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FIRM NEWS

DeEtte Loeffler will be speaking at the Museum of Photographic Arts on The Art of Estate Planning on Thursday, September 13, 2018. The event goes from 10 AM to 12 PM. If you would like to attend, please click the link below and RSVP!
RSVP Here!

IN THIS ISSUE

TREASURY ISSUES PROPOSED REGULATIONS FOR SECTION 199A: MORE GUIDANCE PROVIDED FOR SPECIFIED SERVICE BUSINESSES

By Katie Lepore, CPA, J.D., LL.M., Taxation

On August 8, 2018, the IRS and Treasury Department issued long-awaited proposed regulations for Section 199A. The proposed regulations are "reliance regulations" in that taxpayers who complete transactions based on the language of the proposed regulations will not be penalized if the final regulations change interpretations of the Section.

Section 199A was codified in December 2017 with the Tax Cuts and Jobs Act. It provides a 20% deduction for pass-through income for qualified businesses. Pass-through entities include partnerships, limited liability companies, subchapter S corporations, and sole proprietorships. The deduction is applied differently to taxpayers depending on where they fall among three different taxable income levels. The deduction is also applied differently for certain types of businesses called "specified service businesses" which are specifically identified to not receive favorable tax treatment. Until the proposed regulations were released, there was much uncertainty about what trades and businesses qualified under the broad categories of specified service businesses.

Specified Service Businesses

The Section states that the following are considered specified businesses which are to receive less favorable tax treatment: Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and 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.

The proposed regulations identify certain professions and businesses within each of these broad categories that are non-specified and therefore eligible for the full 20% deduction, and some which are specified and therefore receive unfavorable tax treatment:

Specified businesses and professions include:

- *health:* doctor, pharmacist, nurse, dentist, vet, physical therapist, psychologist
- *law:* lawyer, paralegal, arbitrator, mediator
- *accounting:* accountant, enrolled agent, return preparers, financial auditors, bookkeepers
- *actuarial science*: actuaries
- *performing arts:* actors, singers, musicians, entertainers, directors
- *consulting:* "professional advice and counsel to clients to assist the client in achieving goals and solving problems," including lobbyists
- *athletics:* athletes, coaches, team managers
- *financial services:* financial advisors, investment bankers, wealth managers, advising clients with regard to finances, retirement planner, M&A, valuations, underwriting
- *brokerage services*: securities brokers
- *investment and trading*: securities traders and asset management

Non-specified businesses and professions include:

- *actuarial science:* economists, analysts, mathematicians, statisticians
- *financial services*: banking
- *brokerage services*: real estate agents and brokers, insurance agents or brokers
- *investment management*: real estate management

As for the specified businesses where "reputation or skill" is the principal asset, there is a narrow definition: 1) endorsements, 2) income for use of your likeness, image, trademark, etc., and 3) appearance fees.

There is much more to the proposed regulations for this complicated Code Section, but the IRS guidance will be helpful to taxpayers and tax advisors alike to determine how best to plan for this new deduction.

WOULD HAVING A GRANTOR TRUST REDUCE TAXES?

By DeEtte L. Loeffler, J.D., LL.M., Taxation

There has been much discussion in recent years about using "grantor" trusts in tax planning to reduce income taxes. This article gives an overview of these trusts, their taxation, and whether a grantor trust might be an appropriate part of your estate plan.

What are Grantor Trusts? In a nutshell, a trust is a grantor trust if the income of the trust is taxable to the "grantor" under Internal Revenue Code Sections 671-679. A grantor includes any person to the extent that person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.[i] This includes trustors/settlors, beneficiaries who hold or release a general power of appointment, and others who add assets to the trust. Grantor trusts include not only revocable trusts but also irrevocable trusts such as Intentionally Defective Grantor Trusts (IDGTs), Grantor Retained Annuity Trusts (GRATs) and Qualified Personal Residence Trusts (QPRTs).

What Powers or Interests Make a Trust a Grantor Trust? If a grantor holds or retains certain powers listed in IRC Sections 673-678, the trust will be a grantor trust. These include: (i) a reversionary interest in the assets of more than 5%, (ii) the power to control beneficial enjoyment of the trust assets, (iii) the power to deal with the trust for less than full and adequate consideration; (iv) the power to revoke the trust and obtain the assets; (v) a financial benefit for the trustor; or (vi) a general power of appointment over the assets (for the assets to which the power applies).

Why Might You Want a Grantor Trust? The income of grantor trusts is taxable to the grantor instead of to the trust. Since trusts are taxable at the highest income tax rate (37% in 2018) when their income reaches $12,501, and single individuals do not reach the top tax rate until their income reaches $500,001, less overall income tax might be paid. In addition, if the trust holds assets that are encumbered and that trust's income pays down debt, the trust may not have sufficient cash with which to pay taxes. A grantor trust also allows for faster growth of the trust assets since they grow free of the tax burden. An added benefit is that the payment of income taxes for the trust is not treated as an additional taxable gift by the trustor. If the trust has losses, these also are passed through to the grantor who may be able use the losses (so they are less likely to be suspended at the trust level or wasted). Grantor trusts that allow income to be accumulated can also hold interests in S Corporations (since otherwise they must make an election under the ESBT or QSST rules to distribute the income to the trust beneficiaries). Finally, a grantor trust can engage in tax free transactions with the grantor since these transactions are disregarded for income tax purposes.

Why Does This Work? Planning with grantor trusts works because of differences between the rules for income taxes and gift taxes. A gift is "complete" for gift tax purposes when the trustor relinquishes dominion and control over the assets.[ii] That same gift can be incomplete for income tax purposes under IRC Sections 671-679 if the grantor retains certain powers or controls. Grantor trust planning involves simply taking advantage of these differences to minimize the income tax burden without also bringing the trust assets back into the trustor's taxable estate at death.

What Is the Safest Way to Make an Irrevocable Trust a Grantor Trust? The IRS has provided approved forms to use for QPRTs and GRATs which if followed will result in a trust being accepted as a grantor trust. Drafters who modify the IRS approved form to address state specific law, or options the client would like included, are not guaranteed of approval but the trust may still be approved as long as certain basic requirements are met.

For other types of trusts, including IDGTs, certain powers or interests retained by the settlor, or granted to the Trustee, are considered "safe" because the IRS has either not challenged them or has tacitly approved them. The following are generally considered to be safe ways to make a trust a grantor trust: (i) giving the trustor the power to remove and replace trust assets; (ii) giving the trustee the power to pay premiums for life insurance on the life of the trustor or trustor's spouse; (iii) allowing the trustee to make loans to the trustor without full and adequate consideration; and (iv) allowing the trustee to add charities as beneficiaries.

Terminating Grantor Trust Status. Sometimes the trustor will want to stop having to pay the taxes on a trust. This happens most often when the trust now has sufficient income with which to pay the income taxes and the trustor's personal income stream has decreased. It can also happen when the losses in a trust are used up.

Grantor trust status can change if the trustor relinquishes the power to remove and replace assets. It can also change if the trustee relinquishes its powers that caused the trust to be a grantor trust. Each of these is a permanent change, however. It is also possible to draft a trust to permit grantor trust status to be added or removed by a third party who is neutral (i.e., is not a "related or subordinate person" under IRC Section 672 whose powers could be attributed to the trustor and cause a taxable gift, or an "adverse party" under IRC Section 672 whose exercise of the power could also be treated as a taxable gift to the extent the adverse party's interests in the trust are reduced).

This might be accomplished by giving a neutral party a power (in a non-fiduciary capacity) to add or remove a general power of appointment over some or all of the trust assets. The general power would cause the recipient of the power to be taxed as the grantor of the affected assets for income tax purposes but also for estate tax purposes (thus allowing a basis adjustment at the recipient's death). For example, this power might be exercised to grant a surviving spouse a general power of appointment over the assets in the bypass trust, thus causing inclusion in the estate of the surviving spouse and obtaining a basis step-up at his or her death (assuming this will not also cause the estate of the surviving spouse to have to pay an estate tax, of course).

There are risks associated with this option, however. For example, it may be difficult to find someone willing to change the ultimate beneficiaries of the trust for fear of being sued by the persons who would previously have received the assets. In addition, the recipient of the general power must be competent to exercise that power once granted. The person holding the power to grant a general power of appointment should not wait until so close in time to the recipient's death that he or she is no longer competent. Finally, the IRS will look very closely at any such exercise and may challenge it, thus potentially tying up the trust administration in the dispute process.

Grantor trusts are not appropriate for everyone. However, they might be helpful in reducing current or future income taxes if used in the appropriate situation. We would be happy to speak with you if you have questions about whether including a grantor trust in your estate plan might be appropriate.

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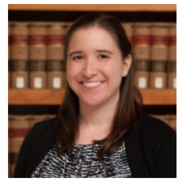
[i] 26 CFR 1.6712(e)(1).

[ii] 26 CFR 2511-2.



FEDERAL TAX UPDATE

By Katie Lepore, CPA, J.D., LL.M., Taxation

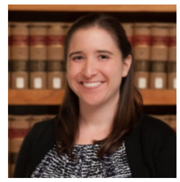
Trump Administration Considers Taking Inflation Into Account When Calculating Capital Gains. The Trump Administration via Treasury Secretary Steven Mnuchin reported to the New York Times on July 30 that it was considering changing tax definitions to take inflation into account when calculating capital gains. The Treasury Department is undecided whether to propose such changes and even further undecided whether the changes could be made unilaterally by the Treasury Department or whether legislation would be needed from Congress. The proposal would adjust a taxpayer's cost basis for inflation to the year of sale so that the capital gain would be calculated based on a sales price and cost basis equalized to value of the same inflationary year. For instance, a stock purchased in 1990 and sold in 2018 would have its cost basis adjusted from 1990 values to 2018 values for a calculation of how much the stock actually appreciated in value over the years after removing inflation. As of yet, there have been no official proposals in Congress or through the Treasury Department.

ABLE Account Contribution Limits. On August 3, 2018, the IRS issued Notice 2018-62 which announced that the Treasury Department and the IRS intend to issue proposed regulations regarding ABLE accounts. ABLE accounts are tax-advantaged savings accounts for persons with disabilities. Currently, the maximum that can be contributed to the account in any given year is the amount of the annual gift exclusion ($15,000 in 2018). The Notice provides that in addition to the annual gift exclusion, a designated beneficiary who works may also contribute "up to the lesser of the designated beneficiary's compensation for the tax year, or the poverty line for a one-person household in the state in which the designated beneficiary lives." However, if a designated beneficiary is employed and also contributes to a tax-deferred retirement plan, he or she will be limited to the annual gift exclusion.

Switching to Cash Method of Accounting. The Tax Cuts and Jobs Act expanded the number of businesses which could use the cash method of accounting instead of the accrual method of accounting. Companies that are eligible to do so are those with average annual gross earnings of $25 million or less in the prior three-year period. On August 3, 2018, the IRS issued Revenue Procedure 2018-40 outlining the process for small businesses to obtain automatic consent to change accounting methods.

Treasury Issues Proposed Regulations on Depreciation. On August 3, 2018, the IRS and the Treasury Department issued proposed regulations on Section 168(k), which allows taxpayers to fully expense (often dubbed "bonus depreciation") business assets purchased and placed in service after September 27, 2017 and before January 1, 2023. The proposed regulations include guidance on requirements to qualify for the deduction, how to calculate the deduction, and the amount of depreciation allowed.

IRS Issues Proposed Regs About the SALT Deduction. The IRS issued proposed regulations regarding the $10,000 cap on state and local tax deductions as an itemized deduction. As previously reported in our MMPPH newsletters, various states were considering implementing laws allowing taxpayers to pay their state income taxes to a state-sanctioned charitable fund so taxpayers could deduct the payments as charitable contributions, which do not have a $10,000 cap. In response to these proposals, the IRS issued a notice saying proposed regulations were forthcoming and such schemes would not be upheld. The recently issued proposed regulations state that if a taxpayer does opt to pay into a state charitable fund, the value of the "donation" must be reduced by any state tax benefit the taxpayer receives for paying taxes in such a way. For instance, a tax payment of $20,000 to the state charitable fund may yield a $4,000 state tax credit (at a 20% rate), so the taxpayer needs to reduce his charitable deduction by $4,000 and only report a deduction of $16,000 on his federal tax return. This is based on the long-standing rule that the value of a charitable donation is only for the portion of a gift for which the taxpayer does not receive a benefit. There are de-minimus exceptions in the proposed regs if the credit is less than 15% of the payment.



STATE TAX UPDATE

By Katie Lepore, CPA, J.D., LL.M., Taxation

Trust Decanting. As first introduced in our August 2018 newsletter, a bill authorizing trust decanting made its way through the California legislature, passing the Assembly on August 16, 2018. It was approved by the Senate and is currently on Governor Jerry Brown's desk. Introduced by Senator Hertzberg (D-Van Nuys), SB 909 allows trustees to decant a trust and will add Sections 19501 through 19530 to the California Probate Code. Decanting is a common tool used on the East Coast where a fiduciary can distribute the assets from one trust into a second trust without the approval of the beneficiaries. Currently, the California Probate Code allows for a trust to be modified with the consent of the settlor and all beneficiaries (Probate Code §15400). If the settlor is not alive, beneficiaries may ask for trust modification only with court approval under Probate Code §15403. Decanting would allow a trustee to distribute the trust assets to a new trust that has more updated terms, but is still consistent with the settlor's intent. The proposed text of the new Sections can be read on the California legislature website at: http://leginfo.legislature.ca.gov/faces/billCompareClient.xhtml?bill_id=201720180SB909

Beverage Taxes. On June 28, 2018, Governor Jerry Brown signed into law AB 1838, banning any new taxes on sugary drinks and sodas for 12 years. The beverage industry, including

Coca-Cola and Pepsi Co., backed a ballot measure that would have made it very difficult for the California Legislature to raise local taxes and fees for any other reason going forward. In exchange for passage of AB 1838 banning excise taxes on beverages, the ballot measure was withdrawn. Four cities in the Bay Area can keep their existing soda tax in place. Public health officials, the California Medical Association, and the California Dental Association have criticized the decision saying soda leads to obesity, diabetes, and tooth decay. On July 2, these groups filed a proposed ballot initiative for vote in 2020 to repeal the ban. According to the American Dental Association, "[t]he 2020 ballot initiative by the California Dental Association and California Medical Association would implement a statewide 2-cents-per-fluid-ounce tax on sugar-sweetened drinks and is estimated to provide about $1.7 billion in revenue for health programs."[1]

Senate Bill 1192 would do an end run by prohibiting restaurants from serving soda to minors without parental consent. The bill would limit restaurants to only serve milk or water. The bill passed the State Assembly in August and was returned to the Senate for re-approval. It was presented to Governor Jerry Brown on August 28.

Tax Relief for Disasters. The California Department of Tax and Fee Administration (CDTFA), has authorized business owners and taxpayers affected by the July 2018 San Diego fires to qualify for tax relief including the extension of tax return due dates, relief of penalty and interest, or replacement copies of records due to the disaster. Other disasters allowed relief for 2018 include January mudslides in Santa Barbara and Ventura, April rainstorms in several counties in Northern California, July rainstorm in San Bernardino, July fires in Northern California and Santa Barbara, and August fires in Orange and Riverside. The CDTFA's major responsibility relates to collecting sales and use taxes or other excise taxes.

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[1] https://www.ada.org/en/publications/ada-news/2018-archive/july/california-dental-medical-associations-want-voters-to-decide-soda-tax-in-2020

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