IPB Tax, Trusts & Estates

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Ivins, Phillips & Barker Chartered

This periodic publication highlights developments and trends in trusts and estates from a practical viewpoint based on IPB's experience. This issue focuses on some changes for 2018 and beyond from the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). Our goal is to share our insights with wealth and philanthropy advisors, corporate fiduciaries, accountants and other advisors in a way that is accessible and actionable. We welcome feedback and additions to our mailing list (ipb@ipbtax.com).

INBOUND INVESTMENTS IN LIGHT OF U.S. TAX REFORM

BY DOUGLAS ANDRE

In our November 2017 *newsletter*, we discussed income and estate tax considerations for non-resident aliens who plan to invest in U.S. businesses including real estate. While these concepts remain relevant for inbound investment planning, the Tax Act introduced a number of significant changes to U.S. tax laws that may impact how inbound investments should be structured. This article addresses options for inbound investments in light of these recent tax law changes.

Changes in U.S. Tax Rules Affecting Inbound Investments

The Tax Act's most significant change to the U.S. code is a reduction of the highest income tax rate that applies to corporations with U.S. business income. The Tax Act reduced the highest corporate income tax rate from 35% to 21% - a 40% reduction. The new rate benefits not only foreign corporations investing in U.S. businesses, but also non-resident alien individuals who want to invest in U.S. assets while mitigating the risk of estate taxation. These investors can structure their investments through a foreign corporation (to avoid estate tax) while benefitting from a reduced corporate level income tax rate. Foreign corporations are generally still subject to the branch profits tax (discussed in our November newsletter); however, many U.S. bilateral tax treaties reduce or eliminate this tax.

The other significant change affecting inbound investments is Section 199A of the tax code that provides for a 20% deduction to certain "qualified business income" earned by pass-through entities (e.g., partnerships and limited liability companies). Qualified business income is income earned by an active trade or business and generally excludes most passive income including capital gains, dividends, interest and notional principal contract income. Notably, rental income and royalty income are included in the definition of "qualified business income."

Section 199A is particularly complex and it contains a number of exceptions and limitations that reduce or eliminate the benefit of the 20% deduction. Generally, the deduction is limited to the greater of:

- 50% of the W-2 wages the entity pays its employees; or
- 25% of the W-2 wages plus 2.5% of the value of depreciable property owned by the entity.

Thus, owners of businesses with significant W-2 wages and/or significant investments in depreciable property will benefit most from the deduction.

Taxpayers that are eligible for the 20% deduction include individuals, S corporations, partnerships, trusts and estates. The deduction will, if fully available, reduce the highest marginal tax rate on pass-through income from 39.6% for individual partners (effective for years prior to 2018) to 29.6%. As currently enacted, Section 199A is a temporary provision. It expires for tax years beginning after December 31, 2025.

Inbound investors should reconsider how their U.S. business interests are structured to take advantage of the recent changes to U.S. tax laws. Inbound investors need to consider not only changes to the income tax rates, but also recognize that despite the temporary nature of the pass-through deduction, Section 199A may benefit many family-owned small businesses. As with all inbound investments by non-resident alien individuals, avoiding U.S. gift and estate tax remains a key consideration.

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1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
202.393.7600
www.ipbtax.com

SIX "SUPER" IDEAS FOR USING THAT "HUGE" NEW EXEMPTION
BY LINDA KOTIS

The Tax Act increases the federal estate tax exemption to $11.2 million per person. Whether a client's estate is $5 million or $500 million, a transfer tax, income tax, or basis benefit awaits:

Love Your Spouse Today: Husband creates SLAT #1 for wife and descendants, and wife creates SLAT #2 for husband, to use some of each spouse's larger lifetime exemption. Spousal Limited Access Trusts are an alternative to waiting until the first spouse's death and electing portability of the decedent's remaining exemption amount for use by the surviving spouse (DSUE). By making the gift now, these nonreciprocal irrevocable trusts address the uncertainty of whether a DSUE based on 2018 rates will be upheld in 2026 after the exemption reverts to 2017 rates.

Wait and See at Death: Make an unlimited marital deduction transfer at death (either outright or in trust) to the spouse through each other's revocable trusts. The surviving spouse can disclaim any amount of that gift, which then passes to a disclaimer trust for his/her benefit. Now more than ever, this frees up a married couple from using a fixed formula otherwise unworkable at death due to fluctuations in client assets, new laws on exemption amount, and changes in the family situation.

Gifts to a Grantor Trust: Make lifetime gifts to a grantor trust where the grantor retains a swap power. Doing so preserves the ability to swap high basis assets into the trust to avoid income taxes on future sales. The tax basis of assets given to the grantor in an exchange receive a step-up in basis upon the grantor's death. The gift of assets also reduces state estate or inheritance taxes.

Think Ahead to the Sale: Give up some exemption now to reap income tax benefits later. Adult daughter makes a gift to dad whose total estate will be under the $11.2 million exemption. Then dad bequeaths the assets back to daughter at his death. When daughter sells the assets, the step-up in basis reduces her gain. Note that dad would need to live at least one year after the gift because IRC Section 1014(e) prohibits a step-up in basis otherwise.

Let the Elders Give: Move assets up a generation to save generation-skipping transfer tax. Adult son gives his less wealthy mother property with a value under the GST exemption amount. Then grandma devises property to trusts for the grandkids at her death, and her GST exemption shelters the gift, preserving son's exemption for other gifts.

Hold On, Benefit Now Anyway: Fund a Domestic Asset Protection Trust with the settlor as a discretionary beneficiary. A DAPT may work for the client who cannot part with assets just yet. She uses some exemption amount now, with continued access to her property, and the remaining exemption is available at her death.

PRACTICE NOTE:

IRS TO TERMINATE OFFSHORE VOLUNTARY DISCLOSURE PROGRAM
BY DOUGLAS ANDRE

The IRS recently announced that it will close the Offshore Voluntary Disclosure Program ("OVDP") effective September 28, 2018. Complete offshore voluntary disclosures conforming to the requirements of the OVDP must be received by the IRS or postmarked by September 28, 2018. The announcement stated the Streamlined Filing Compliance Procedure will remain available and is not affected by the closure of the OVDP. The statement makes clear, however, that the IRS may end the Streamlined Procedure "at some point."

U.S. persons with undisclosed offshore financial assets or who have undeclared income from offshore sources should consider making a voluntary disclosure before these programs are no longer available.

TAX REFORM AND PRIVATE FOUNDATIONS

BY KASEY PLACE

The Tax Act contains several changes that impact private foundations. A private foundation is a type of tax-exempt organization that receives most of its funding from a single donor or a small set of donors and whose primary activity typically consists of making grants to other charitable organizations. This is in contrast to public charities, which generally perform charitable activities directly and receive funding from public sources. Changes in the Tax Act that are relevant primarily or exclusively to public charities are not discussed in this article.

Separately Computed UBTI: Perhaps the biggest change for private foundations relates to how unrelated business taxable income ("UBTI") is calculated. Previously, net operating losses from one unrelated trade or business could be used to offset UBTI from another. Now, under Section 512(a)(6), UBTI must be separately computed for each line of business, which may increase the amount of tax owed.

The UBTI changes are particularly relevant to private foundations that hold alternative investments, such as interests in private equity funds and hedge funds, as such interests often generate UBTI. It is unclear whether a foundation that receives a Schedule K-1 reporting UBTI from a private equity fund or a hedge fund must inquire further to determine the number of underlying businesses or whether it can treat each fund as a single line of business. Obviously, the latter approach is preferable from the foundation's perspective.

Fringe Benefits: The Tax Act imposes changes on the tax treatment of certain fringe benefits offered by tax-exempt employers. Private foundations typically have few, if any, employees, but those that do may have to include in UBTI the value of qualified transportation fringe benefits provided to such employees, as well as expenses related to certain parking facilities and on-site gyms. *See* Section 512(a)(7).

For example, if a tax-exempt employer contributes funds to its employees' subway passes each month, the amount of such contribution that is excludible from the employees' income will be treated as UBTI to the employer. The result is the same if the employee had the option of receiving cash in lieu of the pre-tax contribution. This situation frequently arises for tax-exempt organizations, as some local governments (e.g., NYC, DC) require that employers over a certain size offer pre-tax transit benefits to employees.

Indirect Impacts: In addition to the changes described above, many expect the Tax Act to indirectly impact exempt organizations, including private foundations, by disincentivizing charitable giving. With lower income tax rates, fewer individuals itemizing and fewer individuals subject to the estate tax, a charitable contribution deduction is less valuable and, therefore, does less to motivate charitable giving.

The Tax Act included one major change that works in the opposite direction. Namely, it increased the limitation on charitable contribution deductions from 50% of adjusted gross income ("AGI") to 60% of AGI. *See* Section 170(b)(1)(G)(1). However, the increased limitation only applies with respect to cash gifts to public charities. It does not apply to gifts to private foundations, which continue to be subject to a 20%-of-AGI limit for capital gain property (other than publicly-traded securities) and a 30%-of-AGI limit for cash and other property.

Conclusion: While private foundations may be less affected by the Tax Act than public charities and taxable organizations, the changes are not insignificant and foundations must be aware of their potential impact.

Note: All section references are to the Internal Revenue Code of 1986, as amended.

Past Issues of IPB Tax, Trusts & Estates

Volume 1, Issue 1	February 2017
Volume 1, Issue 2	June 2017
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TO DEDUCT OR NOT TO DEDUCT?
BY LINDA KOTIS

Before the Tax Act, certain costs incurred in connection with estate or trust administration were deductible from the estate's or trust's AGI. These expenses fell into two categories. The first, miscellaneous itemized deductions subject to a 2% floor (Section 67(a) and (b) of the Code), included items such as expenses for "the production or collection of income" (Section 212(1) of the Code). The second was for "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" (Section 67(e)(1) of the Code). These included items such as fiduciary fees, attorney fees, appraisals, and estate/trust accountings. Treas. Reg. § 1.67-4(a), (b)(5)(6).

For tax years 2018 through 2025, the Tax Act's new Section 67(g) eliminates all "miscellaneous itemized deductions" including those for trusts and estates. This change clearly eliminates the deduction for fees related to investment management beginning in 2018. A question arises whether this change also applies to the Section 67(e) expenses.

The Conference Report discussion of the changes to Section 67 states that the new law follows the Senate amendment, which "suspends all miscellaneous itemized deductions that are subject to the two-percent floor under present law." Therefore, the change could be viewed as preserving the distinction between the two categories of expenses and that Section 67(e) expenses continue to be deductible.

Note, however, that the new statute simply states "[n]otwithstanding subsection (a) [of Section 67], no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026." Section 67(b) contains a list of items not included in the definition of "miscellaneous itemized deductions." Neither Section 67(b) nor Section 67(e) states that estate or trust administration costs are excluded from the definition of "miscellaneous itemized deductions." Section 67(e) simply states that in the case of an estate or trust "the deductions for costs" attributable for holding the property in a trust or estate "shall be treated as allowable in arriving at adjusted gross income" and therefore not subject to the 2% limitation.

Many commentators believe the Section 67(g) prohibition on taking deductions does not apply to Section 67(e) expenses. Since the IRS has started to clarify other aspects of the Tax Act, perhaps the IRS will issue guidance on this question of deductibility as well.

IPB IN THE NEWS ...

- *Estate Planning Client Alert: Offshore Voluntary Disclosure Program*, March 2018
- *Estate Planning Client Alert: Sales of Interests in Partnerships*, January 29, 2018
- *Your Heirs May Find Your Single Member LLC Taxing* by Linda Kotis, Wealth Strategies Journal, January 23, 2018

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