client wants dividends?
    - Double tax
    - Corporation’s holding passive assets will disqualify
  - What if we cannot sell stock?
    - Still have only one level of tax.
  - What if the law changes?
    - Cannot control Congress. Remember, before 2018, the excluded gain was added back for AMT purposes. Then, could have two levels of tax.

Section 1202 Mathematics

Business in Partnership	
Asset Sale Price	$10 M
Basis[1]	4 M
Gain	6 M
Tax on Gain	x 20%
Tax on Sale	$1.2 M

Section 1202 Stock Sale	
Stock Sale Price	$10 M
Stock Basis[2]	1 M
Gain	9 M
Tax on Gain	x 0%
Tax on Sale	$0

Section 1202 Sale of Assets	
Asset Sale Price	$10 M
Asset Basis	4 M
Gain	6 M
Tax on Gain	x 21%
Tax on Sale	$1.26 M
Net Distribution	$8.74 M
Stock Basis	1 M
Stock Gain	7.74 M
Tax on Gain	x 0%
Tax on Distribution	$0
Total Tax	$1.26 M

[1] Assumes inside and outside basis are equal
[2] Assumes a $1M initial investment

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Strategies to Maximize Basis

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Move Appreciated Assets Back Into Estate

- With higher estate tax exemption, the estate planning focus for many is less on saving estate tax and more on **getting a step-up**. If your client has transferred assets to a grantor trust to avoid estate tax, the problem is that the assets won't get a step-up at death.
- Swap low-basis assets out of a grantor trust in exchange for cash or high-basis assets so that the appreciated assets will be in the estate at death.
- If the client doesn't have cash or high-basis assets to swap:
  - Borrow cash to swap for the trust's low-basis assets.
  - Use borrowed cash to purchase high-basis assets to swap for the trust's low-basis assets.

- Instead of swapping assets, explore a way to **move assets back into estate** by court reformation.
  - Court could grant a general power of appointment.
  - Court could terminate a portion of the trust early in favor of a beneficiary.
- If a trustee is willing to incur potential liability, the trustee could “wrongfully” distribute trust assets to cause inclusion and generate a step-up. Obviously, you cannot actually advise someone to do this. Gift tax issues of beneficiaries who do not receive distributions would have to be considered.

Convert Non-Grantor Trust to Grantor Trust

- If it's a non-grantor trust, explore converting it to a grantor trust (via court reformation or trust merger).
- Texas now has a fairly liberal trust merger statute.
- Non-grantor trusts can be merged into grantor trusts if none of the beneficiaries will have their interests substantially impaired.

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Upstream Planning to Obtain Stepped-Up Basis

- Client creates a grantor trust benefiting the client's parent.
- The client gifts low-basis assets to the trust.
- The trust gives the parent a general power of appointment over the trust assets.
- The parent exercises the general power of appointment at death and leaves the assets back to the client or to a trust for the client.
- The assets come back to the client with a **stepped-up basis**.

CLIENT
- **Owns low-basis assets**

Gifts assets →

GRANTOR TRUST
(created by client to benefit parent; trust document gives parent GPOA over trust assets)
- **Now owns the low-basis assets**

Parent's Will exercises GPOA and leaves the assets to new trust for client or client's family →

NEW TRUST
(benefits client or client's family)
- **Now owns the assets with new stepped-up basis**

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Caution!

- Code Section 1014(e) denies the basis step-up if the assets come back to the donor/client or the client's spouse within one year.
- This potential limitation may be avoided if the assets pass (i) to a trust for the benefit of the client and/or the client's spouse (with a trustee other than the client or client's spouse) or (ii) to the client's kids.

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Not Enough Exemption?

- What if the client or the client's parent doesn't have enough lifetime exemption? No problem!

- The prior example requires using up exemption for both the client and the client's parent. Instead of the client making a **gift** to the parent, consider a **sale** to the parent.
  - The client can sell the low-basis asset to a grantor trust, taking back a note and a security interest. By selling instead of gifting the asset to the client's parent, the client **won't use up any exemption**.
  - Under Section 2053(a)(4), the asset included in the parent's estate will be offset by the secured debt. The asset gets a stepped-up basis, but the net increase to the parent's estate is zero. Therefore, none of the parent's exemption is used up on this asset.

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Use Powers of Appointment to Obtain Stepped-Up Basis

- Exercise a power of appointment to **cause inclusion**.
- Exercise a special distribution power and cause inclusion.
- Have special trustee create a general power of appointment.
- Note: To use this technique, the trust needed to be drafted at the outset to provide for such a power of appointment or for a special trustee with a power to make extraordinary distributions or create powers of appointment. We routinely draft all trusts to provide for special trustees with such powers.

Mixing Bowl Planning to Obtain Stepped-Up Basis

- Mixing Bowl Planning can provide a free stepped-up basis on appreciated assets.
- What if one family member has an asset with a low basis that he plans to sell (but doesn't want to pay tax on the gain), such as a fully-depreciated building or a stock that has climbed in value?
- Another family member (or S corporation or non-grantor trust) has a high-basis asset that the family plans to hold on to until death, such as a bond portfolio, legacy real estate, or a permanent life insurance policy?
- There's a way to **shift basis** from one asset to another so the family **avoids gain** when it sells the appreciated asset.

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- Dad owns a building with a fair market value of $450,000 and a basis of $0.
- Son owns bonds worth $450,000 with a basis of $450,000.
- Daughter has $100,000 cash.
- The family anticipates selling the building in the future (more than 7 years from now). Upon the sale, Dad **would have a taxable gain**.
- Dad, Son, and Daughter form a partnership. Dad contributes the building. Son contributes the bonds. Daughter contributes the cash.
- Partnership is owned 45/45/10.

DAD

CONTRIBUTES BUILDING WITH FMV = $450,000 AND BASIS = $0

(Dad's basis in his partnership interest is $0 because he had $0 basis in the asset he contributed.)

SON

CONTRIBUTES BONDS WITH FMV = $450,000 AND BASIS = $450,000

(Son's basis in his partnership interest is $450,000 because he had $450,000 basis in the asset he contributed.)

DAUGHTER

CONTRIBUTES $100,000 CASH WITH BASIS = $100,000

(Daughter's basis in her partnership interest is $100,000 because she had $100,000 basis in the asset she contributed.)

45% 45% 10%

PARTNERSHIP

OWNS:

- BUILDING WITH FMV = $450,000 (Partnership's basis in building is $0 because contributor's basis in building was $0 when contributed.)
- BONDS WITH FMV = $450,000 (Partnership's basis in bonds is $450,000 because contributor's basis in bonds was $450,000 when contributed.)
- $100,000 CASH (Partnership's basis in cash is $100,000 because contributor's basis in cash was $100,000 when contributed.)

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- After 7 years, they **liquidate Son's interest** in the partnership by distributing the building to Son.
- Because Son's basis in his partnership interest is $450,000 and the building was distributed to Son in liquidation of Son's interest, the basis in the building is adjusted from $0 to $450,000. (Section 732(b) requires this basis increase; no election is needed to effect this.)
- Then, the building was distributed to Son with a basis of $450,000.

SON

Interest in partnership liquidated.

Building distributed to Son with basis of $450,000.

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- Because the partnership had a "substantial basis adjustment" as defined in Section 734(d), the partnership now must make a **compensating downward adjustment** of $450,000 to its assets.
- The partnership's remaining assets are the bonds and the cash.

PARTNERSHIP

OWNS:

- **BONDS WITH FMV = $450,000 (Partnership's basis in bonds is $450,000.)**
- **$100,000 CASH (Partnership's basis in cash is $100,000.)**

- The basis of cash is always the value of the cash. Therefore, the basis of the bonds is adjusted downward by $450,000.
- Note that this adjustment would not be required if the basis of the building had increased by less than $250,000 which would not have constituted a substantial basis reduction.

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- After **Son's interest liquidated:**

DAD

(His basis in his partnership interest is still $0.)

DAUGHTER

(Her basis in her partnership interest is still $100,000.)

81.82%

18.18%

PARTNERSHIP

Compensating downward adjustment is made to bonds.

OWNS:

- **BONDS WITH FMV = $450,000 (Partnership's basis in bonds was $450,000. After downward adjustment, partnership's basis in bonds is $0.)**
- **$100,000 CASH (Partnership's basis in cash is still $100,000.)**

- At **Dad's death**, the basis of his partnership interest is stepped-up to fair market value (assume $450,000), and the partnership would make a Section 754 election.
- Because of the Section 754 election, the assets inside the partnership with respect to Dad will receive a step-up in basis to $450,000.

DAD'S ESTATE

(Estate's basis in its partnership interest is stepped-up to $450,000.)

DAUGHTER

(Her basis in her partnership interest is still $100,000.)

81.82%

18.18%

PARTNERSHIP

OWNS (ESTATE'S PORTION):

- **BONDS WITH FMV = $368,181.82 (Partnership's basis in bonds was $0. After step-up, partnership's basis in bonds is $368,181.82.)**
- **$81,818.18 CASH (Partnership's basis in this portion of cash is still $81,818.18.)**

OWNS (DAUGHTER'S PORTION):

- **BONDS WITH FMV = $81,818.18 (Partnership's basis in this portion of bonds is still $0.)**
- **$18,181.82 CASH (Partnership's basis in this portion of cash is still $18,181.82.)**

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- The **partnership sells the bonds** for $450,000. Daughter has $81,818.18 capital gain. Dad's estate has no gain or loss.

DAD'S ESTATE

(Estate's basis in its partnership interest is still $450,000.)

DAUGHTER

(Her basis in her partnership interest was $100,000. After $81,818.18 gain, her basis in her partnership interest is $181,818.18.)

81.82%

18.18%

PARTNERSHIP

OWNS (ESTATE'S PORTION):

- **81.82% OF SALES PROCEEDS = $368,181.82 (Partnership's basis in this portion of bonds is still $368,181.82, so no gain or loss.)**
- **$81,818.18 CASH (Partnership's basis in this portion of cash is still $81,818.18.)**

OWNS (DAUGHTER'S PORTION):

- **18.18% OF SALES PROCEEDS = $81,818.18 (Partnership's basis in this portion of bonds was $0, so gain of $81,818.18.)**
- **$18,181.82 CASH (Partnership's basis in this portion of cash is still $18,181.82.)**

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- When the **partnership dissolves** later that same year, Daughter will recognize a $81,818.18 capital loss to offset her $81,818.18 capital gain.
- Family pays no income tax on sale of bonds.

DAD'S ESTATE

Estate's 81.82% portion of proceeds = 81.82% x $550,000 = $450,000

$450,000 proceeds less estate's $450,000 basis in its partnership interest = no gain or loss

DAUGHTER

Her 18.18% portion of proceeds = 18.18% x $550,000 = $100,000

$100,000 of proceeds less her $181,818.18 basis in her partnership interest = $81,818.18 loss

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G1-G2 Loan Planning to Reduce Estate Tax Without Losing Stepped-Up Basis

- Client has $30 million ranch with a $10 million basis. Can we keep the ranch in the estate to enjoy the stepped-up basis and still not pay estate tax on the full amount of the ranch?

- G1-G2 loan planning may help. Key points:
  - Inconsistency between Section 7872 and Sections 2031 and 2511.
  - Under Section 7872, a client may make a long-term, inadequately-secured, low-interest, uncertain-duration loan to a child or to a trust for the child without making a gift.
  - The note representing the loan would then be valued at fair market value for either gift or estate purposes. The note's fair market value would be far less than its face value.
  - This creates the potential to greatly reduce or eliminate estate tax while keeping valuable, low-basis assets in taxable estate to obtain a step-up.

Example:

- Client has $30 million ranch with a $10 million basis.
- Client borrows $30 million from a bank at short-term rates and makes a long-term loan to a child for the life of the child, unsecured, at a fixed 3.06% rate.
- Because of the low-rate and uncertain but long-duration, the note would be valued at about half the loan amount, or $15 million.
- By doing this, we have obtained a basis step-up and still reduced our taxable estate by $15 million.

	BEFORE	AFTER
Assets		
Ranch*	$30 M	$30 M
$30M Note Receivable	0	15 M
Liabilities		
Note Payable to Bank	0	30 M
Net Worth	$30 M	$15 M

*Ranch remains in estate and gets stepped-up basis at client's death

Bonus: Use It or Lose It

- The extra estate and gift tax exemption vanishes 12/31/2025. To lock in the benefit, a couple has to transfer $22 million out of their estate.
- Gifting to a Spousal Lifetime Access Trust ("SLAT") will be a popular approach because the 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 create SLAT for other; each SLAT buy life insurance on other spouse.
  - For example: husband creates SLAT for wife and funds with $11 million; wife's SLAT buys 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 so wife's access to full $22 million isn't diminished when husband dies.

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Bonus: The New "FAST" Trust

- With higher exemption amount 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 from generation to generation) engage in best practices like family retreats, preparing heirs, educating heirs on finances, philanthropy, entrepreneurship, preserving family heritage and values, etc.
- FAST (Family Advancement Sustainability Trust):
  - **Provides Funds** – Provides the funds to pay for family education, enrichment, family retreats, 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** – Assigns the leadership to trustees and committee members who are charged with the responsibility to plan 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.