Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

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Overview – Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

- Compare the overall tax burden when a C corporation distributes none, half, or all of its earnings and how that stacks up against a pass-through entity
- Consider how these issues affect planning for distributions and inform estate planning as well as what entities are best for your clients

Overview – Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

- If capital gain rates are repealed for high income taxpayers, that will be horrible for trusts that accumulate capital gains
- Review practical tools for passing capital gains from trusts to beneficiaries – much more flexibility exists than most people think

Overview – Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

- Compare the overall tax burden when a C corporation distributes none, half, or all of its earnings and how that stacks up against a pass-through entity. Consider how these issues affect planning for distributions and inform estate planning as well as what entities are best for your clients.
- If capital gain rates are repealed for high income taxpayers, that will be

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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 – Moderate State 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

Distributing 50% of Corporate Net Income After Income Tax – Moderate State 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 – Moderate State 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 – Moderate State Income Tax (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 business 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.

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

Income after Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200
Income Taxes at 37.1%	-26,044
Net Cash to Owner	$44,156

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

Income after Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200
Distribution to Owner	$35,100
Income Taxes at 37.1%	-13,022
Net Cash to Owner	$22,078
Corporate Cash Plus Shareholder Cash	$57,178

Distributing None of Corporate Net Income After Income Tax – California Top Bracket (II.E.1.a.)

Distributing None of Corporate Net Income After Income Tax	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200

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

Distributing 100% of Corporate Net Income After Income Tax	55.8%
Distributing 50% of Corporate Net Income After Income Tax	42.8%
Distributing None of Corporate Net Income After Income Tax	29.8%
S Corporation, Partnership, or Sole Proprietorship (Pass-Through)	42.9%-55.6%

C corporation deducts state income tax on business operations; pass-through owners have limited state income tax deduction (but unlimited business property tax deductions). Reinvested C corporation earnings will be taxed later when the company is sold, which just changes the timing of the 55.8% rate above, unless held until death or qualify for Code § 1202 exclusion (II.Q.7.k.), the latter which applies for federal income tax but not for California income tax. 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.)

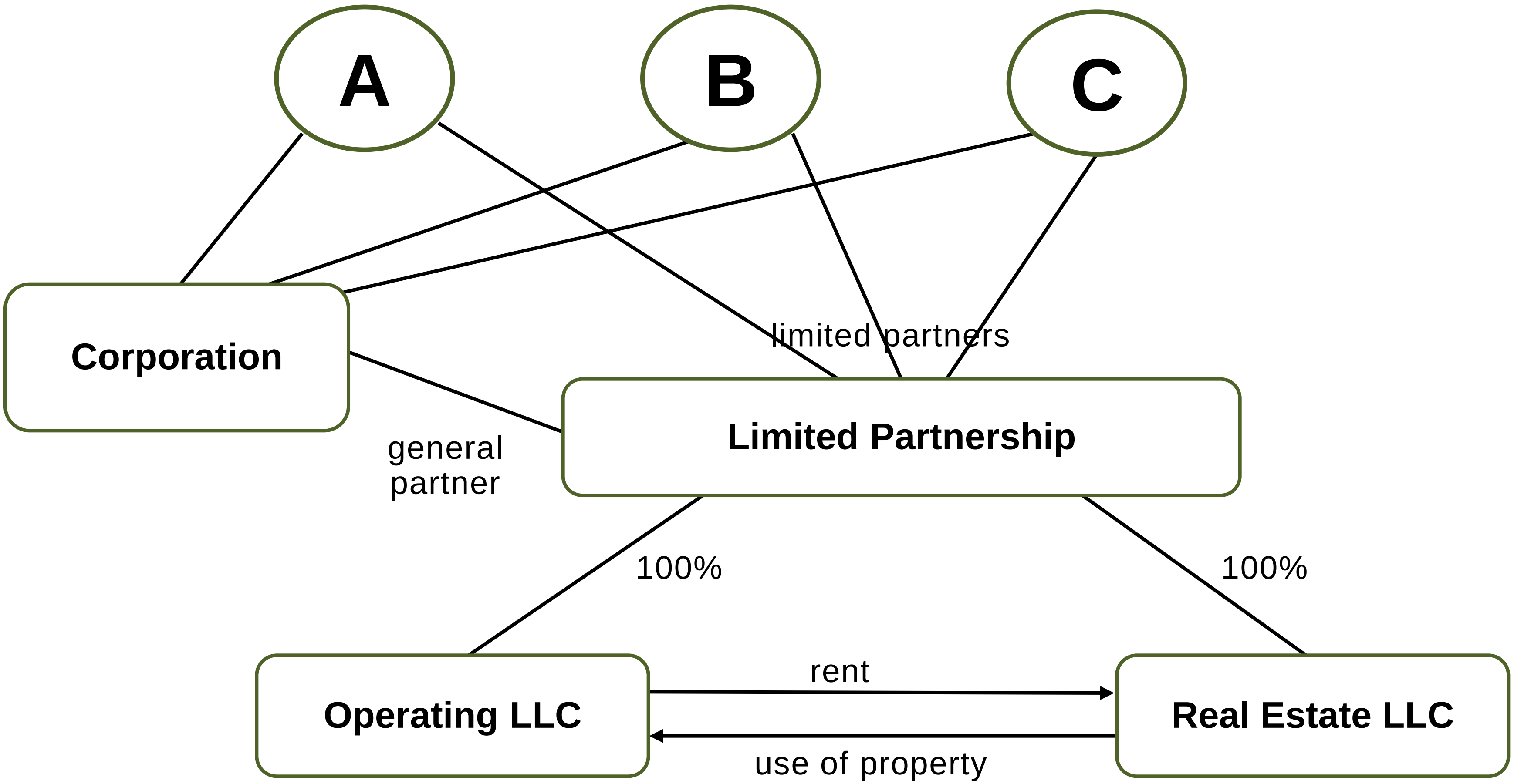
- Entity makes “tax distribution” to trust, which does not pay tax and therefore uses the distribution to pay down the note.
- Grantor uses note payment to pay tax, making the note a disappearing asset
- C corporations pay tax instead of making tax distributions; any dividends undermine favorable C corporation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

Which Entity for Which Stage

- Simple LLC (II.E.3.)
  - Start-Up Losses (II.G.4.)
  - Profitable, But Not Overly So
    - Little or No Earnings in Excess of Taxable Wage Base (II.L.2.a.i.) ($132,900 in 2019)
    - Generous Equipment Write-Offs (II.G.5.)
- Transition to Limited Partnership When Significant Earnings in Excess of Taxable Wage Base

Recommended Structure

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



Capital Gain Elections (II.J.4.b)

- Tax preparation software traps unless take special steps
- Next slides discuss strategic issues, law, and practical issues (II.J.8.)

Additional 5% Capital Gain Tax

	2020	2021
Single	$441,450	$445,850
Married filing jointly	$496,600	$501,600
Trust	$ 13,150	$ 13,250

3.8% Tax on Net Investment Income (II.I.3.)

Single	$200,000
Married	$250,000
Trust	$ 12,950
	($13,050 for 2021)

Indexed for Trusts But Not Individuals

Capital Gain is DNI Unless Excluded (II.J.8.a.)

Code § 643(a)(3): capital gain excluded only if:

- From sale of capital asset
- Allocated to corpus
- Not paid, credited, or required to be distributed to a beneficiary
- Paid, permanently set aside, or to be used for charitable purposes

Capital Asset (II.J.8.a.i.)

Not a capital asset:

- Code § 1231 property
- Amortized goodwill (self-created goodwill not amortizable is a capital asset)

Mechanism for Distributing Capital Gain: Reg. § 1.643(a)-3(b) (II.J.8.c.)

1. Allocated to income
2. Allocated to corpus but distributed consistently
3. 65-day rule distribution

Allocated to Income (II.J.8.c.i.)

- “Power to adjust” principal
- Uniform Principal & Income Act reflects Prudent Investor Rule; UPIA becoming UFIPA (Uniform Fiduciary Income & Principal Act) (Uniform Law Commission adopted in 2018)
- No duty of consistency from year to year except unitrust

Materials

- Uniform Law Commission: https://www.uniformlaws.org/home
- Web site for UFIPA: https://www.uniformlaws.org/committees/community-home?CommunityKey=1105f9bb-eb93-4d4d-a1ab-a535ef73de0c
- Web site for UFIPA has a Documents tab, with a link to the Enactment Kit that includes mapping Principal & Income Act to its UFIPA counterparts
- ACTEC/ALI-CLE: Fun, Flexible, and Fair: Drafting and Administering Trusts Under UFIPA

Power to Adjust (II.J.5.b.ii.(a).)

Under the Uniform Principal and Income Act, a trustee may adjust between principal and income to the extent the trustee considers necessary if:

- The trustee invests and manages trust assets as a prudent investor,
- The trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and
- The trustee determines that the adjustment is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

Power to Adjust (II.J.5.b.ii.(a).)

- UFIPA § 203(a) requires only that the trustee determine that "the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially."
- Thus, UFIPA requires only that the power to adjust will be helpful, not necessary.
- UFIPA - trustee not liable for failing to exercise the power
- UFIPA - trustee not liable for decision in good faith

Power to Adjust (II.J.5.b.ii.(a).)

Factors a fiduciary must consider (adjust or unitrust):

- the terms of the trust
- the nature, distribution standards, and expected duration of the trust
- the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7
- the desirability of liquidity and regularity of income
- the extent to which an asset is used or may be used by a beneficiary
- the increase or decrease in the value of principal assets, reasonably determined by the fiduciary

Power to Adjust (II.J.5.b.ii.(a).)

Factors a fiduciary must consider (adjust or unitrust):

- whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal
- the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods
- the effect of current and reasonably expected economic conditions
- the reasonably expected tax consequences of the exercise of the power

Power to Adjust (II.J.5.b.ii.(a).)

A fiduciary cannot adjust if would:

- Reduce the amount payable to a current income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries
- Change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the trust
- Affect charitable set-aside

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Power to Adjust (II.J.5.b.ii.(a).)

A fiduciary cannot adjust if would:

- Cause a person to be treated as the owner of all or part of the trust for federal income tax purposes (but can appoint special trustee)
- Cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes (but can appoint special trustee)
- Cause an individual to be treated as making a gift for federal gift tax purposes (but can appoint special trustee)
- Be done by fiduciary who is not an independent person
- Affect eligibility for public benefits
- Change a unitrust

Unitrust (II.J.5.b.ii.(b).)

- A fiduciary cannot convert to, modify, or turn off unitrust if would violate certain tax rules
- If trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%
- Terms of the trust may write rules, in whole or in part
- Trustee adopts unitrust policy, including:
  - ➢ the unitrust rate or the method for determining the unitrust rate
  - ➢ the method for determining the applicable value
  - ➢ the application of certain mandatory or permissive rules

Unitrust (II.J.5.b.ii.(b).)

Unitrust policy may include:

- Provide methods and standards for:
  - Determining the timing of distributions;
  - Making distributions in cash or in kind or partly in cash and partly in kind; or
  - Correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;
- Specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or
- Provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

Comparing Power to Adjust to Unitrust (II.J.5.b.ii.(c).)

- Generally, a fiduciary exercises the power to adjust annually and the power to modify a unitrust only once or occasionally
- Exercising a power to adjust generally is included in annual reports, whereas adopting, modifying, or revoking unitrust provisions requires specific notice to the beneficiaries
- However, UFIPA allows a power to adjust to apply to all future periods and also authorizes frequent changes to a unitrust policy, so the above generalization about frequency is not necessarily accurate
- Unitrust probably generates capital gain on distribution in kind (definitely does for CRUT)
- Power to adjust more flexible for tax planning

Allocated to Income

- Trust agreement can allocate capital gain to income
- Cannot "depart fundamentally from traditional principles of income and principal" per Reg. § 1.643(b)-1
- 3%-5% should be OK

Allocated to Corpus But Distributed Consistently (II.J.8.c.ii.)

- Existing trusts – probably did NOT allocate capital gain to DNI
- Solution discussed later
- New trusts – generally allocate capital gain to DNI unless beneficiary in higher federal & state combined bracket (including phase-outs)

Actual or Deemed Distribution (II.J.8.c.iii.)

- Tracing actual distribution often not practical unless terminate trust
- Referring to capital gain suffices – 65-day rule distribution when trustee refers to capital gain
- Can be inconsistent from year to year

Fairness Issues (II.J.8.c.v.)

- Fair for cash distribution to carry out taxable income
- If not, "gross up" distribution for taxes paid by distributee
- "Gross up" payment costs remaindermen less than if the trust paid the tax

Are distributions advisable?

- Are distributions available?
- Protective nature of trust

Are distributions available?

- Support vs. welfare
- Consider or not consider other resources

Additional Tax Issues

- Estate tax on beneficiary’s estate
- Distribution in kind to include in beneficiary’s estate for basis step-up (II.J.8.d.)

Protective Nature of Trust

- Very real creditor or spousal issues
- Burning a hole in the beneficiary's pocket
- Beneficiary saves but might one day have creditors

Income Taxation of Annuities and Life Insurance Held By Nongrantor Trust (II.J.8.)

- Biden plan would tax capital gains at ordinary income rates, presumably when taxable income exceeds approximately $13K
- Distributions to beneficiaries may carry out capital gains to beneficiaries (much more easily than popular misconceptions) so that they can be taxed at the beneficiaries' presumably lower rates (II.J.3.a.)
- How else avoid tax on turnover?

Income Taxation of Annuities and Life Insurance Held By Nongrantor Trust (II.J.19.)

- Annuities defer tax on turnover but convert all inside build-up of investments into ordinary income
- Letter Ruling 202031008 describes IRS' view of nongrantor and grantor trust owning annuities
- Life insurance avoids income tax in many cases, but challenging issue re estate inclusion when beneficiary's life is insured

Trusts Holding Annuities (II.J.19.)

- Code § 72(u)(1) Requirement of Natural Person (N/A to Most Trusts) (II.J.19.a.)
- Taxation of Distributions under an Annuity Contract (II.J.19.b.)
- Code § 72(q) 10% Penalty for Early Distributions from Annuity Contracts (II.J.19.c.)
- Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed (II.J.19.d.)

Trusts Holding Annuities (II.J.19.)

- Annuity Contract Issued to Grantor Trust (II.J.19.e.)
- Annuity Contract Issued to Nongrantor Trust (II.J.19.f.)
- Loss on Sale of Annuity (II.J.19.g.)
- Comparing Annuity to Life Insurance (II.J.19.h.)

Nongrantor Trusts Holding Annuities

(II.J.19.f)

- An annuity contract's investment return is nontaxable to the extent it stays inside annuity
- In most cases, 100% of each distribution is taxable until all of the investment return has been distributed
- An annuity may be rolled over – free from income tax – into another annuity contract with the same annuitant or to a qualified long-term care insurance contract for that person

Nongrantor Trusts Holding Annuities

(II.J.19.f)

- Distributions generally subject to a 10% penalty, according to Letter Ruling 202031008
- Distributions after the sole current beneficiary’s death are not subject to this penalty
- Letter Ruling 202031008 does not address what happens after a beneficiary’s death when more than one beneficiary may receive distributions

Nongrantor Trusts Holding Annuities
(II.J.19.f)

- No basis step-up at beneficiary's death
- After annuitant's death, the annuity must be distributed – generally within 5 years

Nongrantor Trusts Holding Annuities

(II.J.19.f)

- Ordinary income taxation, 10% penalty, and lack of basis step-up make annuity unattractive
- But tax deferral can be powerful
- Lower tax when trust passes through to the beneficiary any distributions if beneficiary is in modest tax bracket

Life Insurance Held By Nongrantor Trust (II.J.19.h)

Lie insurance favorable income taxation:

- No tax on distributions from the policy to the extent of premiums paid (II.Q.4.)
- Death benefit is free from income tax (basis step-up)
- Tax-free rollover into another life insurance, annuity, or qualified long-term care insurance contract

Estate Taxation of Insurance on Beneficiary's Life (II.Q.4.i.ii.)

Life insurance unfavorable estate taxation:

- IRS may assert that a policy insuring a beneficiary's life is includible in the beneficiary's estate – even if beneficiary has no control over the policy whatsoever!
- This argument may be averted if the trustee has absolute discretion to pay premiums

Estate Taxation of Insurance on Beneficiary's Life (II.J.19.h.)

Consider life insurance partnership:

- Partnership interest is opaque if partnership receives death benefit
- Partnership should obtain the insured's consent to the life insurance policy (II.Q.4.g)
- Beware transfer for value rule if the partnership transfers the policy (II.Q.4.b.ii)

Conclusion

- Free quarterly newsletter includes the most recent version of fully searchable PDF of my business structuring materials (a few thousand pages). Completing form at https://www.thompsoncoburn.com/forms/gorin-newsletter gets you the newsletter, which includes a link to the PDF. It also includes an offer to subscribe to blog or Heckerling commentary (below).
- Blog that is less technical is at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.
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