How to Avoid a Headache at the Bank

By Andrea Chomakos and Deborah King

As estate planning attorneys, we are well versed in the process of estate administration and have expectations of how others should acknowledge and respect the documents that we prepare for our clients – wills, trusts, powers of attorney. And many times things work as expected – our clients walk into a bank branch, meet with a branch manager or other employee, and present a power of attorney, letters testamentary, or trust document and the bank adds the agent to the principal’s account, closes the decedent’s account, or establishes the trust account as requested.

However, sometimes, things are not as seamless. Hiccups definitely are frustrating for our clients, in particular as these issues often arise in the context of an already stressful situation – a loved one is sick or has died, the task at hand is not routine and the legalese is incomprehensible. But, financial institutions are subject to increasing regulations from both the state and federal government, and policies have been developed to address potential risks to financial institutions and to protect customers and their confidential information. At the root of most of the frustration is a lack of understanding of the regulations to which the banks must adhere. Your Section’s Council has reached out to the North Carolina Banker’s Association (the “Association”) and invited a member from the Association to join the Section’s Council as a liaison and to co-author a series of articles to address some of the issues we have heard you raise in dealing with financial institutions in estate and planning related matters. This article will present several common situations that arise in dealings with banks and explain the North Carolina statutes applicable to the banks so that you can advise and assist your clients in being prepared in transacting with a financial institution.

Power of Attorney

It is important to remember that banks have a number of strict rules that they must comply with, which derive from federal and state laws and other regulations. Those rules are intended to protect both the bank and its clients. In the context of powers of attorney, it is important for the bank to confirm that the power of attorney is valid and the person presenting the power of attorney has the appropriate authority to act under it.

The North Carolina legislature recently adopted the Uniform Power of Attorney Act (effective Jan. 1, 2018). That new act will help address two common situations encountered by banks (and other third parties presented with a power of attorney) under the prior statute.

Previously, N.C.G.S. Section 32A-9 stated:

“(b) No power of attorney executed pursuant to the provisions of this Article shall be valid subsequent to the principal’s incapacity or mental incompetence unless it is registered in the office of the register of deeds of that county in this State designated in the power of attorney, or if no place of registration is designated, in the office of the register of deeds of the county in which the principal has his legal residence at the time of such registration or, if the principal has no legal residence in this State at the time of registration or the attorney-in-fact is uncertain as to the principal’s residence in this State, in some county in the State in which the principal owns property or the county in which one or more of the attorneys-in-fact reside. A power of attorney executed pursuant to the provision of this Article shall be valid even though the time of such registration is subsequent to the incapacity or mental incompetence of the principal.” (emphasis added).

So, if the principal was incapacitated and the agent presented a power of attorney that had not been recorded, the bank could not treat the agent as having the authority to act on behalf of the principal. The new act does not require a power of attorney to be registered subsequent to the principal’s incapacity, and extends this rule to powers of attorney executed before the effective date of the new law.

The other issue that the new act addresses is lack of clarity regarding whether a power of attorney is durable or springing. The new act provides that a power of attorney is effective immediately, unless specifically provided to be springing. This is the opposite presumption from the prior law. Practitioners should be careful in how clients execute the new statutory form, to avoid any confusion on the effectiveness of the power of attorney. Further, to the extent that a power of attorney is springing, the bank will necessarily require additional information and documentation to determine whether the power of attorney is effective. Agents should be prepared with this information and documentation when presenting a springing power of attorney to a bank.

While the new statutory form should be viewed as an improvement over the current statutory form and may be sufficient in many cases, a well drafted custom power of attorney that clearly states the powers of the agent is a helpful tool as well. While the statutory form provides for a number of powers to be granted to the agent, it is not all-inclusive and unique issues can arise that are not covered under the power of attorney.

Under certain circumstances, it may be difficult for a bank to determine if the agent is acting within the scope of the power of attorney and one option is for a bank to contact the attorney that drafted the power of attorney. Discussing the power of the attorney with the bank is a valuable service you can provide. Additionally, banks are required by regulators and the state to take steps to detect financial elder abuse and are aware that a power of attorney is a favored method for those trying to take advantage of the elderly. Providing information to the bank may avoid the filing of an unnecessary financial elder abuse report or help the bank determine that a report should be filed. Once a financial elder abuse report is filed pursuant to N.C.G.S. Section 32C-1-120(9) the person that has filed or is aware of the filing is not required to follow the directions of the agent.

Safe Deposit Box

Another area where clients may become frustrated is in trying to access a decedent’s safe-deposit box. There are specific rules in North Carolina regarding the access to a deceased person’s safe de-
Posit box. N.C.G.S. Section 28A-15-13(c) allows a safe deposit box to be opened without the presence of a clerk of court when:

“[T]he person requesting the opening of the decedent’s safe-deposit box is a qualified person. In that event, the qualified person shall make an inventory of the contents of the box and furnish a copy to the institution and to the person possessing a key to the box if that person is someone other than the qualified person.”

A qualified person includes a qualified personal representative, a person with an order of summary administration, co-lessee or a deputy. A deputy is “a person appointed in writing by a lessee or cotenant of a safe-deposit box as having right of access to the safe-deposit box without further authority or permission of the lessee or cotenant, in a manner and form designated by the institution.” N.C.G.S. § 28A-15-13(a)(1a).

Thus, if an individual goes to the bank with a copy of the will or just the decedent’s death certificate, and no qualifying letters testamentary or administration, the bank cannot give that person — who is not a qualified person — access to the safe deposit box. Of course the quandary of “but the will is in the safe deposit box” always triggers sympathy, but is not the magic key to grant the bank authority to open the box. This is why clients should be advised not to put the will in the safe deposit box! However, when these situations arise, the clerk or representative of the clerk must access the box and take inventory of the box, including taking the will and filing it. Because of this cumbersome statutory procedure, clients should be advised not to retain the original will in a safe deposit box or to otherwise designate on the safe deposit contract a person who can access the box.

Joint Accounts

Another common issue is obtaining financial information for a decedent’s accounts, to report to the court and/or IRS with the decedent’s estate tax return. However, if the account is jointly owned, the bank must be cognizant of the customer information as it pertains to the other account owner. Specifically, when the decedent owns a joint account that is held as joint with right of survivorship, on the death of the decedent the account automatically becomes the property of the survivor and the bank has to guard the financial information of the surviving owner. Financial institutions understand the personal representative’s needs and if informed of the situation can generally comply with the request for account statements that cover periods prior to and including the date of death. Thus, if a personal representative explains why the statements are being requested, the bank can usually comply with the request.

In addition to requesting information about joint accounts, a personal representative may believe that the estate owns a portion of a joint account. When a bank reviews a joint account after the death of the decedent to determine ownership, the bank must comply with the terms of the account agreement. A client may believe that the account is owned as joint tenants with right of survivorship, but the account application may state that the account is a joint account without a designation of rights of survivorship. In this situation, depending on when the account was established, it may be classified as a tenant-in-common account. Accordingly, the bank is obligated to treat the account as owned per the account application. While this may be frustrating to the parties who thought the account was joint with right of survivorship, the bank must comply with the applicable laws and account application.

Conclusion

The combination of statutes, regulations and coping with the sickness or death of a loved one can be stress inducing but with careful preparation estate planning attorneys can help minimize that stress for their clients. Hopefully the above tips, along with well drafted documents, can help avoid a call from a frustrated client.

Andrea Chomakos (ACHomakos@mcguirewoods.com) is a partner at McGuire Woods, and member of the North Carolina Estate Planning & Fiduciary Law Section Council.

Deborah King (deborah.h.king@wellsfargo.com) is Senior Counsel at Wells Fargo Bank, N.A. and the North Carolina Banker’s Association Liaison to the Estate Planning & Fiduciary Law Section Council. She focuses on ways to create opportunities for additional dialogue and understanding between estate planning attorneys and financial institutions. The views expressed herein are the personal views of the author and do not necessarily reflect or state the views of Wells Fargo & Company, its affiliates and subsidiaries.

If you have any suggestions for additional article topics related to this work please contact either one of them.
Business Tax Planning and Fiduciary Income Tax After Tax Reform

By Thomas Cooper

The Tax Cuts and Jobs Act (the “Act”) has sought to overhaul the tax regime applicable to American businesses under the Internal Revenue Code (the “Code” or “IRC”), with the goal of encouraging investment in, and the growth of, business activity. While much is still left to be determined as to the ultimate impact of the Act on the American economy, it is certainly the case that changes brought about by the reform will fundamentally alter the manner in which some business owners and operators choose to handle business operations, finances, and management. In the context of businesses which are closely held, owners may come in the form of owner-operators, individual investors, or, with trust ownership being especially applicable to closely held businesses passed down from one family generation to another, trust fiduciaries. Each may face unique challenges, but as a general matter, businesses and their owners and operators, together with their advisors, now face the task of adapting to the new law so that they may continue to operate in a tax-efficient, but also practical, manner. This article attempts to note certain items of significance for business owners, operators, and advisors and important planning approaches they might use to adjust to the Act.

Portions of the Code affecting businesses not discussed here have undergone change as well—substantial change, in some cases, such as the transition to a “territorial” system in the international tax arena. Many provisions related to business taxation also pertain only to certain industries, such as the life insurance, farming, or alcoholic beverage industries, and some others affect only publicly traded companies. The substance of those are outside the scope of this article, which focuses on the impact of the Act, generally, on closely held, domestically owned and operated businesses. While relevant to the operations of closely held businesses, this article also does not fully address all provisions of the Act relating to employee compensation and benefits or depreciation methods and other managerial accounting issues, since those are less relevant to the high-level tax planning addressed in this article.

Preliminary Considerations

As a starting point, business owners, operators, and advisors should consider certain principles to guide their analysis of tax planning involving businesses.

Political Uncertainty

Unlike the portions of the Act applicable to individual taxpayers, most of the benefits afforded to businesses are made permanent with the exception of the new Code Section 199A deduction for pass-through income. Much in the same way there also exists political uncertainty for the tax reform on individuals, however, political forces could always cause an unexpected change to the Code which mitigates or reverses benefits that might be obtained from structuring a business in a certain manner. Any further reform could even cause tax planning measures to become counterproductive in the long run, such as an increase in the corporate tax rate. Accordingly, businesses, possibly even more so than individuals, notwithstanding the “permanence” of items affecting businesses under the Act, should be mindful of the possible need to pivot in the event of further tax reform.

Need for Additional Guidance

Guidance on the Act is also lacking in many places, which is especially problematic given that certainty of the tax effects of a transaction or business arrangement is often crucial for businesses. Treasury has acknowledged the need to allocate resources to provide additional support on issues, particularly on the Code Section 199A deduction and the new interest expense limitations, but taxpayers will be forced in the interim to operate without additional direction. Treasury has also indicated that general guidance on the new three-year holding period applicable to profits interests for long-term capital gain treatment is less of a priority given its more limited application to taxpayers.

Non-Tax Considerations

A business might evaluate an opportunity for tax planning in conjunction with the non-tax benefits of a restructuring or reorganization. For example, a business might desire to streamline its expansion efforts or operations, position itself for a sale, minority investment, or other liquidity event, support its efforts to deleverage, obtain financing at a lower cost of capital, or improve the terms of a buy/sell arrangement among its owners. A restructuring or reorganization combined with estate planning might also facilitate additional asset protection for an individual owner’s business interests. Where direct cost savings from tax planning are less substantial, tax and non-tax benefits combined might still provide a net benefit for a business or owner and weigh in favor of taking proactive measures.

Corporate Income Tax

The corporate income tax rate is now simplified with a new 21% flat entity-level tax rate imposed on C corporations, including personal service corporations, to replace the graduated rates previously in place of up to 35%. IRC § 11(b). The corporate alternative minimum tax (AMT) has been repealed, with a refundable amount for future years being used to account for credits received in prior years. IRC §§ 55(a); 53(e).

The dividends received deduction is adjusted downward consistent with the lower overall corporate tax rate so that non-qualified dividends from domestic corporations not constituting small business investment companies (SBICs) or corporations owned more than 20% by the recipient corporation are now 50% deductible. IRC § 243(a)(1).
The accumulated earnings tax for corporations will apply in excess of a $250,000 credit, generally, with a $150,000 credit applied to corporations engaged in services similar to those constituting specified service businesses for the Code Section 199A deduction discussed below, with a few notable differences. IRC § 1561(a). The types of businesses subject to this lower credit include service corporations with principal functions in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. IRC § 535(c)(2)(B). Unlike the Code Section 199A definition of “specified service businesses,” for which the deduction for pass-through income becomes limited above certain income thresholds, engineering and architecture are included here, and athletics are omitted.

Income Tax on Estates and Trusts

Estates and non-grantor trusts, which, unlike grantor trusts, are treated as standalone taxpayers for federal income tax purposes, are now subject to four income tax brackets for ordinary income ranging from a 10% rate up to a 37% rate, consistent with the range of rates for individual taxpayers, but as has been the case for some time, the top 37% rate for estates and trusts becomes applicable at a much lower threshold of $12,500. IRC § 1(j). The brackets for taxable income for estates and trusts are as follows:

<table>
<thead>
<tr>
<th>Income not over $2,550</th>
<th>10% of income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income over $2,550 but not over $9,150</td>
<td>$255 plus 24% of the excess over $2,550</td>
</tr>
<tr>
<td>Income over $9,150 but not over $12,500</td>
<td>$1,839 plus 35% of the excess over $9,150</td>
</tr>
<tr>
<td>Income over $12,500</td>
<td>$3,011.50 plus 37% of the excess over $12,500</td>
</tr>
</tbody>
</table>

The long-term capital gains brackets remain the same. All income tax brackets, as well as the permanent brackets returning after the sunset, are to be inflation-adjusted using chained CPI, (discussed in more detail in “Individual Estate and Tax Planning After Tax Reform” in this newsletter) and sunset back to their original levels after 2025. IRC §§ 1(j)(3)(B); -(f)(2); -(e). Nominal exemption amounts also remain.

Income Tax Deductions

The central focus for many businesses will be the effect of the Act on income tax deductions which are either being introduced for the first time or modified from their previous form.

Pass-Through Income

One of the most notable results of the Act in any area is the ability for non-corporate taxpayers owning interests in pass-through entities, meaning entities that are not separately taxed for federal income tax purposes, such as S corporations and partnerships, to deduct a portion of the domestic income generated from operations of a trade or business. Code Section 199A introduces this new concept, which borrows from the deduction previously available under Code Section 199, repealed by Section 13305 of the Act, for domestic production activities.

Any non-corporate taxpayer receiving “qualified business income” (QBI) from a trade or business in the form of a pass-through entity may take a deduction of up to 20% on that income, not to exceed the taxpayer's taxable income (excluding net capital gain) for the year. IRC §§ 199A(a)–(b). QBI is limited to income effectively connected with a trade or business in the United States excluding capital gains, dividends, interest and annuity income (other than that attributable to a trade or business), gains from commodities and currency transactions and derivatives, compensation, and, in the case of a partnership, guaranteed payments or other payment for services rendered by a partner and therefore is limited to income generated from the actual operations of the trade or business. IRC §§ 199A(c)(3)–(4). If the determination of QBI in any year actually comes to a loss, the loss amount is carried forward to subsequent years to offset any later-generated QBI. IRC § 199A(c)(2). This will be a standalone deduction not considered an itemized deduction on Schedule A. Deductions are also permitted for real estate investment trust (REIT) dividends, cooperative dividends, and publicly traded partnership (PTP) income, but the analysis here will focus on QBI.

The extent of the deduction that is permitted is dependent on one or more of (1) the taxpayer's taxable income for the year, (2) whether the QBI is derived from a “specified service business,” and (3) W-2 wages paid and “qualified property” owned by a business generating QBI and not classified as a specified service business. Unlike many of the business tax reforms made under the Act, this deduction, as noted above, is only temporary, as it sunsets for taxable years after 2025. IRC § 199A(i).

A specified service business includes a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, investing and investment management, or trading or dealing in securities, partnership interests, or commodities. IRC § 199A(d)(2) (referencing IRC § 1202(e)(3)(A)). While architecture and engineering were specifically removed from this list, it is unclear whether certain businesses conducted by architects or engineers could still separately fall into the “reputation or skill” prong of the term. Unfortunately, what does and does not constitute a specified service business based on this aspect of the term and other generalities is hardly clear and will result in confusion for many taxpayers across a wide variety of businesses.

Qualified property is depreciable property owned by a trade or business at the end of a taxable year for the production of income and for which the depreciable period has not ended. For purposes of determining the depreciable period, the property is deemed to have a depreciable period of no less than 10 years. IRC § 199A(b)(6)(B).

If a married taxpayer (assumed for this article to be a married taxpayer filing joint returns) has taxable income below a threshold amount of $315,000 or an unmarried taxpayer has taxable income below a threshold amount of $157,500, in each case adjusted for inflation, the taxpayer can deduct the full amount of 20% of QBI eligible for the deduction. If a taxpayer has taxable income in excess of those amounts, however—between $315,000 and $415,000, in the case of a married taxpayer, and $157,500 and $207,500, in the case of an unmarried taxpayer, in each case adjusted for inflation—the deduction either phases out, in the case of QBI generated by a specified service business, or limitations based on the W-2 wages...
paid by a business and its qualified property, in the case of a non-specified service business, become phased in.

With respect to QBI from any specified service business for taxpayers having taxable income in excess of the upper end of the phase out thresholds, a taxpayer becomes completely ineligible for any deduction. In the case of any other businesses the taxpayer’s deduction becomes fully subject to limitations based on the business’ W-2 wages and qualified property. In that case, the deduction is limited to the greater of (1) 50% of the W-2 wages paid by a business or (2) the sum of 25% of its W-2 wages and 2.5% of the “unadjusted basis immediately after acquisition” of its qualified property, which would include the cost basis of property at the time it is placed in service, although the effect of certain subsequent changes to basis, as a result of a Code Section 754 election adjustment, for example, is unclear.

For partners of a partnership and shareholders of an S corporation, the deductible amount is determined at the partner or shareholder level. W-2 wages are apportioned to them based on their allocable shares of wage expenses, and qualified property is apportioned to them based on their allocable shares of depreciation. IRC § 199A(f). Treasury is given authority to issue regulations governing the application of the deduction to tiered entities. IRC § 199A(f)(4)(B). In a last-minute change to the legislation for the Act, trusts and estates owning business interests also became eligible for the deduction, with W-2 wages and qualified property limitations to be apportioned among a trust and its beneficiaries similar to the rules previously in effect for the Code Section 199 deduction. IRC § 199A(f)(1)(B).

So much for the simplification of the Code promised leading up to the Act. The pass-through deduction introduces enormous complexity and arbitrarily rewards some types of businesses over others, likely prompting many taxpayers to rearrange their business affairs to ensure the greatest eligibility for the deduction. While planning opportunities exist to take full advantage of the deduction, taxpayers and their advisors should understand that any claim of a deduction under Section 199A also causes a taxpayer’s margin of error to be cut in half from 10% to 5% in assessing a substantial understatement penalty for the taxpayer’s entire return. IRC § 6662(d)(1)(C).

Interest Expense

The ability to deduct interest expense is now limited for businesses having more than $25 million in average annual gross receipts for the 3 years prior to a taxable year, with the limitation generally equal to the sum of any business interest income earned by a business during the taxable year and 30% of other taxable income, subject to adjustments for NOLs, any Code Section 199A deduction, and prior to 2022, depreciation and amortization. IRC § 163(j). A shorthand for the adjustments to income subject to the 30% limitation is earnings before interest, taxes, depreciation, and amortization (EBITDA) prior to 2022 and earnings before interest and taxes (EBIT) for 2022 and thereafter. Pass-through entities are subject to this limitation at the entity level, with adjustments made to income and basis for their owners to the extent necessary to accommodate an entity-level determination. IRC § 163(j)(4). Any interest expense that is disallowed in a particular year is carried forward to subsequent years. IRC § 163(j)(2).

Certain lines of business are not subject to the limitation, some on an elective basis, including a real property trade or business, which can make an irrevocable election. IRC § 163(j)(7)(B). The tradeoff to such an election is that the electing real property trade or business is then required to use the alternative depreciation system (ADS) for nonresidential real property, residential real property, and qualified improvement property (i.e., nonresidential real property with interior improvements made after the property was placed into service), allowing for less efficient depreciation than might otherwise be permitted. IRC § 168(g)(8).

Excess Business Losses and Net Operating Losses

A non-corporate taxpayer’s “excess business losses,” meaning a taxpayer’s deductions attributable to a trade or business (including losses incurred at the shareholder or partner level in the case of pass-through businesses), now cannot offset non-business income, such as income from passive investment, in excess of $250,000 for single taxpayers and $500,000 for married taxpayers, adjusted for inflation, with the limitation to sunset after 2025. IRC §§ 461(l)(1); -(3); -(4). Any excess business losses are instead treated as net operating losses (NOLs) and must be carried forward to offset business income in future years. IRC § 461(l)(2).

Deductions for NOLs are now also capped in most cases for any taxable year at 80% of taxable income. With certain exceptions, the 2-year carryback that was previously allowed has been eliminated, but unlimited carryforwards are now permitted in most cases. IRC §§ 172(a); -(b)(1)(A). Note that the statute contains a disconnect in the effective dates of the amendments, with the changes to the NOL deduction to be effective for taxable years beginning after Dec. 31, 2017 but the changes to carryforwards and carrybacks to be effective as to taxable years ending after Dec. 31, 2017. § 13302(c) of the Act. The Conference Report for the Act indicated that the provisions affecting NOLs were to be effective for taxable years beginning after Dec. 31, 2017. A technical correction may have to be made to reconcile the difference.

Depreciation and Expensing

Expenses associated with certain depreciable business assets, now including elected roof, HVAC, fire protection, and alarm or security systems, may be immediately expensed up to $1,000,000, if all property subject to the expensing during a taxable year does not exceed $2,500,000, in each case adjusted for inflation, instead of being deducted over time subject to a depreciation schedule. IRC §§ 179(d)(1)(B); (f).

Similarly, “bonus depreciation,” allowing expensing of a percentage of basis for certain depreciable assets before applying a regular depreciation schedule, including used depreciable assets at the time they are first placed in service by a business, has also been expanded to allow higher percentage amounts to apply to acquired assets in earlier years, stepped down in later years before ultimately being phased out altogether. IRC §§ 168(k)(1)(A); -(6). The bonus depreciation schedule to be applied to adjusted basis of property is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017-2022</td>
<td>100% of adjusted basis</td>
</tr>
<tr>
<td>2023</td>
<td>80% of adjusted basis</td>
</tr>
<tr>
<td>2024</td>
<td>60% of adjusted basis</td>
</tr>
<tr>
<td>2025</td>
<td>40% of adjusted basis</td>
</tr>
<tr>
<td>2026</td>
<td>20% of adjusted basis</td>
</tr>
<tr>
<td>2027 and later years</td>
<td>No deduction</td>
</tr>
</tbody>
</table>
Charitable Contributions

The treatment of charitable contributions by partnerships has now been brought somewhat in parity with the treatment of charitable contributions by S corporations by providing that the standard loss limitation rules to which a partner is subject are now applicable to charitable contributions from the partnership, but only to the extent of the basis of contributed partnership property (and not its fair market value). IRC § 704(d)(3).

E lecting small business trusts (ESBTs) are no longer subject to gross income limitations on charitable contributions made pursuant to their governing instruments and, instead, the charitable deduction requirements for individuals apply. IRC § 641(c)(2)(E).

Partnerships

A substantial built-in loss, for which an adjustment of basis is to take place upon a transfer of a partnership interest regardless of whether a Code Section 754 election is in place at such time, now includes the allocation of a loss of more than $250,000 to a transferee partner if the partnership assets were sold for fair market value at the time of transfer. IRC § 743(d)(1)(B).

While a basis adjustment previously had to take place if the partnership's basis in partnership property exceeds its fair market value by more than $250,000, this new requirement prevents the allocation of gain, loss, deductions, and credits in a manner that would provide the transferee partner with a loss in excess of that amount.

Technical terminations of partnerships, which occur if more than 50% of capital and profits in a partnership are transferred within a 12-month period, have been removed. IRC 708(b)(1).

While technical terminations were usually something to be avoided and may have been caused in many cases inadvertently, they also could be useful in cases if triggered intentionally such as to make a different Code Section 754 election (other than with respect to the incoming partner) or employ different Code Section 704(c) allocation methods.

Profits Interests

Profits interests in a partnership provided in exchange for a partner's services, sometimes referred to in the investment management context as "carried interests," are no longer able in certain cases to take advantage of long-term capital gain treatment on "capital gain with respect to such interests" for a disposition having a holding period of less than 3 years. The practical effect, therefore, is that owners of such profits interests will be taxed at an ordinary income rate for dispositions with a holding period of 1 to 3 years, and may have been caused in many cases inadvertently, they also could be useful in cases if triggered intentionally such as to make a different Code Section 754 election (other than with respect to the incoming partner) or employ different Code Section 704(c) allocation methods.

Unrelated Business Taxable Income

Unrelated business taxable income (UBTI), in the case of multiple investments in separate unrelated trades or businesses made by a single tax-exempt organization, is now computed separately for each trade or business, including any NOL resulting from a particular trade or business, so that loss from one trade or business cannot offset UBTI incurred from another. IRC § 512(a)(6).

Like-Kind Exchanges

Like-kind exchanges, which were previously available for investment property other than real property used in a trade or business, are now limited only to real property. § 13303 of the Act.

Accounting Methods

The cash method of accounting is generally prohibited for C corporations (other than personal service corporations) or partnerships with a C corporation partner, but with a gross receipts floor amount that exempts smaller businesses. That amount has been increased to $25,000,000, adjusted for inflation, up from $5,000,000 previously, of the average annual gross receipts of the business for its prior 3 taxable years. IRC § 448(c)(1).

The accrual method of accounting used by businesses is now subject to a limitation on the "all events" test whereby income is required to be recognized for tax purposes no later than it is recognized in certain financial statements for a business, including audited financial statements provided to a third party such as a lender or investor. IRC §§ 451(b)(1)(A); -(3)(A)(ii). Additional flexibility is added, however, for recognition of advance payments, other than rent, insurance premiums, payments on financial instruments, and certain other payments, which may now be elected to be deferred until the year following the year in which they are received (subject to the requirement that they be included in income earlier as a result instances, there still remain questions that will need to be answered as to determining the actual holding period to be applied against the profits interests, and a misalignment of incentives is now potentially created between service providers and capital investors in the investment management context.

Another material issue in the statute is that an "applicable partnership interest" does not include "any interest in a partnership directly or indirectly held by a corporation." IRC § 1061(c)(4)(A).

While the aim of the statute certainly was to exclude C corporations, which incur an entity level tax, the intended treatment of interests owned by S corporations, for which income is taxed to individual shareholders on a pass-through basis, and whether S corporation shareholders should also be subject to the new holding period limitation, is unclear. Based on the express terms of the statute, a profits interest housed in an S corporation would not be subject to the limitation, although Treasury has indicated an intent to issue guidance to close the "loophole."
of being recognized in a financial statement). IRC § 451(c).

Any change in the accounting methods used by a business as a result of the increased exemption for small businesses, the financial statements limitation, or the permitted advance payments deferral is to be adjusted in accordance with Code Section 481, including by obtaining the consent of Treasury. § 13221(d) of the Act.

Planning Considerations

For businesses, it is important when considering tax planning objectives that advisors take a holistic approach, as tax benefits brought about by one provision of the Act might have an offsetting effect on another. Effective planning will involve all types of advisors—attorneys, accountants, business advisors both inside and outside of a business, life insurance advisors, financial advisors, and any other parties having input as to the operation and ownership of a business—to arrive at a solution that is both beneficial and workable. Situations are rarely the same, but there are general starting points for various options to be evaluated. From there, models employing different assumptions can be fine-tuned to make projections suggesting an appropriate course of action.

Choice of Entity

The most fundamental principle guiding business tax planning is the form of entity a business chooses to assume, both at inception and, in some cases, later over the course of its existence. A C corporation, S corporation, limited liability company, and partnership now each offer separate potential advantages and disadvantages to a business dependent on its operations and assets, the stage of its lifecycle, and its anticipated income or loss and cash flow.

Based on tax rates, for example, a C corporation, with income initially to be taxed at an entity-level 21% rate and with distributions thereafter assumed to be taxed at a deferred 23.8% rate—which, at a 35% entity-level rate previously, was a non-starter for many businesses—could now be considered most advantageous on a purely hypothetical basis compared to an up-front rate of up to 40.8% taxed to individuals owning interests in S corporations or partnerships (assuming that an S corporation shareholder or partner of a partnership is taxed in the highest individual bracket and remains subject to the 3.8% net investment income tax (NIIT), which must be applied to C corporation dividends). A C corporation arrangement might also possibly meet the requirements of a qualified small business so that all or a portion of income from a later stock sale is excluded from an owner’s income under Code Section 1202.

Business owners, however, should consider any rate arbitrage together with the risk inherent in having a business housed in a C corporation in the event the corporate tax rate is later increased. C corporation owners also must contend with accumulated earnings taxes or personal holding company taxes, which are imposed to prevent attempted deferrals for obtaining a lower effective tax rate. A C corporation might block losses that would ultimately be better used by an individual owner on a pass-through basis, if not hampered by the excess business loss limitation. A C corporation’s income will not qualify for the Code Section 199A deduction to its business owners.

There is no one-size-fits-all approach. There are a multitude of additional considerations that drive a choice of entity, which may ultimately outweigh basic income tax rate efficiency, in some cases to a large degree. Among others, business owners will want to consider the following:

- The need to provide preferred returns to certain owners.
- The need to attract certain types of investors, such as tax-exempt organizations, foreign investors, or venture capitalists, all of which, for various reasons may prefer a C corporation (or the use of a “blocker” C corporation as an investment vehicle).
- The possibility of in-kind distributions of property to owners.
- The need for special allocations of items of gain, loss, deductions, or credits or for a particular owner to be allocated liabilities of the business.
- The benefit of adjusting the “inside basis” of business assets upon the occurrence of certain events.
- A desire to make charitable contributions of business property.
- The use of a fiscal year of reporting not tracking the calendar year.
- Whether business owners also serve as employees or otherwise provide services to the business.
- Fringe benefits provided to employee-owners.
- The ability to issue equity compensation.
- The application of employment and Social Security taxes.
- The application of the NIIT.
- The application of state franchise and excise taxes.
- The application of the AMT to individual owners.

As a general matter, it is much easier to move assets into a business entity at the outset of a business venture than it is to move them from a business entity in one form to another, and for existing businesses, reversing course after an initial choice of entity might prove challenging as a result of negative tax consequences from any transition. The effects of converting to and from C corporations, S corporations, and partnerships or otherwise moving assets among them are most notably dependent upon the built-in gain or loss of the owners’ interests in a business, the built-in gain or loss of the assets owned by the business, the types of assets owned by the business, and the outstanding liabilities of the business at the time a conversion in corporate form might take place. A highly leveraged business with depreciable assets or with a low asset turnover (resulting in a larger mismatch between basis and fair market value) might experience a much more dramatic tax effect upon a conversion than a business with little leverage and little built-in gain or loss in its owners’ interests and its assets. A conversion from one corporate form to another might also require significant ancillary administration and legal work, such as revisiting material contracts, redoing payroll and employee benefits, and staff training. That all being the case, an existing business likely will, first, want to evaluate a reorganization within its current form before undergoing such a significant change.

Restructuring and Reorganizations

Because a wholesale conversion from one form to another might prove to be too burdensome, businesses, particularly pass-through businesses, should first consider options to reorganize and restructure tax items within their current forms to the extent necessary to obtain a tax benefit.

In the case of pass-through businesses, a large part of that analysis will involve taking full advantage of the Code Section 199A deduction. For both specified service business and non-specified
service businesses alike, business owners having income in excess of the phase-out thresholds, in the case of specified service business, and the phase-in thresholds, in the case of non-specified service businesses, may be able to minimize the effects of the phase-out or phase-in using various techniques, some more involved than others.

For non-specified service businesses where the owners are subject to the qualified property and W-2 wage phase-in thresholds, immediate expensing of property might reduce taxable income, for example, but the expensed property is then not eligible to count as qualified property since it is not considered depreciable property. A simple alternative might be to use bonus depreciation as a substitute, which achieves a similar objective in an immediate reduction of income and also allows the depreciated property to be deemed to be placed in service for the minimum 10 year term for purposes of the pass-through deduction. As another simple measure, independent contractors working primarily for a single business might be hired full time as employees to increase W-2 wages. Implementing a retirement plan may reduce an owner-employee's income below the threshold amounts, keeping in mind the offsetting effect a retirement plan has on W-2 wages.

For either specified service businesses or non-specified service businesses with insufficient W-2 wages and qualified property, non-grantor trusts might be used to disperse taxable income so that it is separately earned in amounts falling within the phase-out or phase-in thresholds, although in the case of specified service businesses, there also may be difficult non-tax considerations to address, such as whether particular businesses can be owned by non-professionals under applicable state law. Depending on the particular tax circumstances of an individual owner, these trusts may or may not be structured as completed gifts for federal gift tax purposes to remove the business interests from the owner's taxable estate for estate tax purposes. In any event, the fact that a trust will have its own separate threshold amount for pass-through income may result in an additional deduction, and multiple trusts can be used to leverage additional deductions.

Take the case of a married taxpayer with 4 children and 2 grandchildren and who owns a business generating $1,260,000 of QBI a year. A non-grantor trust for each descendant as the primary beneficiary could be created to absorb taxable income up to the $157,500 threshold for individual taxpayers and bring the taxpayer's own taxable income down to the $315,000 threshold for married taxpayers, resulting in annual savings after giving effect to the deduction of up to $11,332 per trust (ignoring the rate differential thresholds between individual taxpayers and trusts) and up to $12,836 for the taxpayer, dependent on the other taxable income included on the taxpayer's individual return, or up to $80,828 total per year. If a greater amount of QBI is being generated, in the case of a business earning $3,150,000, for example, and distributions are also separately made in respect of individual descendants (or trusts to which they are the taxpayers as a result of having a withdrawal right under Code Section 678), total savings could be obtained of up to $157,844 per year, although the actual amount of savings could very well be lower depending upon the descendants' marital status and the other taxable income included on the descendants' individual returns. Nonetheless, non-grantor trust arrangements such as these might also allow for multiple state and local tax (SALT) deductions for which an individual taxpayer would not otherwise be eligible, as well as deductions to be taken for administrative fees. Conversely, however, the potential application of the NIIT would have to be considered, as well as the disallowance of expensing deductions under Code Section 179 in the case of non-grantor trusts.

Businesses with consolidated operations might also consider segmenting separate lines of business so that specified service businesses are segregated from non-specified service businesses. If, for example, a business owns its own real estate for its operations, consider whether a related party lease, the rent for which is deductible by one party as a business expense and the QBI for which is deductible by the other under Code Section 199A, might be an option between affiliated entities. Some businesses could form a separate management company and outsource their back office services to a specified service business. These means of "earnings stripping" might allow for a full business expense deduction on one end and a pass-through deduction of 20% of the QBI generated from that expense on the other. While it is likely that tiered entity regulations will attempt to address situations such as these, there could be structures, created also to serve a non-tax business purpose, that could reach a beneficial tax result.

Like a wholesale conversion in corporate form, any restructuring process will potentially involve revisiting material contracts, retitling assets, and obtaining consents from lenders and owners, so the amount of effort involved should be evaluated at the outset before proceeding.

Income Recognition, Expensing, and Deleveraging

In light of new limitations on losses, deductions, and expenses now imposed under the Act, taxpayers will need to become more aware of the timing of income and how it can best be offset or managed within these new parameters. Businesses may consider reducing outstanding debt if they are now subject to the interest expense limitations. A decision between expensing or depreciating property will become important based on its ultimate impact on a taxpayer's income recognition and the effects that has on loss limitations and deductions.

Managing income streams will be particularly important for taxpayers seeking the pass-through deduction. For charitably inclined taxpayers, a charitable remainder trust might allow income to be efficiently recognized over time while also achieving a taxpayer's charitable objectives. The use of non-grantor trusts might also allow income to be streamlined through the flexibility afforded to trustees with the 65-day rule for trust distributions. In any event, businesses will need to make projections and put together models so that they are able to gauge expectations in terms of income and deductions so as not to miss tax savings opportunities.

Buy/Sell Arrangements and Corporate Life Insurance

Buy/sell arrangements will need to be evaluated in the context of any reorganization or restructuring among business owners to ensure that they are still consistent with each owner's individual goals as well as the welfare of the business itself. Given the increase in the estate tax exemption (at least through 2025), perhaps liquidity will be less of a concern upon death for some owners and, therefore, the need for a buyout upon an owner's death can be revisited, particularly for an owner who does not have a management role in the business.

As a result of the repeal of the corporate AMT, life insurance might also now be used as a buy/sell redemption funding mechanism for C corporations not previously exempt from the corporate AMT or which...
otherwise risked becoming subject to the corporate AMT upon the receipt of policy proceeds. This approach could simplify a redemption of corporate stock at a shareholder’s death in lieu of each of the remaining shareholders maintaining separate policies and allow for better pricing on a single policy versus multiple policies that are separately owned.

**Final Thought**

The Act has presented numerous challenges to future tax planning for businesses, and accordingly, an understanding of the reform is important, together with consideration of the uncertainty that remains. Significant opportunities exist for effective tax planning, and with a thorough analysis of the provisions of the Act and the manners in which they interact, business owners, operators, and advisors can adapt effectively.

Thomas Cooper is an attorney in the Charlotte, North Carolina, office of Moore & Van Allen PLLC.

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**Recent Developments**

By the Trusts and Estates Team of Moore & Van Allen PLLC

### Federal Statutes

**New Tax Act Passed.**


### Federal Cases

**Estate and trusts funded from estate liable as transferees for corporate income tax unpaid after sham transaction.**

In Billy F. Hawk, Jr., et al. v. Commissioner, T.C. Memo 2017-217 (Nov. 6, 2017), a decedent’s estate and surviving spouse were the successors-in-interest to the decedent’s bowling alley business, which was organized as a C corporation. After the decedent’s death, the estate and surviving spouse caused the corporation to sell its bowling alley-related assets, causing a $2.7 million gain. Then, in the same calendar year, the estate and surviving spouse participated in a sham transaction that purported to be a sale of the corporation’s stock to a third party buyer for cash, but the buyer essentially paid the purchase price to the shareholders with the corporation’s own money. The buyer paid a premium for the stock above the amount of the corporation’s net assets as reduced by the built-in capital gain, representing that it could offset the built-in capital gain with operating losses from other businesses the corporation would undertake after the stock sale and therefore cause the corporation to pay no capital gains tax. In reality, the corporation was essentially liquidated in favor of the shareholders and the buyer, and it subsequently existed as a shell for several years without ever paying any income tax. The Service issued a notice of deficiency, and finding the corporation insolvent, it proceeded against the estate, the two marital trusts funded from the estate, and the surviving spouse for the unpaid corporate income tax, including penalties and interest, under the transferee liability provisions of Code § 6901. The Tax Court upheld the Service’s assessment, except that it did not hold the transferees liable for interest on the unpaid tax that accrued before the Service’s notice of transferee liability. Critical to the Service’s ability to recover from the transferees was the determination that the “sale of stock” by the shareholders to the buyer could be recharacterized under applicable state fraudulent transfer law as a distribution from the corporation to the shareholders.

**Loss-related income tax deduction denied, penalty imposed, in transaction lacking economic substance.**

In Robert E. Smith, III, et ux. v. Commissioner, T.C. Memo 2017-218 (Nov. 6, 2017), two taxpayers contributed personal assets to an S corporation in exchange for stock. The S corporation then contributed the assets to a limited partnership, which was controlled by the taxpayers, in exchange for a limited partnership interest. Later that same year, the S corporation dissolved and distributed the limited partnership interest to the taxpayers. The taxpayers then claimed a loss-related income tax deduction based on the value of the distributed limited partnership interest, which the taxpayers claimed was discounted for lack of control and marketability, being less than the value of the assets the taxpayers contributed to the S corporation. The Service applied the economic substance doctrine to deny the loss deduction and assessed an accuracy-related penalty for the underpayment of tax. The Tax Court upheld the Service’s position, finding that the S corporation had no genuine business purpose and was organized solely for tax avoidance and that the taxpayers did not act in good faith or in reasonable reliance on the advice of a tax professional.

**Conservation easement deduction denied when mortgage lender’s rights were not subordinated to rights of charitable grantee.**

In Palmolive Building Investors, et al. v. Commissioner, 149 T.C. No. 18 (Oct. 10, 2017), the Tax Court denied an income tax deduction for the grant of a façade conservation easement because the conserved property was subject to a mortgage; the mortgage lender retained rights to any proceeds of the conserved property (up to the then outstanding amount of its loan) that followed any judicial extinguishment of the conservation easement, which extinguishment could occur if the property containing the façade were destroyed and insurance proceeds claimed with respect thereto; and the mortgage lender’s rights to such proceeds were superior to those of the charitable recipient of the conservation easement. Regulation § 1.170A-14(g) requires the charitable recipient of a conservation easement to be entitled to a ratable portion of any proceeds from the conserved property following the judicial extinguishment of the conservation easement and forbids any mortgage lender from having superior rights to the charitable recipient in the conserved property. The court denied the taxpayer’s argument that the circumstance of the destruction of the conserved property was so remote...