Choice of Entity In Light of 2017 Tax Law Changes

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Overview

- Type of Entity
- Corporate Level Tax Savings Combined with Level of Dividends Distributed to Shareholders
- 20% Deduction of Qualified Business Income under Code § 199A
- S Corporation Compared to Partnership
- Whether Real Estate is Qualified Business

Overview

- Conversion Strategies
- C Corporation Promissory Note
- Other Issues

Type of Entity

- Corporation
  - C Corporation
  - S Corporation
- Partnership
  - Limited Liability Company
  - Limited Partnership
- Limited Liability Company
  - Partnership or Disregarded Entity
  - S or C Corporation

Distributing 100% of Corporate Net Income After Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,00
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

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Distributing 50% of Corporate Net Income After Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,00
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

Distributing None of Corporate Net Income After Income Tax (II.E.1.a.)

Distributing None of Corporate Net Income After Income Tax	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

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Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities (II.E.1.)

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

C corporation deducts state income tax on business operations; pass-through owners have limited state income tax deduction (but unlimited property tax deductions).
Reinvested C corporation earnings will be taxed later when the company is sold, which just changes the timing of the 47.3% or 40.8% rate above, unless held until death or qualify for Code § 1202 exclusion (II.Q.7.k.). Reinvested pass-through earnings add to tax basis.

Declaring Dividends

- Personal holding company tax (II.A.1.e.)
- Accumulated earnings tax (if not a personal holding company) (II.Q.7.a.vi.)
- Professional firms tend to distribute all profits

Declaring Dividends

Sale to irrevocable grantor trust (II.E.2.a., III.B.2.b.)

- Entity makes “tax distribution” to trust, which does not pay tax and therefore uses the distribution to pay down the note.
- Grantor uses note payment to pay tax, making the note a disappearing asset
- C corporations pay tax instead of making tax distributions; any dividends undermine favorable C corporation taxation
- Grantor not taxed on C corporation income

Code § 199A Deduction for Qualified Business Income (II.E.1.c.)

- Repealed Code § 199 deduction for domestic production activities
- Taxable years beginning after December 31, 2017 but not beginning after December 31, 2025
- Applies to an individual or trust that owns a partnership interest, S corporation stock, or a sole proprietorship (passthrough entity)
- Deduction up to 20% of qualified business income (QBI)
- Income tax but not NII tax or SE Tax (II.E.1.c.i.(a))
- Causes underpayment penalty to apply at 5% instead of 10% understatement
- Proposed regulations and preamble are at https://www.federalregister.gov/documents/2018/08/16/2018-17276/qualified-business-income-deduction

Calculation of Deduction Generally
(II.E.1.c.v.)

- (A) the sum of certain qualified business income (QBI)-related amounts for each qualified trade or business the taxpayer carries on, plus
- (B) 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.
- Focus on (A)
- Losses from a qualified trade or business carry to the following year to reduce the deduction

QBI-related amount (II.E.1.c.v.)

For each separate trade or business, the lesser of:

•20% of the taxpayer's QBI with respect to the qualified trade or business, or

•the wage and UBIA limitations

The wage and UBIA limitations do not apply when taxable income (before the Code § 199A deduction) is below certain thresholds (II.E.1.c.v.(b).).

Wage Limitation (II.E.1.c.vi.)

For each separate trade or business, the greater of:

- 50% of the W–2 wages with respect to the qualified trade or business, or
- the sum of:
  - ➢25% of the W–2 wages with respect to the qualified trade or business, plus
  - ➢2.5 percent of the unadjusted basis immediately after acquisition (UBIA) of all qualified property

The proposed regulations refer to the former as the wage and the latter as the UBIA limitation.

Wage Limitation (II.E.1.c.vi.(a))

W-2 wages:

•Wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans

•Must relate to qualified business income

•Must be properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return

Proposed regulations provide relief for leasing employees; however, using an independent contractor still does not help

Qualified Property (II.E.1.c.vi.(b))

Depreciable property:

- held by, and available for use in, the qualified trade or business at the close of the taxable year
- used at any point during the taxable year in the production of qualified business income
- the depreciable period for which has not ended before the close of the taxable year

Depreciable period is greater of 10 years or class life

Land would not count (except for depreciable improvements)

Qualified Property – UBIA (II.E.1.c.v.(b))

- Unadjusted basis immediately after acquisition (UBIA)
- Proposed regulations clarified that Code § 179 expensing is ignored
- Bonus depreciation capitalizes and depreciates part immediately (II.G.4.b.)
- Using bonus depreciation, most property placed in service after September 27, 2017, and before January 1, 2023 receives an immediate deduction for the <u>entire</u> purchase price. This is simpler and more favorable than Code § 179 (but not because of Code § 199A).

UBIA (II.E.1.c.vi.(b))

When move property to a new taxable entity in a nontaxable exchange, get the worst of both worlds:

- Original life continues
- Adjusted basis at time of contribution becomes the new unadjusted basis

Instead, consider leasing to new entity:

- Consider aggregating if same people own majority of lessor and lessee; see later slide re real estate
- Equipment rental is generally a trade or business (II.L.2.a.ii.)

UBIA (II.E.1.c.vi.(b))

Inside basis change:

•For most income tax purposes, automatically applies for property owned directly by individual, is available to partnerships, and does not apply to S corporations

•Prop. Reg. § 1.199A-2(c)(1)(iii) denies UBIA change when inside basis change applies to partnerships, but the preamble says it applies if individually owned.

•Gorin example why no UBIA change: Original purchase price and current value $100,000; accumulated depreciation $40,000. Old UBIA $100,000 plus $40,000 of new inside basis equals $140,000.

Should the partnership's or S corporation's owners directly own the depreciable property?

UBIA - Equipment (II.E.1.c.vi.(b))

Would changing UBIA and the depreciable period help for equipment? Effect before and after death/transfer to individual who leases to business:

- Equipment rental generally is trade or business
- If rental income is 20% of UBIA, then tentative deduction of 4% (20% times 20%) of UBIA. This gets reduced to the wage/UBIA limitation of 2.5%.
- Used equipment would have lower basis, so UBIA would be reduced – not good unless near end of depreciable period, which would restart

UBIA – Real Estate (II.E.1.c.vi.(b))

Would changing UBIA and the depreciable period help for real estate? Effect if individual leases to business instead of the operating business owning:

- Real estate rental is trade or business only if sufficient activity or under common control with tenant's trade or business
- If rental income is 8% of UBIA and depreciation is 2.5% (1/40) for 5.5% net income, then tentative deduction of 1.1% (5.5% times 20%) of UBIA. This is not reduced by the wage/UBIA limitation of 2.5% unless rent later increases.

UBIA – Real Estate (II.E.1.c.vi.(b))

After death of or transfer to individual who leases to business:

- Change in UBIA – compare new value to original investment (including later improvements)
- If property is near or past the end of the depreciable period (its class life), then helpful to restart
- If this strategy helps and real estate is in a partnership, consider distributing separate parcels to each owner (II.Q.8.b.), but generally each parcel should be 100% owned by that owner (II.C.9.)

Taxable Income Thresholds (II.E.1.c.v.(a))

- $315,000-$415,000 for married filing jointly
- $157,500-$207,500 for all other taxpayers, including trusts
- Below threshold, most ineligible service businesses become eligible and the wage limitations do not apply
- Benefits phase out over that range
- Phase-outs apply cumulatively

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii., II.E.1.c.iii.)

- Must be a qualified trade or business
- Each is tested separately; no guidance how to delineate
- Many cases describe common law principles (II.G.3.i.i.).
- Must be effectively connected with U.S. trade or business (II.E.1.c.ix.)

Types of Income and Activities Eligible for Deduction (II.E.1.c.)

Each relevant passthrough entity (RPE) must determine:

- If it is engaged in one or more trades or businesses and whether SSTB. Implicitly, the individual owner cannot make this determination.
- The QBI for each trade or business engaged in directly
- The W-2 wages and UBIA of qualified property for each trade or business engaged in directly
- The amount of any qualified REIT dividends or qualified PTP income

Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

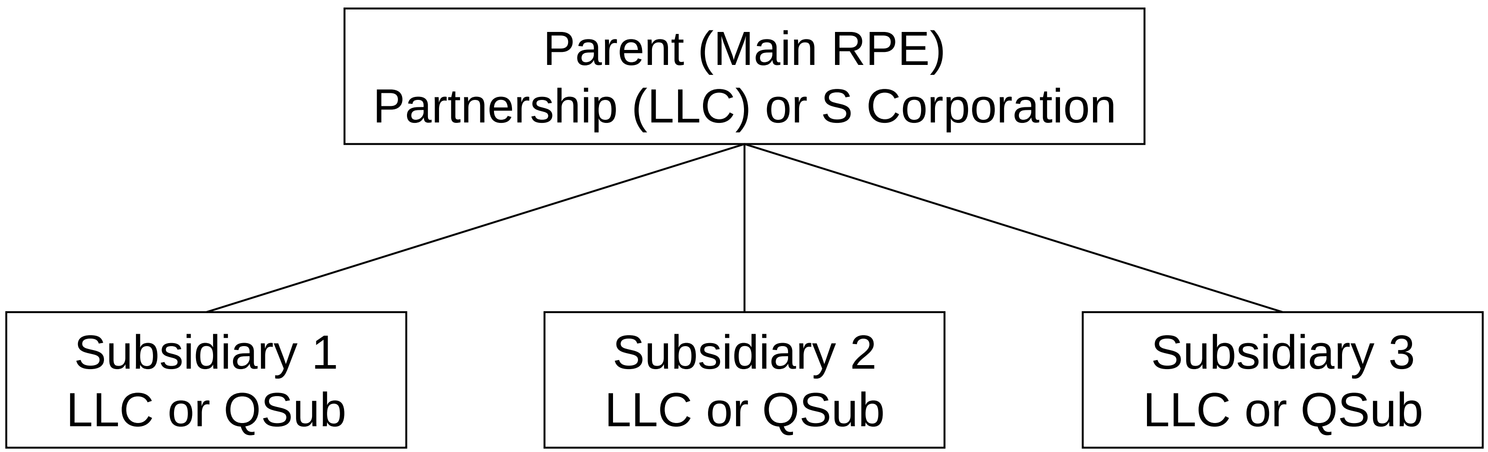
- Aggregation is completely voluntary but is irrevocable once done
- Preamble rejected using passive loss grouping but asked for comments whether to apply these rules for passive loss purposes
- Each owner can separately aggregate
- Next slide discusses effect of aggregating
- Then we discuss when permissible

Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

- Each RPE separately reports QBI, W-2 wages, and UBIA to its owners
- Aggregation is done at the individual (or trust/estate) level. If an RPE owns another RPE, then each trade or business continues to be separated at each level until aggregated at the individual level.
- Aggregation does not involve reporting on a consolidated-type return transactions between RPEs that are being aggregated.

Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

May need to restructure to have single member LLCs under the main RPE (if main RPE is an S corp, also might use QSub) (II.E.1.c.):



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Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

Prop. Reg. § 1.199A-4(b)(1) says when permissible:

- The same person or group of persons, directly or indirectly, owns 50% or more of each trade or business to be aggregated
- That ownership exists for a majority of the year
- All items aggregated are on returns same year
- SSTB cannot be included; separate rules for those
- The trades or businesses to be aggregated satisfy at least two of three factors

Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

Common ownership:

- At least 50% of issued and outstanding shares
- At least 50% of capital or profits in a partnership
- Can aggregate sole proprietorship, partnership, and S corporation with each other
- Individual deemed to own interest in a trade or business owned, directly or indirectly, by or for-
  - ➢ The individual's spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
  - ➢ The individual's children, grandchildren, and parents
- How far does "indirectly" extend?

Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):

A. The trades or businesses provide products and services that are the same or customarily offered together.

B. 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.

C. 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).

Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

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:

- Yes - two businesses, a catering business and a restaurant, "share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting" (Example (1))
- No – only connection is 75% owner manages both businesses (Example (3))
- Yes - human resources and accounting centralized for 4 businesses (Example (4))
- Yes - centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business (Example (6))

Aggregating Activities for Code § 199A
(II.E.1.c.iii.(b).)

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 **(continued)**:

- No – same products and services does not mean centralized business elements (Example (7))
- Yes - common advertising and management (Example (8))
- Yes - executive chef of all of the restaurants orders food and supplies for all (Example (10))
- Yes - centralized human resources department, payroll, and accounting department (Example (14))

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii.(c))

Does not include:

•Compensation for services rendered (salary to S corporation owner-employee)

•Code § 707(c) guaranteed payment (but preferred profits interest should qualify)

•Code § 707(a) payment for services rendered

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii.(c))

Consider company that manages many properties for their owners:

•Management fee would be QBI

•But, if company becomes a partner in a landlord whose property it manages, Code § 707(a) or 707(c) would disqualify management fee from being QBI.

Perhaps the prohibition against Code § 707 payments should merely not attribute landlord’s trade or business status rather than prohibiting service provider from qualifying independently. The legislative history did not comment on this issue. Proposed regs do not address, but preamble asked for comments re: Code § 707.

Types of Income and Activities Eligible for Deduction (II.E.1.c.iv.)

Specified service trade or business (SSTB) (II.E.1.c.iv.(a)-(n))

- Disfavored businesses include any trade or business involving the performance of services in the fields of health; law; ~~**engineering; architecture**~~; 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 other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.
- Taxable income (before QBI deduction) below threshold means that these businesses are not blacklisted (II.E.1.c.iv.)

Specified Service Trade or Business (SSTB) Anti-Abuse Rules (II.E.1.c.iv.(o))

Specified service trade or business (SSTB) in conjunction with other activity may disqualify the other activity partially or wholly

- De minimis rule
  - ➢ If trade or business has gross receipts $25 million or less for the taxable year, it is not an SSTB if less than 10% of its gross receipts are attributable to the performance of SSTB services
  - ➢ Otherwise, it is not an SSTB if less than 5% of its gross receipts are attributable to the performance of SSTB services
- Services or property provided to an SSTB (next slide)

Anti-Abuse Rule - Services or Property Provided to an SSTB (II.E.1.c.iv.(o))

- If trade or business has 50% or more common ownership under Code § 267(b) or 707(b) with an SSTB:
  - If the trade or business provides 80% or more of its property or services to an SSTB, then it is an SSTB, too
  - If the trade or business provides 80% or more of its property or services to an SSTB, then that portion providing property or services to the commonly-owned SSTB is treated as a part of the SSTB
- Example – Law firm splits into separate entity providing services to client, owning building used only by the law firm, and providing administrative services only to the law firm. All three entities are treated as one SSTB.

Anti-Abuse Rule - Services or Property Provided to an SSTB (II.E.1.c.iv.(o))

Code § 267(b) (II.G.3.i.iv.):

1. Members of a family, as defined in Code § 267(c)(4)
2. An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual
3. Two corporations which are members of the same controlled group (as defined in Code § 267(f))
4. A grantor and a fiduciary of any trust
5. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts
6. A fiduciary of a trust and a beneficiary of such trust
7. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts

Anti-Abuse Rule - Services or Property Provided to an SSTB (II.E.1.c.iv.(o))

Code § 267(b) (II.G.3.i.iv.):

8. A fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust
9. A person and certain charitable organizations controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual
10. A corporation and a partnership if the same persons own—
    (A) more than 50% in value of the outstanding stock of the corporation, and
    (B) more than 50% of the capital or profits interest in a partnership
11. An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation
12. An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation
13. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate

Anti-Abuse Rule - Services or Property Provided to an SSTB (II.E.1.c.iv.(o))

Code § 707(b) (II.Q.8.c.):

- a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or profits interest, in such partnership, or
- two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interest or profits interests.

Items Included in or Excluded from QBI
(II.E.1.c.ii.(a).)

- Code § 751 ordinary income from sale of partnership interest (II.Q.8.b.i.(f).) attributable to the trades or businesses conducted by the partnership is QBI
- Income from guaranteed payment for the use of capital is not QBI, but the expense reduces QBI
- Income/loss from change in accounting methods under Code § 481 is QBI
- Post-12/31/2017 previously disallowed losses or deductions (including under Code §§ 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. Nothing specifically mentions including related W-2 and UBIA amounts.
- Code § 172 net operating loss (II.G.3.i.iii.) does not reduce QBI (separate rules apply re losses from QBI activities)

Effect of Losses from Qualified Trades or Businesses On Code § 199A Deduction (II.E.1.c.vii.)

- Current year net QBI losses offset current year QBI from other activities proportionately to their respective QBI
- Excess net QBI losses are carried over and offset next year QBI from other activities proportionately to their respective QBI
- Wages and UBIA from trade or business with negative (or low positive) QBI do not benefit other activities unless aggregated
- Suspended passive loss may be better than net operating loss (II.K.3.), but being passive can generate net investment income (NII) tax (II.I.8.)

Items Excluded from QBI (II.E.1.c.ii.(c).)

These items are never QBI:

•Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

- Preamble says Code § 1231 gains and losses are QBI to the extent not capital gain
- Ordinary income depreciation recapture would be as well
- Sale of business assets may convert capital gain to ordinary income; often elect to sale of S corporation stock as sale of assets (Code § 338(h)(10) or 336(e) election – see II.Q.8.e.iii.(f).)

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Items Excluded from QBI (II.E.1.c.ii.(c).)

These items are never QBI:

- Dividends, income equivalent to a dividend, etc.
- Any interest income not properly allocable to a trade or business
  - Interest on working capital is not QBI
  - Interest on accounts receivable for services or goods provided by the trade or business is QBI
- Certain Code § 954 items relating to hedging

Partnerships Compared to S Corporations (II.E.1.d.)

Example

- $300K QBI before owner's compensation
- Reasonable comp would be $200K
- Distribute $200K or more

Results:

- S corporation deduction based on $100K QBI after deducting wages
- Partnership deduction based on $300K QBI

However, may need S corporation to generate wages if taxable income is too high.

Consider self-employment tax on reinvested earnings if not using a limited partnership.

Real Estate as QBI (II.E.1.e.)

- Code § 199A deduction is only for a "trade or business"
- From preamble to NII regulations: "Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease)."
- Consider moving expenditures and employees to landlord with tenant reimbursing costs

Real Estate as QBI (II.E.1.e.)

Should expenditures and employees move to landlord, with tenant reimbursing landlord for costs?

- Tenant may have plenty of wages and not need them for wage limitation; employees would help landlord with wage limitation calculation
- Are landlord’s owners different from tenant’s owners?
- Does landlord want to devote time to this active role?
- Landlord entity becomes liable for employees’ action or inaction; whoever controls landlord may be personally liable for negligent hiring
- Consider perceived adequacy of liability insurance

Real Estate as QBI (II.E.1.e.)

Prop. Reg. § 1.199A-1(d)(4), Example (1) assumes that leasing several parcels of land to several suburban airports for parking lots constitutes QBI.

Rental does not need to be a trade or business if:

•It is rented or licensed to a trade or business which is commonly controlled under Prop. Reg. § 1.199A-4(b)(1)(i), whether or not it is aggregated

•The same person or group of persons, directly or indirectly, owns 50% percent or more of each trade or business to be aggregated, including 50% or more of the issued and outstanding shares of an S corporation or 50% or more of the capital or profits in a partnership

But, excluded from QBI if leased to commonly controlled SSTB (II.E.1.c.iv.(o) per a prior slide)

Trusts and QBI (II.E.1.f.)

- Grantor trusts are disregarded and their items attributed to their deemed owners.
- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income ("DNI"), determined after applying the separate share rules, if relevant.
- The Code § 199A deduction is not included in calculating DNI.

Trusts and QBI (II.E.1.f.)

- Taxable income thresholds are applied separately at the trust and beneficiary levels.
- However, Prop. Reg. § 1.199A-6(d)(3)(iii) asserts that the income distribution deduction is not deducted in computing a trust's taxable income for the threshold. This would double-count the beneficiary's share. My example:
  - $300,000 QBI; no other income to trust or beneficiary; ignore exemption and standard deduction
  - Distribute $150,000 to beneficiary
  - Actual taxable income $150,000 for trust and $150,000 for beneficiary
  - Prop. Reg. would, for purposes of Code § 199A threshold, treat trust as having $300,000 in taxable income and beneficiary as having $150,000 in taxable income for a total of $450,000 taxable income

S Corporation Trusts and QBI (II.E.1.f.)

- Electing Small Business Trusts (ESBTs) (II.E.1.f.iii.)
  - Trapping income inside ESBT portion (general income tax rule)
  - Prop. Reg. § 1.199A-6(d)(3)(iv): "The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT."
  - Informal statements from government at 9/13/2018 webinar say add both non-grantor trust portions' taxable income together for one taxable income threshold
- Qualified Subchapter S Trusts (QSSTs) (II.E.1.f.iv)

Trusts, QBI, and NII (II.E.1.f.v.)

- Shifting pass-through income to a trust may trigger the 3.8% tax on net investment income (NII) if the business income is passive (II.I.8.).
- To avoid the tax on passive business income, the trustee of a nongrantor trust or the deemed owner of a grantor trust must sufficiently participate in the business (II.K.2).
- If the trust is a QSST, then consider having the trustee sufficiently participate, to avoid NII tax in case the business is sold (II.J.15.a and II.I.8.g).

Trusts and Depreciation (II.J.3.d.; II.J.11.)

- Trusts cannot use Code § 179 to expense the cost of purchases of depreciable property (which complicates tax accounting for pass-through entities with trust shareholders). However, presumably the deemed owners of any grantor trust portion can.
- Trusts can use bonus depreciation, which is described in II.G.4.b.
- Beneficiaries may deduct depreciation directly, as a separate K-1 item ("directly apportioned deductions"), except to the extent that the trustee maintains a reserve for depreciation.

Trusts and 2017 Law (II.J.3.d.)

- Trust administrative expenses – Code § 67(e) makes deductions not be itemized
- State tax deduction under Code § 164(b)(6) – separate $10,000 limitations; consider that property taxes but not income taxes are unlimited for trade or business or rental real estate
- ESBT may now have nonresident alien as permissible current beneficiary (II.A.2.f.)
- ESBT deduction for charitable contributions on K-1 from S corporation now applies Code § 170 instead of Code § 642(c) (III.A.3.e.ii.(b).)

Code § 199A Anti-Abuse Rule re Trusts (II.E.1.f.).

Prop. Reg. § 1.199A-6(d)(3)(v):

“Trusts formed or funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A.”

Informal statements from government at 9/13/2018 webinar indicate this means no Code § 199A deduction whatsoever. Seems overreaching – should just say no benefit from taxable income thresholds.

Multiple Trust Rule (II.J.9.c.).

Statute requires:

•The trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and

•a principal purpose of the trusts is the avoidance of income tax.

Prop. Reg. § 1.643(f)-1(a): "… two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person."

Multiple Trust Rule (II.J.9.c.).

- Prop. Reg. § 1.643(f)-1(b): "A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts."
- What is a "primary beneficiary"? Prop. Reg. § 1.643(f)-1(c), Example (2) implies that being able to receive discretionary distributions merely for medical expenses indicates a primary beneficiary.

Multiple Trust Rule (II.J.9.c.).

- Prop. Reg. § 1.643(f)-1(c), Example (2) indicates that significant non-tax differences between the substantive terms of the two trusts means that tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts
- But it leaves open that other facts or circumstances may indicate that a principal purpose for creating the two separate trusts was income tax avoidance

Multiple Trust Rule (II.J.9.c.).

- Effective date for taxable years ending after August 16, 2018.
- Preamble: “In the case of any arrangement involving multiple trusts **entered into or modified before August 16, 2018**, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the rule in proposed § 1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f).”

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Multiple Trust Rule (II.J.9.c).

What are the consequences of collapsing trusts?

- Suppose each of 5 children is the sole beneficiary of his or her own trust created by parents. Multiple trust rules does not apply (but query Prop. Reg. § 1.199A-6(d)(3)(v)).
- Suppose parents then create a trust for the benefit of all 5 children. Result?
  - All 6 trusts now aggregated?
  - Tax attributes of 6^{th} trust spread among the 5 trusts?

Convert from S Corporation to C Corporation (II.E.2.b.)

- Might need to convert from cash to accrual method if more than $25M gross receipts and not a qualified farmer or personal service corporation
- Consider distributing money in first C corporation year
- Consider distributing note before end of final S corporation taxable year

C Corporation Promissory Note

- Tool to move cash from corporation to shareholder without dividend taxation
- Turns shareholder into an unsecured (usually) creditor, which may help if other unsecured creditors have claims against the corporation
- Contrast 21% federal corporate deduction (perhaps limited) against 40.8% (37% + 3.8% NII) federal income tax on lender

Business Interest Deductions Limited
(II.G.19.a.)

- Added by 2017 tax reform.
- Applies to businesses with gross receipts over $25 million
- Does not apply to electing real property business, electing farming business, and certain other businesses
- Deduct interest only to extent of interest income, floor plan financing for auto dealers, and 30% of adjusted taxable income (ATI)
- Depreciation N/A to ATI until 2022

Convert from S Corporation to C Corporation (II.E.2.b.)

Preserving AAA in case later convert back to S corporation (II.P.3.c.v.)

- Form new parent S corporation
- Old corporation becomes a QSub, and its tax attributes now belong to parent
- QSub converts to C corporation (II.A.2.g.)
- When convert back to QSub later (Code § 332 liquidation), the old AAA remain

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Convert from S Corporation to C Corporation (II.E.2.b.)

Other Benefits/Detriments

- Avoid 5-year waiting period for moving C corporation to S corporation status (because the S election never terminates)
- C corporation is considered a new entity that may be eligible for Code § 1202 exclusion
- C corporation treatment is not retroactive
- Lose post-conversion benefits of free use of AAA to extract cash in first post-conversion year plus pro-rated use in later years

Convert C Corporation to S Corporation (II.E.2.c.)

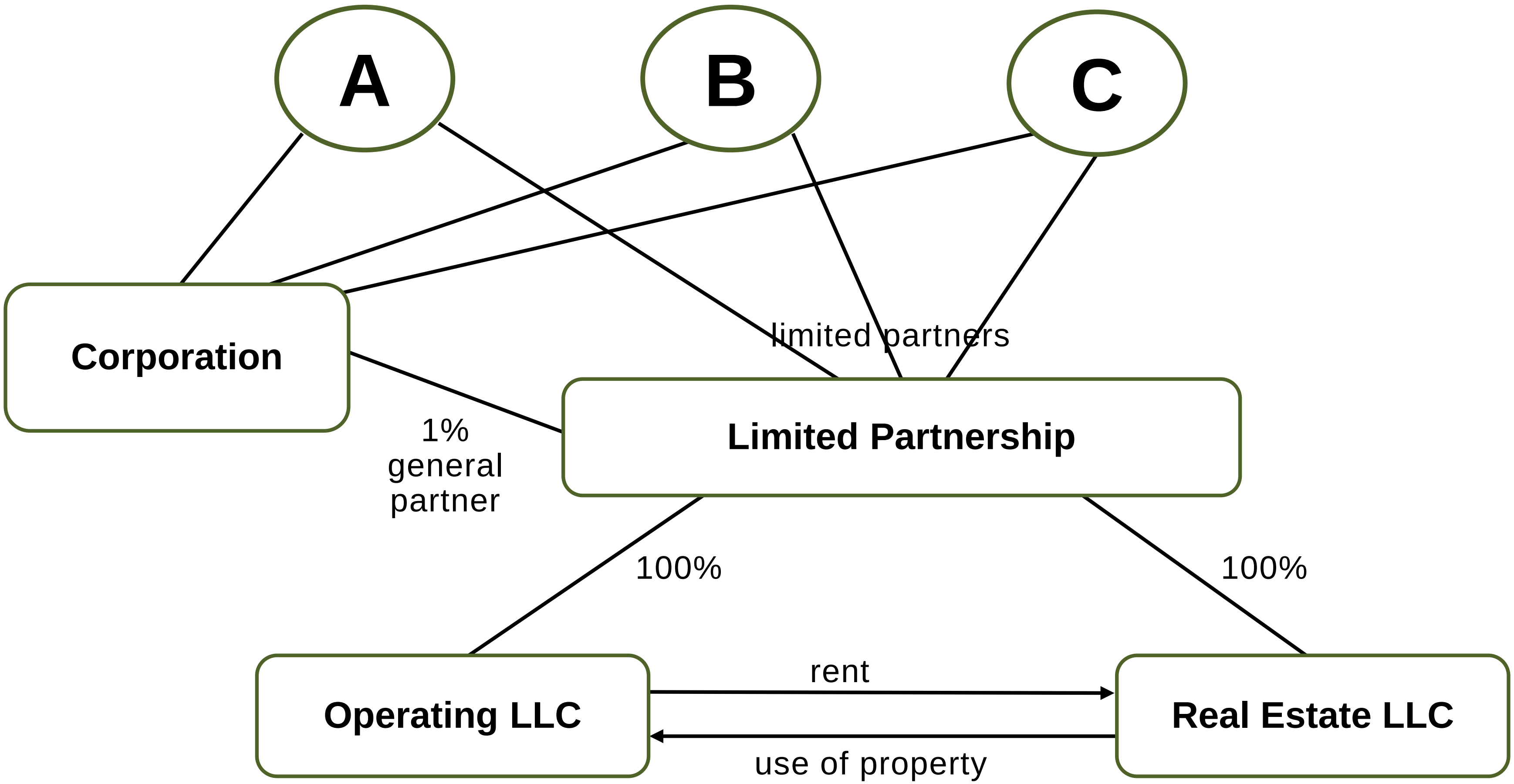
- Code § 1374 built-in gain tax (II.P.3.c.ii.). Consider pre-conversion (a) converting from cash to accrual if material accounts receivable, and (b) selling assets that might be sold within 5 years.
- Excess passive investment income (II.P.3.c.iii.); tax-free investments do not generate AAA (II.P.3.c.iv.)
- If inventory, beware LIFO recapture (II.P.3.c.i.)

Hybrid (II.E.4.)

- Consider a limited partnership with a C corporation general partner.
- C corporation is allocated the profits intended to be reinvested and then loans them to the partnership.
- Limited partners are allocated the profits intended to be distributed.
- As with any structure, it is easier to get into this structure if one starts with a partnership than if one starts with a corporation (whether S or C).

Recommended Structure

(II.E.5. and II.E.6.)



Profits Interest

Under 2017 tax reform, certain sales of compensatory partnership interests recharacterized from long-term to short-term gains (II.M.4.f.ii.(b).)

- More than 3-year holding period
- Taxpayer may net the gains and losses unless sale to a related party.

How 2018 Partnership Audit Rules Affect Ownership (II.G.18.c.)

- New rules provide procedures that help IRS audit partnership returns and shift some of the administrative burden of the audit from the IRS to the partnership
- Opt out allowed annually if no more than 100 direct or indirect owners and each partner is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner
- Revocable or other grantor trusts and disregarded LLCs are not eligible partners
- May be good not to opt out so that minor adjustments are easier to deal with

How 2018 Partnership Audit Rules Affect Ownership (II.G.18.c.)

More details are in the first of three features in a free webinar April 24; see https://www.thompsoncoburn.com/insights/tcle/presentation/detail/2018-03-22/partnership-audit-rules-effects-of-tax-reform-using-a-business-entity-to-help-defray-fees to access the recording.

Investment Taxation after Tax Reform

- Investment Management Fees as Itemized Deductions (II.G.3.i.ii.)
- Alternative Way to Pay for Investment Management (II.G.3.i.i.(e).)
- Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1g.)

Investment Management Fees as Itemized Deductions (II.G.3.i.ii.)

- For an individual, investment management fees are miscellaneous itemized deductions unless investment income is self-employment income or rental income
- Miscellaneous itemized deductions disallowed before 2026
- Alternative minimum tax disallows miscellaneous itemized deductions anyway

Lender Management, LLC v. Commissioner (II.G.3.i.i.(d).)

Lender Management, a 2018 Tax Court case involving managing investments, was the third of three features in a free webinar April 24; see https://www.thompsoncoburn.com/insights/tcle/presentation/detail/2018-03-22/partnership-audit-rules-effects-of-tax-reform-using-a-business-entity-to-help-defray-fees to access the recording.

Lender Management, LLC v. Commissioner (II.G.3.i.i.(d).)

- Three investment partnerships:
  - ➢ Private equities
  - ➢ Hedge funds
  - ➢ Public Equities
- Lender Management, LLC received a profits interest for services; any co-investment was small

Lender Management, LLC v. Commissioner (II.G.3.i.i.(d).)

- Compensation was a percentage of assets under management, plus a percentage of either increase in net asset value or trading profits
- Compensation for managing an LLC could not exceed that LLC's profits
- "It operated for the purpose of earning a profit, and its main objective was to earn the highest possible return on assets under management."

Lender Management, LLC v. Commissioner (II.G.3.i.i.(d).)

- Lender Management, LLC had 5 employees
- Chief investment officer worked 50 hrs/week:
  - Made all investment decisions on behalf of Lender Management, LLC and the investment LLCs
  - Reviewed personally approximately 150 private equity and hedge fund proposals per year on behalf of the investment LLCs
  - Met with Lender Management, LLC's clients at annual business meeting and separately travelled as well
  - Created computer models to better serve clients

Lender Management, LLC v. Commissioner (II.G.3.i.i.(d).)

- Arrangements subjected to "heightened scrutiny" because the end-level investors in the investment LLCs – and the chief investment officer - during the tax years in issue were all members of the Lender family
- But no requirement or understanding among members of the Lender family that Lender Management, LLC would remain manager

Lender Management, LLC v. Commissioner (II.G.3.i.i.(d).)

- Investment choices and related activities were driven by client needs
- Clients were able to withdraw their investments if they became dissatisfied with Lender Management, LLC’s services
- Clients had outside income
- Clients were geographically dispersed, many did not know each other, and some conflicted and refused to attend the same business meetings

Whether Managing Investments Constitutes a Trade or Business (II.G.3.i.i.(d).)

- “No matter how large the estate or how continuous or extended the work required may be,” managing one’s own portfolio of marketable securities does not constitute a trade or business. *Higgins v. Commissioner*, 312 U.S. 212 (1941).
- Code § 212 relief for individuals (*Whipple* 1963).
- Managing investments for one’s self, wife, and three children without compensation did not constitute a trade or business in *Beals v. Commissioner*, T.C. Memo. 1987-171.

Lender Management, LLC v. Commissioner (II.G.3.i.i.(d).)

- Profits interests in exchange for services and not because of family relationships
- Lender Management, LLC's own investment in any investment LLC was small compared to others'
- Family members expected Lender Management, LLC to provide them with services similar to those of a hedge fund manager
- Relationship between Lender Management, LLC and the investment LLCs was business relationship

Alternative Way to Pay for Investment Management (II.G.3.i.i.(e).)

- Form an investment partnership, with the investment manager receiving:
  - ➢Base that is a fraction of annual operating income
  - ➢Separate sharing of gain and loss from the sale of investments.
- Profits interest is annually renewable
  - ➢Minimizes Code § 2701 concerns (III.B.7.b., III.B.7.c.)

Alternative Way to Pay for Investment Management (II.G.3.i.i.(e).)

- Issuance is nontaxable (II.M.4.f.)
- Investment manager must hold 3 years to obtain capital gain treatment on sale (II.M.4.f.ii.(b).)

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Alternative Way to Pay for Investment Management (II.G.3.i.i.(e).)

- Family office needs to consider securities law restrictions on managing others' financial assets
- Slides after family office securities discussion focus on using a C corporation as the family office
- What to do when C corporation accumulates investment income is discussed but may be moot if family office is minimally profitable

Family Office – Securities Law Issues
(II.G.3.i.i.(f).)

Caveat – I am not a securities law expert. The following slides are ideas to discuss with a securities law expert.

- Family office needs to consider securities law restrictions on managing others' financial assets
- The family could give a registered investment advisor the profits interest referred to in the preceding slides
- Or the investment advisor who receives the profits could find an exception to registration

Family Office – Securities Law Issues
(II.G.3.i.i.(f).)

- If the advisor merely advises and does not implement advice, or if the assets being managed are within applicable federal and state thresholds, the advisor might be exempt from registration
- Another exemption from registration is qualifying as a “family office” under 17 C.F.R. § 275.202(a)(11)(G)-1, which also exempts the family office from state registration

Family Office – Securities Law Issues
(II.G.3.i.i.(f).)

A family office is:

- A company that
- Has no clients other than family clients
- Is wholly owned by family clients
- Is exclusively controlled by one or more family members and/or family entities, <u>and</u>
- Does not hold itself out to the public as an investment adviser

Family Office – Securities Law Issues
(II.G.3.i.i.(f).)

- A family office must be exclusively controlled by one or more family members and/or family entities
- Control means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company
- "Family entities" means a family's wholly owned companies or family trusts
- Thus, a key employee may have some ownership of a family office, but the equity interest may not include any control functions
  - ➢ The rule permits "key employees to own a non-controlling stake in the family office to serve as part of an incentive compensation package for key employees"
  - ➢ Stock appreciation rights seem fine. Limited partner in a limited partnership or owner of nonvoting stock would also seem to be OK.

Tax Issues: Alternative Way to Pay for Investment Management (II.G.3.i.i.(e).)

- Proof of trade or business challenging for pass-through because reported on individual return
- Rev. Rul. 78-195 (II.G.3.i.i.(a)) allowed C corporation to take Code § 162 deduction for expenses related to its investment property (unimproved real estate not rented)
- Even in C corporation can't deduct, deflected income taxed at lower rates (see next slides)

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

- Dividends a C corporation receives from another domestic C corporation have up to 10.5% federal income tax rate
- Taxable interest and capital gains have 21% federal income tax
- Top individual – 23.8% on qualified dividends and long-term capital gain
- Top individual – 40.8% on taxable interest income, nonqualified dividends, and net short-term capital gains

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

But a C corporation needs to pay dividends to avoid:

- Personal holding company tax, or
- Accumulated earnings tax ($125,000 accumulated earnings & profits if merely holds investments and is not a personal holding company)

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

How distribute earnings?

- Convert to S corporation to distribute current taxable (not tax-exempt) but not accumulated earnings and profits
- Passive investment income test easy to plan around

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

How divide assets on death of taxpayer or primary beneficiary?

- Code § 355 N/A
- Create partnership of C corporations now – one for each share of bequest or remaindermen
- Post-mortem, partnership divides assets among corporations according to each beneficiary's desired allocation

Conclusion

- Email me at sgorin@thompsoncoburn.com for full searchable PDF of my business structuring materials (over 1,700 pages).
- Free quarterly newsletter includes the most recent version of the PDF. Completing form at https://www.thompsoncoburn.com/forms/gorin-newsletter gets you the PDF and newsletter.
- Blog that is less technical is at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.