

FEATURE: ESTATE PLANNING & TAXATION



By **Charlie V. Douglas** & **Blake N. Melton**

A Multidisciplinary Approach to the New Tax Law

Greater complexity warrants greater collaboration

Representing the largest overhaul of the U.S. Tax Code in more than 30 years, the Tax Cuts and Jobs Act of 2017 (the Act) was supposed to provide tax simplification. Yet, the Act is full of phase-outs, phase-ins, threshold limitations and ill-defined terminology. Instead of tax simplification, many taxpayers and advisors are faced with tax complication.

No single planning discipline has the expertise to adequately address the many facets of the Act. Providing proper planning advice in view of the sundry of complexities of the Act will require greater collaborative efforts by the multidisciplinary team. From the newly added Internal Revenue Code Section 199A, to the doubling of the estate, gift and generation-skipping transfer (GST) tax exemptions, new planning opportunities and pitfalls present themselves.

Enhancing the collective wisdom of the multidisciplinary team after the Act will entail greater efforts toward mutual communication, coordination and cooperation among planning peers. The goal of delivering effective and exceptional planning advice through collaborative team efforts can be both personally and professionally rewarding. Still, the collaboration road is an uphill challenge, requiring collective team effort and intentionality.

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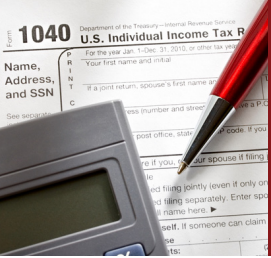
Filling the Estate Tax Void

Perhaps we find collaboration in estate planning to be so challenging because there's no agreed-on definition of what estate planning is. Surprisingly, neither academics nor such leading institutions as the National Association of Estate Planners & Councils, the American College of Trust and Estate Counsel and the American College of Financial Services have a common definition.

Understandably, the public seems to be confused as to what estate planning is and how best to go about it. According to a recent WealthCounsel survey, three-fourths of Americans are confused regarding their thoughts about estate planning.¹ This lack of clarity around estate planning may help explain the lack of public engagement (64 percent of Americans don't have a will).²

For years, leading with estate tax minimization and tax saving strategies was an effective way to get clients in the door to do proper estate planning. Post-Act, however, the estate tax minimization card is missing from the deck for more than 99 percent of the public. As practitioners seek to fill the estate tax void, they may do well to expand their services to include more qualitative aspects of legacy planning that involve intangible client discernment, in addition to the quantitative planning techniques of estate planning that result in tangible client deliverables.

The definition of "estate planning" should be enduring and unchanging. However, the expression of estate planning must continually adapt and change with the times. In its most fundamental form, estate planning should support the family (or the individual) first, and thereafter concern itself with the tax-efficient transition of assets. Simply put, estate planning should be a multidisciplinary process in which planning professionals are collaboratively engaged in nurturing, protecting and enhancing the family through the accumulation,



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conservation and distribution of one's assets and values.

It stands to reason that if the multidisciplinary team has a better understanding of what they're collaborating about and what they're trying to accomplish from an estate-planning perspective, they can more effectively advise the client in helping him to achieve his goals.

IRC Section 199A

When it comes to business planning, estate planners have long focused on intrafamily discounts of closely held business interests. Recapitalizing closely held companies into voting and non-voting interests and then gifting or selling the non-voting interests for discounted values into intentionally defective grantor trusts, for

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example, has been a staple business and estate tax planning strategy for many years. And, intrafamily discount strategies should continue unabated for the foreseeable future since the Treasury Department withdrew its proposed regulations under IRC Section 2704 toward the end of last year, which would have reduced or eliminated certain valuation discounts for family owned and operated businesses.

Even so, intrafamily discount planning primarily focused on the succession of the entity, not on the revenue and the operation of the business or the income tax intricacies regarding the choice of the business entity. That all changed, however, with new Section 199A. Planning advice must now factor in the more complicated choice of entity and the operational revenue of the business. With business planning complexity increasing, collaborative team efforts should likewise increase, including the business owner as operator and stakeholder and perhaps senior level managers with active day-to-

day management roles.

From a business planning standpoint, the provisions of the Act that will most commonly impact the choice of entity are the flat 21 percent corporate rate for C corporations (C corps) and the potential deduction of 20 percent regarding qualified business income (QBI) for passthroughs under Section 199A. In many instances, choosing to conduct business through a C corp or a pass-through entity will depend on whether the Section 199A deduction will be available.

Consider that without the Section 199A deduction, the combined effective tax rate of a C corp, even taking into consideration the double tax, is slightly more favorable than the highest marginal tax rate for individuals with pass-through income—39.8 percent versus 40.8 percent, respectively.³ And, C corps offer another advantage over passthroughs because earnings can grow on a tax-favorable basis before being subject to a second tax on distribution.

At first glance, Section 199A seems to be straightforward. In general, it provides a deduction equal to the sum of 20 percent of the QBI of each of the taxpayer's qualified businesses that operate as pass-through entities, such as sole proprietorships, S corporations, limited liability companies, trusts, estates or partnerships. Thus, eligible taxpayers can claim a 20 percent deduction and realize a maximum effective tax rate of 29.6 percent (37 percent x .80) on a taxpayer's QBI earned in a qualified trade or business (QTB).

But, first glances can be deceiving. Section 199A is extraordinarily involved, and it should be approached with great caution in light of the significant understatement penalty that comes with it. Even the most experienced tax professionals are often left wanting regarding how to correctly interpret Section 199A. A recent letter from the American Institute of CPAs to the Internal Revenue Service identifies a plethora of areas requiring guidance, including Section 199A.⁴

Critical definitions regarding this new section are less than clear. For example, QBI is generally the net amount of income, gain, deduction and loss from an active trade or business in the United States, but it excludes certain types of investment income such as capital gains, dividends and interest. Notably, however, there are a multitude of deductibility limitations on wages and qualified property that are allocable to particular qualified trade or business activities that must also be considered.

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Now consider QTBs, which include all trades and businesses except the trade or business of performing services as an employee and specified service businesses (SSBs), such as health, law, accounting, consulting, athletics, financial services, brokerage services, investing, investment management, trading and dealing in securities or any business in which the principal asset is the reputation or skill of one or more of its owners.

Importantly, any business that isn't an SSB is considered to be a QTB. Therefore, if the taxpayer has QBI exceeding the threshold amount, determining whether his business is an SSB or a QTB is critical in determining whether the QBI from that business will qualify for the 20 percent deduction. However, distinguishing an SSB from a QTB can be tricky, and much more guidance is needed from the IRS.

Under Section 199A, many planning considerations, questions and issues arise for the multidisciplinary team, such as:

- Whether a business entity should be structured as a C corp to take advantage of the lower tax rate on current income (perhaps investment income), understanding that a subsequent dividend tax applies when dividends are withdrawn by shareholders.
- Should business owners of passthroughs allow more employees to become partners so that some or all of their compensation will constitute QBI. If so, what might be the impact on the control of the entity, the owner's estate plan, buy/sell planning and other ancillary concerns? Could more workers possibly be paid as true independent contractors?
- Whether the taxpayer may consider a management company to be an integral part of the operating trade or business (and thus, not an SSB) if substantially all of the management company's income is from that other trade or business.
- Should an SSB be sliced and diced into a separate firm(s) that might provide ancillary support services



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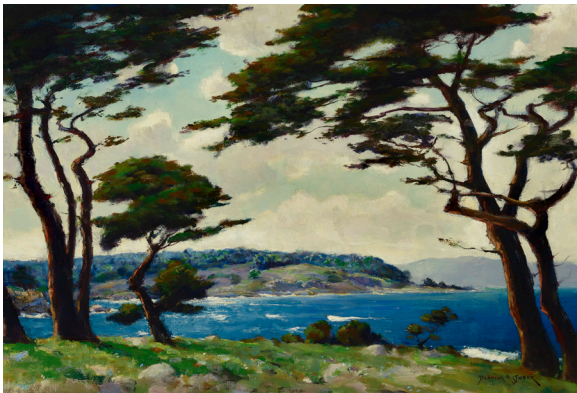
(for example, IT or accounting), in the hopes that the ancillary support services charged to the SSB would qualify for the 20 percent deduction?

- What will be the impact on buy/sell agreements, life insurance arrangements and estate plans should a client restructure his business entity to capitalize on Section 199A?
- Should closely held ownership interests be gifted to irrevocable non-grantor trusts because each trust is considered to be a separate taxpayer and has its own independent threshold amount? What about step-up and carryover basis considerations in making a gift?

Achieving optimal results under the many nuances and planning pitfalls of Section 199A will likely require CPAs, tax attorneys and others on the multidisciplinary team to more intentionally collaborate with the business owner. While these concerted efforts may be considerable, they're typically worth it. After all, closely held family businesses are often the most valuable assets in the family enterprise and in the taxpayer's estate.

Increased Planning Considerations

The Act doubles the amount of assets that may be passed on transfer tax free. Specifically, it increases the basic exclusion amount from \$5 million to \$10 million



SPOT LIGHT

En Plein Air

Blue Waters, Monterey by Dedrick B. Stuber sold for \$6,000 at Bonhams' California and Western Paintings and Sculpture auction on Aug. 7, 2018 in Los Angeles. Stuber was a California landscape painter who preferred to work during the early morning hours when the sunrise provided the most appealing light, shadow and color.

(indexed for inflation occurring after 2011) for estates of decedents dying, GST transfers and gifts made after 2017 and before 2026. For 2018, the indexed exclusion amount is \$11.18 million. However, this transfer tax exclusion is set to sunset back to about \$5.5 million (projected indexed amount) in 2026.

Here too, questions, planning considerations and issues abound for the multidisciplinary team in such areas as:

- **Basic estate planning.** Without the goal of estate tax minimization, will clients perceive the need to even do an estate plan or to update the one they have because portability and the doubling of exemptions greatly diminishes tax urgency? Will the non-tax reasons for trusts, namely, management of assets, asset protection and distribution control be enough to spur clients on to act?
- **Fundamental transfer tax formulas.** Will the transfer tax formulas embedded within many outdated estate documents produce unintended funding of bequests? Might credit shelter/family trusts be overfunded (perhaps causing state estate taxes), while trusts like the marital trust remain unfunded altogether? Should planners send letters to clients warning them that their plans should be reviewed in light of the Act and the doubling of the estate tax exemptions?
- **Powers of attorney (POAs).** Should POAs be reviewed and refined with respect to the ability of the attorney-in-fact to make gifts? Perhaps gifts beyond the annual gift tax exclusion should be prohibited in many circumstances.
- **Outdated irrevocable trusts.** Might trust provisions in older irrevocable trusts lack the tax efficiency and asset protection of properly structured dynastic trusts today? Should irrevocable trusts be dismantled if they may no longer be needed for estate tax purposes, or should appreciated assets be distributed out for estate tax inclusion and step-up purposes? What about decanting to modify outdated irrevocable trusts?
- **Life insurance.** Does the doubling of the estate tax exemption eliminate the need for most clients to purchase or maintain existing life insurance policies to pay a federal estate tax? Should practitioners caution clients against canceling existing coverage in view of a future administration changing the estate tax rules?



And, importantly, what was the purpose of the life insurance when the policy was taken out? Does that purpose still exist, and is there a good fit between the type of insurance and the irrevocable trust? If not, might the insurance be canceled or repurposed to meet other planning needs? Should insurance be considered as part of the overall investment portfolio, where it could be positioned to provide an attractive tax-free rate of return for premature death prior to life expectancy and placed into more flexible planning trusts like spousal lifetime access trusts (SLATs)?

- **Basis planning considerations.** Should an IRC Section 2038 power be added to the will or trust to create a mechanism to cause appreciated assets to be included in the client’s taxable estate to achieve a basis step-up?

To Gift or Not to Gift?

Like a new car with more overhead room for taller passengers, the doubling of the estate tax basic exclusion gives more overhead room for wealthier clients to consider making more substantial gifts (between \$5 million and \$11.18 million) without the fear of adverse consequences from an IRS audit. Moreover, *Wandry*-type⁵ defined valuation clauses, designed to control the value of a difficult-to-value asset, may be seen less often with higher transfer tax exemptions.

Making substantial gifts through leveraging the doubled gift tax exclusion is available for eight years through 2025. Undoubtedly, this “use it or lose it” tax provision will motivate some clients to make more substantial gifts before it sunsets in 2026. Other significantly wealthy clients, however, may not be so quick to act. They may rightly remind us of our needless clarion calls for them to consider making gifts back in 2012.

More than ever, the multidisciplinary team is needed to help these clients of means answer the difficult question of “to gift or not to gift?” Making irrevocable transfers of significant wealth is something that should be thoroughly pondered. Should dynastic SLATs be used as a primary planning tool in case access may be needed to the assets transferred? How much can a wealthy client really afford to gift away? How much does a charity or do the children really need? Can we continue to have enduring economic prosperity regarding our portfolios in the face of rising deficits? What about the unknown economic effects of reversing quantitative easing?

In the end, estate and business planning aren’t

static activities that somehow became simplified under the Act. Rather, they became more challenging in many cases, requiring the multidisciplinary team to retool their collective skillset and deepen their ongoing collaborative efforts.⁶

Endnotes

1. https://craft.wealthcounsel.com/images/downloads/Estate-Planning-Awareness-Survey-2016.pdf?_ga=1.2030899371805206389.1478107764.
2. www.usatoday.com/story/money/personalfinance/2015/07/11/estate-plan-will/71270548/.
3. Reuven S. Avi-Yonah, Lily L. Batchelder, J. Clifton Fleming, David Gamage, Ari D. Glogower, Daniel Jacob Hemel, David Kamin, Mitchell Kane, Rebecca M. Kysar, David S. Miller, Darien Shanske, Daniel Shaviro and Manoj Viswanathan, “The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation,” 103 *Minn. L. Rev.* ___ (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.
4. Letter dated Jan. 29, 2018 from Annette Nellen, chair, American Institute of Certified Public Accountants Tax Executive Committee to The Honorable David J. Kautter, assistant secretary for Tax Policy and William Paul, principal deputy chief counsel and deputy chief counsel.
5. *Joanne M. Wandry, Donor v. Commissioner*, T.C. Memo. 2012-88.
6. Experienced practitioners looking to up their collaborative resources and processes may do well to consider obtaining the Accredited Estate Planner designation through the National Association of Estate Planners & Councils.



SPOT LIGHT

From the Top

Pacific Heights by Jade Fon sold for \$5,000 at Bonhams’ California and Western Paintings and Sculpture auction on Aug. 7, 2018 in Los Angeles. Fon was known for his brilliant watercolor paintings, sometimes of scenes of the San Francisco nightclub where he was a singer and emcee for a few years. The club atmosphere would aggravate his asthma, leading him to focus on teaching.