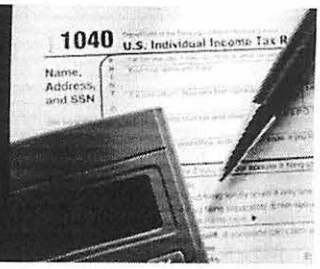

By **Martin M. Shenkman** & **Jonathan G. Blattmachr**

Trust Planning After the New Tax Law

New perspectives that may be useful to some clients

President Donald J. Trump signed into law the Tax Cuts and Jobs Act of 2017 (the Act) (more formally referred to as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget") on Dec. 22, 2017.[1] The Act made many significant changes directly affecting trust taxation and planning. Some include:

- a different tax rate schedule;
- elimination of many itemized deductions;
- permitting trust-owned pass-through entities to qualify for the favorable tax treatment afforded those entities;
- severe restriction of state and local tax (SALT) deductions by individual itemizers that might change the nearly ubiquitous default rule of creating grantor trusts in favor of non-grantor trusts;
- the pressure for moderate wealth families (about $6 million to $8 million for individuals and $12 million to $15 million for couples) to use the increased temporary wealth transfer tax exemptions by making completed gifts to irrevocable trusts; and
- new electing small business trust rules.

The Act also changed many traditional planning paradigms and, as a result, has had a more significant effect on trust planning than just its direct changes might suggest. We'll explore some of these. While there are risks and uncertainties with some of the planning ideas suggested below, the goal is to identify new perspectives on planning that might be useful to certain clients. No doubt, given the complexity and scope of the Act, new concerns, planning ideas and interpretations will evolve.

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SALT Limitations

A key change made by the Act was to cap deductions for SALT to $10,000 a year. This change will require reconsideration of trust planning:

- When will non-grantor trusts make more sense than grantor trusts for certain settlors in high tax states? You must evaluate that question considering the other changes to the planning environment, such as the temporary doubling of the transfer tax exemptions.
- Can trusts be structured to expand the amount of allowable SALT deductions?
- Trustees may need more closely to monitor distributions when the distributable net income (DNI) attributed to beneficiaries in high income tax states will face a greater net tax cost because of the loss of SALT deductions.

DNI Distributions and SALT

Fiduciaries may have to monitor more closely trust income and distributions of DNI post-Act. For example, if a beneficiary is in a state with no income tax, should distributions be made to that beneficiary to pass trust income out at a lower net tax cost considering the limits on SALT deductions that might adversely affect a beneficiary in a high tax state? Will that tax benefit outweigh the impact of addressing the issues of unequal distributions or loss of asset protection afforded by the trust? Might the trustee loan funds to the beneficiary in the high tax state, thereby avoiding DNI flowing out to that beneficiary (understanding that the trust will have

taxable interest by reason of the loan)? Will the trustee be willing to make unequal distributions if doing so overall saves income taxes? If $50,000 is distributed to a beneficiary in a no tax state and a loan of $50,000 is made to a beneficiary in a high tax state, will the Internal Revenue Service or a state taxing authority respect the loan or recharacterize it as a disguised DNI distribution?

Another new consideration in monitoring distributions is the possible impact on a beneficiary trying to maximize the new Internal Revenue Code Section 199A deduction. The new pass-through entity 20 percent deduction is limited, in general terms, to the lesser of the taxpayer's combined qualified business income or an amount equal to 20 percent of the excess of the taxpayer's taxable income for the taxable year, over the sum of the taxpayer's net capital gains. Might the trustee inquire of beneficiaries whether they require additional income to fully use their IRC Section 199A deduction under the formula limitation? Alternatively, might a beneficiary need to limit taxable income to avoid the phase-out under 199A? If so, perhaps the trust can use the 65-day rule under IRC Section 663(b) to make a distribution of income following the close of the tax year and elect to have it treated (but only to the extent of the greater of DNI or fiduciary accounting income) as pertaining to the prior tax year to facilitate the beneficiary qualifying. Note that DNI may be greater relative to the post-Act fiduciary accounting income because of the elimination of itemized deductions subject to the 2 percent floor.

One of the issues to consider in post-Act trust planning is whether additional tax benefits might be achieved by bifurcating a trust.

Trust Payments of Property Taxes

SALT deductions are limited, but how will the limitation apply to trusts? Section 11042 of the Act provides in part:

> In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026 … the aggregate amount of taxes taken into account … for any taxable year shall not exceed $10,000 … The preceding sentence shall not apply to any taxes described in paragraph (1) and (2) of subsection (a) which are paid or accrued in carrying on a trade or business or an activity described in section 212.

IRC Section 212 provides in part:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income…

Assume the trust instrument for a directed trust designates that the investment trustee (advisor) must approve the trust's purchase of personal use residential property. That would squarely put the determination of the decision in the realm of being an investment decision, not a distribution decision. Would that suffice to characterize a personal use residence or vacation home as an investment property held by the trust so that the SALT limitation on property tax arguably wouldn't apply? It seems unlikely that this would suffice to characterize a personal use residence as a Section 212 asset.

Dividing Trusts

One of the issues to consider in post-Act trust planning is whether additional tax benefits might be achieved by bifurcating a trust. For example, if one non-grantor trust owns three vacation homes, one used by each of one of the three trust beneficiaries, will the property taxes on those homes be limited to a single $10,000 SALT deduction? It may appear to be so. Might that cap be tripled if the trust were divided into three separate trusts, or three separate trusts were created from inception with substantive differences, so that each trust owned a home and thereby might avail itself of a separate $10,000 property tax deduction? Perhaps. One of the hurdles in this approach are the anti-abuse rules under IRC Section 643(f):

> …under regulations prescribed by the Secretary,

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

However, no such regulation has been adopted or even proposed. The trust instrument itself might permit the trustee to divide the trust, but if the change is significant, the trustee might prefer a non-judicial modification agreement be used instead. Depending on state law, the beneficiaries may be able to agree to modify a single sprinkle trust into three separate trusts pursuant to a non-judicial modification agreement. For example, Delaware statutes Title 12, Section 3342 permits an irrevocable trust to be modified to include any provision that could be included in a governing instrument on the date of the modification with the written consent or written non-objection of the settlor (who must be living), all fiduciaries and all beneficiaries.

The rationale supporting such a division could include an array of reasons. For example, each beneficiary would like to be able to receive distributions and access to trust assets without the other beneficiaries being considered or informed. The IRS may view any trust division that enhances the SALT deduction as suspect, but in the absence of regulations under Section 643(f), the IRS might not prevail in trying to ignore the division into three separate trusts. When the IRC authorizes the issuance of regulations and none are in fact issued, the effect is unclear. In some cases, the courts hold that the regulations are self-executing—the IRC provision is to be given effect even though no regulation has been issued. In other cases, the courts hold that, in the absence of regulations, the IRC provision is ineffective.[2]

BDT Variation

A trust described in and governed by IRC Section 678, commonly known as a "beneficiary defective trust" (BDT), has traditionally been used by a lower wealth settlor (that is, someone with little or no need for estate planning) who creates a trust for a wealthy heir. The trust is structured to be grantor as to the beneficiary/heir, not as to the settlor. This is accomplished through the use of a $5,000 gift to an irrevocable trust with a power of withdrawal, described in the section, which lapses after a time (commonly called a "*Crummey* power"). That heir would often sell assets to the BDT to remove them from her estate, in exchange for a note from the trust. A new spin on the traditional application of a BDT may be useful in limited circumstances after the Act. A wealthy settlor with business interests who resides in a high tax state but has an heir in a low tax state could create a BDT. The BDT, as in the past, would be grantor as to the heir/beneficiary. The parent/settlor could then transfer a business opportunity to the trust so that the income from that opportunity would inure to the trust and be taxed to the heir in a low or no tax state.[3]

> Traditional estate tax minimization planning should continue apace given that the estate tax wasn't repealed, and the new exemption is only temporary.

Temporary Exemption Increase

Clients should consider the merits of using the new increased exemptions before they sunset or before a future administration changes the law and rolls back the new exemption amounts. For ultra-high-net-worth (UHNW) clients, the use of the exemptions may simply serve to enhance or expand ongoing planning efforts. However, for moderate wealth clients, using as much of the new exemptions as feasible before they sunset or are changed by a future administration will be more challenging and impacts planning in several ways:

- Moderate wealth clients may need access to trust assets to be comfortable making such large transfers.
- How that access is provided, and the interplay of the SALT rules, may change how practitioners opt to structure some trusts.

- Moderate wealth clients may be inclined to "use it before they lose it" with the new increased exemptions resulting in transfers that are more significant as a percentage of their wealth than traditional trust transfers may have been. Practitioners might consider phasing gift transfers over several future years, obtaining a signed solvency affidavit (even if not required, for example in states like Alaska) prior to each transfer and taking other steps to deflect arguments of a fraudulent conveyance.

Here are several variations in planning for different types of client situations, considering the above objectives.

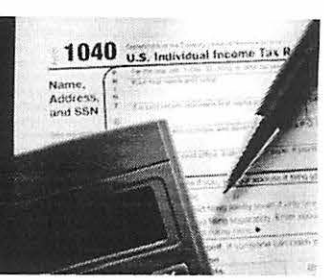
Moderate wealth clients in low tax states. These clients' objectives are to use the temporary increase in the exemption and preserve access to assets transferred. Moderate wealth clients will need access to assets if they're to gift large new exemption amounts to irrevocable trusts. Traditional grantor trusts that are spousal lifetime access trusts (SLATs), domestic asset protection trusts or other variations the planner might feel comfortable with, and similar planning as common in the past, may be appropriate.

Moderate wealth clients in high tax states. These clients may also wish to use the temporary increase in the exemptions and preserve access to assets transferred, but also save high state income tax. The interplay of a completed gift to use the exemption with a non-grantor trust to save state income tax raises complications different from most traditional planning. Can a non-grantor completed gift SLAT be created? The grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of an adverse party, is or may be in the discretion of the grantor or a non-adverse party or both, distributed to the grantor's spouse or accumulated for future distribution to the grantor or the grantor's spouse.[4] The grantor is treated as the owner of any portion of a trust if the income may be paid to the grantor's spouse without the consent of an adverse party.[5] So, if an adverse party must approve distributions to the grantor's spouse, a SLAT can be a non-grantor trust. This will be a complicated needle to thread. The determination of what constitutes an adverse party is difficult and, in general, uncertain, and the approval itself might constitute a gift. The grantor must not retain: the right to direct disposition of trust income or property; the right to receive trust income; or the right to have the trust pay life insurance premiums on her behalf as that could cause the trust assets to be included in the grantor's gross estate at death. It may be preferable to use a separate irrevocable life insurance trust and not include life insurance on the life of the grantor or the grantor's spouse in a trust that's intended to be non-grantor, to avoid grantor trust status under IRC Section 677(a)(3). Moderate wealth clients wishing to use the new exemption amounts before sunset must use a completed gift for the trust. A gift is complete if the donor "has so parted with dominion and control as to leave him in no power to change its disposition."[6] However, if under the terms of the trust, the grantor retains the power to consent to distributions, the gift is considered incomplete as would be the case in an incomplete gift, non-grantor (ING) trust, as discussed in the article, "Fundamentals of DING Type Trusts."[7] A SLAT that's structured to be non-grantor to save SALT deductions may be referred to as a "SALTy SLAT."

UHNW clients in high tax states. These clients should use the temporary increase in the exemptions to continue existing or new planning (for example, gifts to existing trust structures). The remaining goal is only to save high state income tax. Traditional ING trust planning may be a solution to save high state taxes considering the SALT limitation and avoid incurring gift tax once the new exemption amounts have been used in other planning. Traditional estate tax minimization planning should continue apace given that the estate tax wasn't repealed, and the new exemption is only temporary. From an income tax perspective, UHNW clients in high tax states will be more apt than their wealthy counterparts in low tax states to pursue traditional ING trust planning. These trusts can save state income tax (except for New York, which has expressly legislated against this technique) without triggering gift tax on the transfers. New York Tax Law Section 612(b)(4) provides that when a transfer to a trust is incomplete for gift tax purposes, that trust will be characterized as a grantor trust for income tax purposes. Query whether other high tax states may consider similar modifications to protect their tax base.

For high income moderate wealth clients in high tax states, a variation of the tradition ING that's a completed gift trust, if feasible, may accomplish the dual goals of saving state income taxes and using the new doubled temporary exemption.

UHNW clients in low tax states. The objective for these clients is to maximize estate tax savings before



the sunset of the new exemption provisions or in case the estate tax planning pendulum swings in the opposite direction with the next administration. Traditional estate tax minimization planning with grantor trusts would be a likely planning pattern for these types of clients to continue to pursue.

Charitably Inclined Clients

There's yet another category of clients that might benefit from a variation of traditional trust planning in the new post-Act environment. Lower income clients (assuming that higher income clients may have sufficient charitable contributions to exceed the new doubled standard deduction) may still benefit from creative trust planning in at least one instance. This technique may offer an interesting option for clients who are charitably inclined and unlikely to receive sufficient benefit from bunching itemized deductions into one year or for those unwilling to time their charitable gifts to bunch them in one year. This planning concept may be useful for a religious client who's accustomed to tithing and who wishes to gain some income tax benefit from doing so. Because of the wealth required for this technique, these clients are referred to as being "merely" wealthy. The term "merely" in this context is intended to imply no need for estate tax planning of any significant nature (and hence is a lower wealth level than the moderate wealth level referred to above). This trust can be created to benefit a class of persons including descendants and charities. To avoid grantor trust status, neither the settlor nor the settlor's spouse can benefit from the trust. The client would create a relatively low cost trust in her home state, as it would be unlikely to justify shifting the trust to a more trust tax-friendly state. The client would gift a portion of her securities portfolio to the trust. Distributions to heirs or charitable contributions can be made in the designation of an independent distribution committee. Because the trust is characterized as a non-grantor trust, there's no standard deduction, and income is offset by the charitable contribution deduction so long as the requirements of IRC Section 642(c) are met. This assures that the contributions will provide an income tax benefit and leaves the standard deduction to offset non-trust income on the client's personal return. If the amounts available to allocate to charity exceed what's desired to gift to charity in a given year, those amounts could instead be directed to the heirs listed as beneficiaries of the trust. Although it's not widely known, the Section 642(c) deduction reduces DNI for discretionary distributions to the individual beneficiaries, for example, the settlor's children. Nonetheless, consider structuring and locating the trust so that any taxable income left in the trust wouldn't be subject to state or local income tax.

Example: The client is charitably inclined but lives in a low tax state and is unlikely to ever exceed the new standard deduction amounts. The client gifts $250,000 of marketable securities to a non-grantor trust to benefit named charities (for example, a house of worship the client donates to regularly), children and their descendants. There likely will be little concern about allocating generation-skipping transfer (GST) tax exemption to a trust that's an inefficient use of GST tax exemption (because much of the trust property won't pass to grandchildren or other skip persons who attract GST tax) because the transfer tax exemptions before the Act's doubling them already greatly exceeded the client's wealth. The $250,000 generates $12,500 of taxable income a year. The trustee pays $10,000 to charity and $2,500 to heirs. The trust deducts the $10,000 charitable contribution, and all remaining income passes out to the children as part of DNI. If the trust paid all $12,500 to charity and then made discretionary distributions of corpus to the children, the children would have no gross income to report from the trust.

Ripple Effects

The Act has made a myriad of changes that affect many areas of the tax law. The ripple effects of these changes and how they should be addressed for trust planning will result in more complex and granular planning. Generalizations of how to plan will be less helpful than in the past. Practitioners will have to apply traditional trust planning in new variations to meet the needs of different clients.

Endnotes

1. Public Law 115-97.
2. For a recent case exploring the issue, *see 15 West 17th Street, LLC v. Commissioner*, 147 T.C. No. 19 (2016).
3. *Cf. Bross Trucking, Inc. v. Comm'r*, T.C. Memo. 2014-107.
4. Internal Revenue Code Section 677(a).
5. *Ibid.*
6. Treasury Regulations Section 25.2511-2(b).
7. Jonathan G. Blattmachr and William D. Lipkind, "Fundamentals of DING Type Trusts," 26 *Probate Practice Reporter* 1 (April 2014).

Leimberg Information Services, Inc.

Steve Leimberg's Income Tax Planning Email Newsletter Archive Message #136

Date:12-Mar-18

Subject: Alan Gassman, Martin Shenkman, Jonathan Blattmachr & Brandon Ketron - Using Multiple Entities to Reduce Income Taxes for Families Owning Personal Service Corporations Under Section 199A and Unique Concerns

"Planners have great challenges with respect to planning under Section 199A. Proper restructuring of existing trades and businesses may save considerable tax dollars, but may be challenged by the IRS, notwithstanding good intentions, logical reporting, and reorganization and changes to entities' functions with respect to relationships between both related and unrelated parties.

A good many taxpayers will be best served by making affirmative changes that will enhance the chances of qualification for the greatest possible Section 199A deduction, while others may maintain the status quo in the hopes that deductions will be available. Reorganization will often be appropriate when it achieves both Section 199A benefits and accomplishes other objectives, which may include estate tax planning, liability limitation by segregation of business assets and activities, state income tax planning, and creditor protection planning. Time will tell which approach works best, but clients should at least be advised of alternatives and strategies."

Alan S. Gassman, **Martin M. Shenkman**, **Jonathan G. Blattmachr** and **Brandon Ketron** provide members with important commentary that examines how multiple entities can be to reduce income taxes under Section 199A for families owning personal service corporations. The authors would like to sincerely thank **Adriana Choi** and **Scotty Schenck** for their assistance in writing this newsletter.

Alan Gassman, JD, LL.M is the founding partner of the law firm of Gassman, Crotty & Denicolo, P.A. in Clearwater, Florida. Alan is a frequent contributor to LISI, and has authored several books and many articles on Estate and Estate Tax Planning, Trust Planning, Creditor

Protection Planning, and associated topics. Alan will be speaking on Section 199A planning at the 44th Annual Notre Dame Tax and Estate Planning Institute which will be in South Bend, Indiana on October 11 and 12, 2018 followed by the Notre Dame Fighting Irish vs Pittsburgh Panthers football game on Saturday, October 12, 2018 at 3:30 p.m. Contact Jerry Hesch at: jhesch62644@gmail.com for further information. You can contact Alan at agassman@gassmanpa.com.

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Fort Lee, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. Estate Planning After the Tax Cut and Jobs Act of 2017, written by Marty Shenkman, Jonathan Blattmachr and Joy Matak, is available at the link below as an e-book on https://www.amazon.com/Estate-Planning-after-Jobs-2017-ebook/dp/B0797F1NVD/ref=sr_1_5?s=books&ie=UTF8&qid=1516724216&sr=1-5&keywords=martin+shenkman or as a PDF download on www.estateplanning2018.com. Steve Leimberg recently noted that: Every tax professional in the country will (or should be) reading this book! This is the most complex and far reaching tax law passed in the over 50 years I've been studying, teaching, and writing about tax law and this resource arms you not only with the necessary and vital information you need to know but also the thinking and planning concepts of three of the brightest minds in the tax world!

Jonathan G. Blattmachr is the Director of Estate Planning for Peak Trust Company (formerly the Alaska Trust Company) which has offices in Alaska and Nevada, a principal of Pioneer Wealth Partners, LLC, and co-developer, with Michael L. Graham, Esq., of Dallas, Texas, of Wealth Transfer Planning, a computer system produced by Interactive Legal that provides artificial intelligence advice and automated document assembly systems for practitioners.

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undergraduate degree at Roanoke College where he graduated cum laude with a degree in Business Administration and a concentration in both Accounting and Finance. Brandon is also a licensed CPA in the states of Florida and Virginia.

Here is their commentary:

EXECUTIVE SUMMARY:

The Federal legislation enacted last year and known as Tax Cut Jobs Act of 2017 ("Act") discriminates against certain personal service companies called Specified Service Businesses ("SSBs"). Many professional service companies and other entities are faced with the prospect of restructuring to qualify income attributable to non-SSB activities such as leasing real estate or equipment, management activities including billing, licensing intangible assets with trademarks and other intellectual property rights, and selling ancillary products to be entitled to the qualified business income deduction under Section 199A. The objective is to delineate these arguably ancillary functions to be separate and apart from the provision of professional services that are clearly tainted as SSBs under the Act where the individual taxpayer or trust has high earnings that would partially or completely disqualify the deduction under the Section 199A regime. We will review certain planning techniques, potential challenges, and traps for the unwary that will often apply to this type of planning.

Recent AICPA and New York Bar Tax Section writings on Section 199A are also considered herein. Below we have provided some examples of entities that may be affected by the Act.

Medical Practice Example: A large medical practice attributes a good deal of its profitability to the return on costly medical equipment and buildings that could have been leased to related or unrelated entities, top notch management that might typically cost significantly more than the salaries paid to the management personnel of the practice, intellectual property rights with respect to branding, managed care relationships, protocols and unique business systems.

Law Firm Example: A law practice in a large city attributes significant return to a building it purchased decades ago and has continued to occupy

as rents have skyrocketed. The law firm also has a division that does private investigative work that is used in matrimonial and other forensic activities.

Veterinary Practice Example: A large veterinary practice sells an array of pet products in each of its locations, and even has an online presence to sell products with its own brand.

Hedge Fund Example: A large fund years ago built an internal department to handle report generation, investor relations and related activities as it felt it could provide better quality service than outside firms available to be hired at that time. These services are so developed that they could stand as an independent firm the fund could hire.

Prior to the Act, and being tainted as SSBs, there may have been insufficient incentives or reasons to split-off various activities that would differentiate them from what is now characterized as an SSB activity. In many instances there may have been advantages to that type of restructuring, and in particular, asset protection benefits of splitting off assets and activities that are not essential to the main service business. However, because of inertia or other reasons, these changes were not made. Now the questions is whether they can be made post-Act to preserve or enhance the 20% deduction under Section 199A.

Quite possibly, the financial statements and tax returns of such an entity may be allocated into departments with consequent separate taxable income amounts calculated for purposes of the Section 199A deduction. To a great, extent for many SSBs, this is merely a matter of cost-accounting steps that could have been taken in the past, but which the principals of the business may now be motivated to address.

Alternatively, and to be safer, such separate non-service, non-SSB, assets and functions may be appropriately transferred to related entities that charge the services entity at arm's-length for lease, license, sale, management and other services. This could take one of three general forms:

1. An S corporation SSB might separate a non-SSB activity into a Qualified Subchapter S Subsidiary (Q-Sub) to distinguish the Q-

Sub's operations and income from the parent S corporation's SSB activities.

2. A new S corporation might be formed to become the owner of the historical S corporation, and form subsidiaries to be brother/sister companies of the original S corporation in a tax-free "new Parent F" reorganization (see below for more details).

3. A professional service LLC might create wholly owned disregarded single member LLCs as separate entities for accounting purposes for each non-SSB activity. While the new 100% owned LLC will be disregarded for income tax purposes they may (should) be respected for purposes of segregating non-SSB activities from the primary SSB activity for purposes of 199A.

Some practitioners might believe that a brother-sister entity structure might be preferable to a parent-subsidiary structure for these purposes, particularly where an active company wants to keep its name, Taxpayer Identification Number, and other identity information the same, as opposed to dropping an active business into a subsidiary. However, it is relatively easy to establish a new parent company that can own the active business, whether in the form of an S or C corporation, and retain its Taxpayer Identification Number and identity by using IRC Section 368(a)(1)(F), in what is commonly referred to as "New Parent F Reorganization." Under this statute, the stock of an existing active S corporation can be transferred to the new parent S corporation, and the active company that becomes a subsidiary can elect to be treated as a Q-Sub by filing an IRS Form 8869, or it may be classified as disregarded for income tax purposes if it is an LLC or converted to an LLC with only one member.

New Parent F Reorganizations are especially well suited for medical practice adjustments, since the active practice entity can retain its Taxpayer Identification Number, name, and Medicare and Medicaid Contracts.[1]

While the AICPA has recommended to Treasury that mere separate accounting or reporting (e.g., divisions) within the same entity should suffice for Section 199A purposes (i.e., that there should be no need to require taxpayers to form new entities solely to qualify for Section 199A purposes), although currently there is no guidance on this matter. The

AICPA proposals can be viewed at the following link: here. While the logic of the AICPA proposal is compelling (why require taxpayers to form entities that otherwise will not be needed) some practitioners have suggested that the IRS may be less willing to accept a mere reporting of SSB vs. non-SSB and that formation of a separate entity is advisable if the potential savings warrant. While there have been indications that Regulations will be issued by summer, there is no certainty of that timeframe nor what issues will be addressed. Thus, especially if the potential savings warrant, forming a new entity may be the safer approach.

To what extent will taxpayers be able to receive the 20% deduction for taxable income under Section 199A for the differentiated non-SSB revenues under such scenarios?

This newsletter will discuss several weapons that the IRS may have available, and possible planning structures and outcomes as a result thereof.

FACTS:

The Assignment of Income Doctrine was first developed in 1930 by the Supreme Court in the case of *Lucas v. Earl.*[2] Under this doctrine, a taxpayer's right to receive income from services rendered must be taxed to the taxpayer who earned the income and not to another person or entity who was assigned the right to receive income.

At its inception, the Supreme Court solved the issue before them – preventing individuals from assigning income to lower their taxable income. However, this doctrine has further developed in professional sports cases where athletes working for a sports team were not permitted to consider the income to have passed through a company owned by the athlete (a "loan-out" entity) unless formal documentation confirmed that the sports team was paying the athlete's company, which was in turn paying the athlete, and that the athlete's company, and not the sports team, had the power to direct the athlete's actions.[3]

One of the earlier cases that involved professional service companies ("PSCs"), a professional basketball player, and the assignment of income doctrine was *Johnson v. Commissioner.* Here, the Court noted that looking

at employment contracts alone does not determine the earner of income.[4] The court made its final determination as to who was the earner of the income by applying a two-prong control test. Under this test, "a professional service company controls the service and receives revenues, and earns income, if: (1) The service-provider is an employee of the professional service company, and the company has the right to direct and control him or her in a meaningful sense; and (2) the PSC and the service-recipient have a contract or similar indicium recognizing the controlling position of the PSC."[5]

Athletes are not the only ones who have struggled with the assignment of income doctrine. Victor Borge, a well-known musical and comedy genius, was one of the first entertainers to use a "loan-out company" where he was an employee of the company, and the company was paid by concert halls and otherwise for his "loan out of services."[6] The IRS assessed significant additional taxes by reallocating the income between Mr. Borge and his closely held company.

In 1958, the highest individual tax rate was 91% and the highest corporate rate tax was only 52%. The bad news was that the Tax Court upheld the IRS's assertion of reallocating income under the Internal Revenue Code Section 482, which still exists, but the good news was that Mr. Borge still came out far better under the IRS proposed allocation than he would have if he had not used the loan-out company.[7] The court noted that such an arrangement should be respected only if the taxpayer would have entered into a similar arrangement with unrelated third parties. The Service may invoke Section 482 to distribute, apportion or allocate income or deductions among two or more "organizations, trades or business" in order to prevent evasion of taxes or clearly to reflect income when the organizations, trades or businesses are owned or controlled by the same interests. It is the reality of the control which is decisive for section 482 purposes, not the form or mode of exercise of control.[8] Note that this standard, that such an arrangement should be respected only if the taxpayer would have entered into a similar arrangement with unrelated third parties, would be a fair standard to apply under an IRC Sec. 199A analysis of SSB vs. non-SSB income. If a tainted professional practice would pay $X to an unrelated landlord for comparable space there should be no reason that same amount of rent cannot be treated as non-SSB income. However, it remains to be seen whether this logic will prevail. Applying IRC Sec. 469 definitions of trade or business and aggregation rules might well prevent this.

The Doctrine became more taxpayer friendly after the 1981 case of *Keller v. Commissioner*, where the Tenth Circuit Court of Appeals in review of a Tax Court decision held that a medical doctor could have revenues and expenses attributable to his traditional medical practice taxed under his professional corporation, which was therefore able to provide him with employee benefits on a tax advantaged basis.[9] Important, the PSC also presumably paid him reasonable compensation commensurate with what an arm's-length arrangement between unrelated parties would be.[10]

This case was followed by the enactment of the IRC Section 269A in 1970, which provides that the IRS can reallocate income and expenses, or completely disregard a PSC where substantially all of the services of the company are performed for one other entity, and the principal purpose of the company is to avoid income tax. This statute does not prevent professional service companies from being used to provide services to multiple patients, clients or customers.

It is also important to note that by definition under Section 269A, a professional service company "means a corporation the principal activity of which is the performance of personal services, which are substantially performed by **employee-owners**."[11] An employee owner is "any employee who owns more than 10 percent of the outstanding stock of the personal service corporation on any day during the taxable year. For purposes of the preceding sentence, the section 318 relationship attribution rules apply, except that '5 percent' is substituted for '50 percent' in section 318(a)(2)(C)."[12] Thus, if the IRS audits a PSC doing work on behalf of one customer, the IRS can reallocate income between the PSC and whatever entity it primarily performs services for, unless the PSC is structured to not have any 10 percent or greater owner or relative thereof act as an employee of the company.[13]

The setting of payments between related entities in exchange for services rendered, assets leased, licensing rights and for products sold is called "transfer pricing." The IRS has a long record of using its transfer pricing reallocation powers under Section 482 when auditors have concluded that payments were more or less than arm's-length and to the tax advantage of the taxpayer. [14] Section 269A gives the IRS more power than does Section 482 in that it enables the IRS to re-allocate *all* payments/income between related entities and not just those that do not satisfy the arm's length test;

therefore, it is preferable to structure the related entity so that Section 269A does not apply, as discussed above.

The IRS may allocate or impute the income received by the corporation to its employee-owner under Sections 269A and 482 (which does not have as many requirements as 269A) in order to put the employee-owner on a tax parity with uncontrolled taxpayers. The IRS can raise the argument that the employee-owner is taxable on the income paid to his or her corporation for personal services he or she rendered to another entity under the assignment of income doctrine because the employee-owner was able to control, and possibly manipulate, the characterization of income and expenses as between the related parties.[15] As noted in FSA 1992-11162, "...the enactment of section 269A was not intended to preclude the Service from reallocating income under section 482." [16]

Planning for Section 199A could be problematic and challenged by the Service under the face of Section 269A where the company primarily performs services for one other company or other entity. Consider the following:

- Substantially all of the services of a PSC are performed for (or on behalf of) one other corporation, partnership, or other entity.

- While the principal purpose for forming the PSC is not the avoidance or evasion of Federal income tax by securing the benefit of a deduction (e.g., under Section 199A), which would not otherwise be available because the PSC pre-existed, a new entity (division, subsidiary or brother-sister entity) would have in fact been formed for this purpose.

- It may be argued that the new division or entity providing non-SSB services should not be a PSC, as its principal activity is not the performance of personal services, caution should be exercised as the Section 269A and 199A definitions of personal services are not the same.

- Most worrisome, perhaps, is that Section 269A permits the IRS to treat all related persons (within the meaning of Section 144(a)(3)) as one entity. Might that be interpreted to negate the bifurcation of non-SSB and SSB revenue sources? But if the future Regulations

indicate that separate entities are not required and that accounting for non-SSB and SSB revenue sources internally under one entity will be sufficient then, perhaps, Section 269A has no bearing on the ultimate Section 199A tax result?

COMMENT:

Planners have many opportunities, and traps for the unwary, in this area.

One of the troubling issues with planning for Section 199A is the mere fact that the taxpayer had not differentiated various activities or assets in the past. The authors believe that this should not prevent such differentiation post-Act, yet, on audit, agents may well argue that if the various activities were really separate, then they would have been separated before 2018. While the Conference Report followed the Senate version of Section 199A with modifications the House report included the following: "It is intended that the activity grouping the taxpayer has selected under the passive loss rules is required to be used for purposes of the passthrough rate rules." Query whether if Section 469 rules are grafted onto Section 199A that the past groupings will be argued to govern under Section 199A as well. See discussion below.

Management companies for medical and dental practices, according to one author's experience, commonly receive profits that can represent 20-25% of the total entity income. This is based upon arm's-length arrangements that are commonly entered into between venture capital companies and the medical practices that they purchase. It should be possible for a medical doctor, dentist, or other professional to sell his practice to a family owned management company, be hired at an arm's-length compensation as an employee of the company, and receive reasonable compensation for having sold personal goodwill and having signed a long-term employment agreement and non-competition covenant in a legitimate estate planning arrangement.

With reference to setting up a separate management company that can receive arm's-length management fees from a professional practice, it can be helpful to have a key individual who is integral to management operations invest to own a small percentage of the management entity, and to participate in negotiations and oversight of that entity to help assure that

economic arrangements occur at arm's-length. This may also be a good way to encourage key employees to "think like owners", and become more involved to enhance the bottom-line of an affiliated entity. Finally, having equity owned by a key person in one of the ancillary businesses may break an identity of ownership between the SSB and non-SSB. A practical issue with providing such equity is terminating the equity arrangement if the relationship is not successful or if it is not desired after 2025 when the Section 199A benefit is scheduled to sunset.

While it seems safest to have brother/sister entities owned by the same company actually pay each other for goods, services, and the use of tangible and intangible property rights, this may not be necessary under Section 199A rules. Under these rules, it would appear discriminatory to provide, for example, that a law practice which also has a rental building being maintained would not be entitled to allocate a reasonable profit to the building ownership and maintenance in the same way that a typical landlord would. A law firm owning a building has to do everything that a landlord owning a building would do.

In states like Florida, where a 6.8% sales tax normally applies on the payment of rent, it may be possible to not pay rent, and to have accountants allocate law firm revenues and expenses to a separate subsidiary that would be entitled to a percentage of firm revenues, and responsible for building related expenses. The optics of this to the Service on audit have to be weighed. This incremental cost illustrates why projecting the costs of creating, administering, and unwinding a 199A restructure plan is so important.

Currently, under Section 199A there is no indication that would seem to preclude this, although it is rumored that individuals working for the IRS are considering regulations that could restrict or even prevent such allocation and segregation from occurring under single entities, or between brother/sister companies.

The House Report that was issued with the House's initial bill for Section 199A indicated that the statutes and regulations promulgated under Section 469 (the passive loss rules) would be used to require aggregation of entities. The Senate Report did not include this language and the Conference Report followed the Senate proposal with modifications that did not again mention Section 469. This could then cause service companies

that fall under one of more of the eleven listed limited deduction services to be considered to include functions like management, intellectual property development, real estate, and equipment leasing as a single activity when the primary activity is service business.

It seems inappropriate to use Section 469 as an aggregation rule to apply under Section 199A, since Section 469 was designed to differentiate between passive and non-passive activities, and to allow aggregation for the benefit of taxpayers, yet some practitioners have suggested that the IRS use Section 469 Regulations as a guide to determine the aggregation of activities for 199A purposes.

Clients who can take real estate and other assets and functions out of an operating S corporation or partnership without triggering income tax may therefore consider doing so. Partnerships and S corporations that cannot distribute such separate assets or functions income tax free might consider dropping these into wholly owned LLCs (subsidiaries) that may be disregarded for income tax purposes, but which at least have separate economic substance, and may also have separate Taxpayer Identification Numbers, even though the parent S corporation will report all income and deductions.

Alternatively, an S corporation may contribute a particular set of assets or functions to an LLC taxed as a partnership, which might, for example, be owned 95% by the S corporation, and 5% by S corporation shareholders who contribute assets in a pro-rata manner. The partnership owned 95% by the S corporation may sell to, license to, provide services to, or lease assets to the S corporation, which may continue to conduct its trade or business.

While not the focus of this article, practitioners should also be mindful that there may be advantages of transferring equity in an SSB, if not proscribed by professional practice regulations, into non-grantor trusts for the professional's heirs. If appropriate slices of equity are so transferred, each non-grantor trust should be able to have its own taxable income threshold test and therefore may avoid the application of the phase out of the Section 199A benefit.

Conclusion

Planners have great challenges with respect to planning under Section 199A. Proper restructuring of existing trades and businesses may save considerable tax dollars, but may be challenged by the IRS, notwithstanding good intentions, logical reporting, and reorganization and changes to entities' functions with respect to relationships between both related and unrelated parties.

A good many taxpayers will be best served by making affirmative changes that will enhance the chances of qualification for the greatest possible Section 199A deduction, while others may maintain the status quo in the hopes that deductions will be available. Reorganization will often be appropriate when it achieves both Section 199A benefits and accomplishes other objectives, which may include estate tax planning, liability limitation by segregation of business assets and activities, state income tax planning, and creditor protection planning. Time will tell which approach works best, but clients should at least be advised of alternatives and strategies.

Taxpayers, and their advisors, who go the extra mile with proper care will almost always be in a better position than those who do not.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman
Martin Shenkman
Jonathan Blattmachr
Brandon Ketron

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LISI Income Tax Planning Newsletter #136 (March 12, 2018) at http://www.leimbergservices.com

CITATIONS:

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[1] Medicare must be advised of a change in ownership by the filing of a Form CMS 855 paper enrollment or via the Internet based Provider Enrollment, Chain and Ownership System (PECOS), and a health care lawyer or consultant should be consulted in advance before any corporate structural changes are made to assure that other factors that may be important will be attended to. The filing of Form CMS 855 or through PECOS does not cause any delay or adjustment in payments from CMS in the experience of the authors.

[2] *Lucas v. Earl,* 281 U.S. 111 (1930).

[3] *Sargent v. Commissioner,* 929 F.2d 1252 (8th Cir. 1991).

[4] *Johnson v. Commissioner,* 698 F. 2d 372 (1982).

[5] See *Leavell v. Commissioner,* 104 T.C. 140, 182 (Tax 1995) discussing the application of the two-prong control test which evolved from case law.

[6] It was Victor Borge who said "the difference between a violin and a viola is that a viola burns longer." *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968).

[7] The predecessor to Section 482 of the Internal Revenue Code was enacted in 1918.

[8] Treas. Reg. Sec. 1.482-1(a)(3). Note that for 199A purposes the 20% deduction must be calculated for each trade or business, which would seem to lend planning to challenge under Section 482.

[9] *Keller v. Commissioner,* 723 F.2d 58, 58 (10th Cir. 1983).

[10] *Id.*

[11] 26 U.S.C. § 269A (b).

[12] *Id.*

[13] 26 U.S.C. § 269A – Personal service corporations formed or availed of to avoid or evade income tax.

(a) General rule.--If--

(1) substantially all of the services of a personal service corporation are performed for (or on behalf of) 1 other corporation, partnership, or other entity, and

(2) the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available, then the Secretary may allocate all income, deductions, credits, exclusions, and other allowances between such personal service corporation and its employee-owners, if such allocation is necessary to prevent avoidance or evasion of Federal income tax or clearly to reflect the income of the personal service corporation or any of its employee-owners.

(b) Definitions.--For purposes of this section—

(1) Personal service corporation.--The term "personal service corporation" means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners.

(2) Employee-owner.--The term "employee-owner" means any employee who owns, on any day during the taxable year, more than 10 percent of the outstanding stock of the personal service corporation. For purposes of the preceding sentence, section 318 shall apply, except that "5 percent" shall be substituted for "50 percent" in section 318(a)(2)(C).

(3) Related persons.--All related persons (within the meaning of section 144(a)(3)) shall be treated as 1 entity.

[14] 26 U.S.C. § 482 – Allocation of income and deductions among taxpayers.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

[15] FSA 1992-11162 (Nov. 16, 1992).

[16] See Proposed Treas. Reg. §1.269A-1(f) ("Nothing in section 269A or the regulations thereunder, including the safe harbor provided in paragraph (c) of this section, precludes application with respect to personal service corporations or their employee-owners of any other Code section (e.g., sections 61 or 482) or tax law principle (e.g., assignment of income doctrine) to reallocate or reapportion income deductions, credits, etc., so as to reflect the true earner of income")."