# End of an Era is Looming: Preparing Now for Expiring TCJA Provisions

September 19, 2023

# Notice

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

# Choice of Entity Considerations – Why is this a Hot Topic (Again)?

# Why is this a Hot Topic? Pre-2017 TCJA Landscape

Corporate Rate*

- 15% on income to $50,000
- 25% on income above $50,000 to $75,000
- 34% on income above $75,000 to $10 million
- 35% on income above $10 million

Individual Rates / Passthrough Entities

- Top rate bracket of 39.6%
- 20% rate for Qualified Dividends / Long Term Capital Gains

*Ignoring “catch-up” corporate rates

# 2017 TCJA Changes

Corporate Rate

- Non-graduated 21% rate

Individual Rates / Passthrough Entities

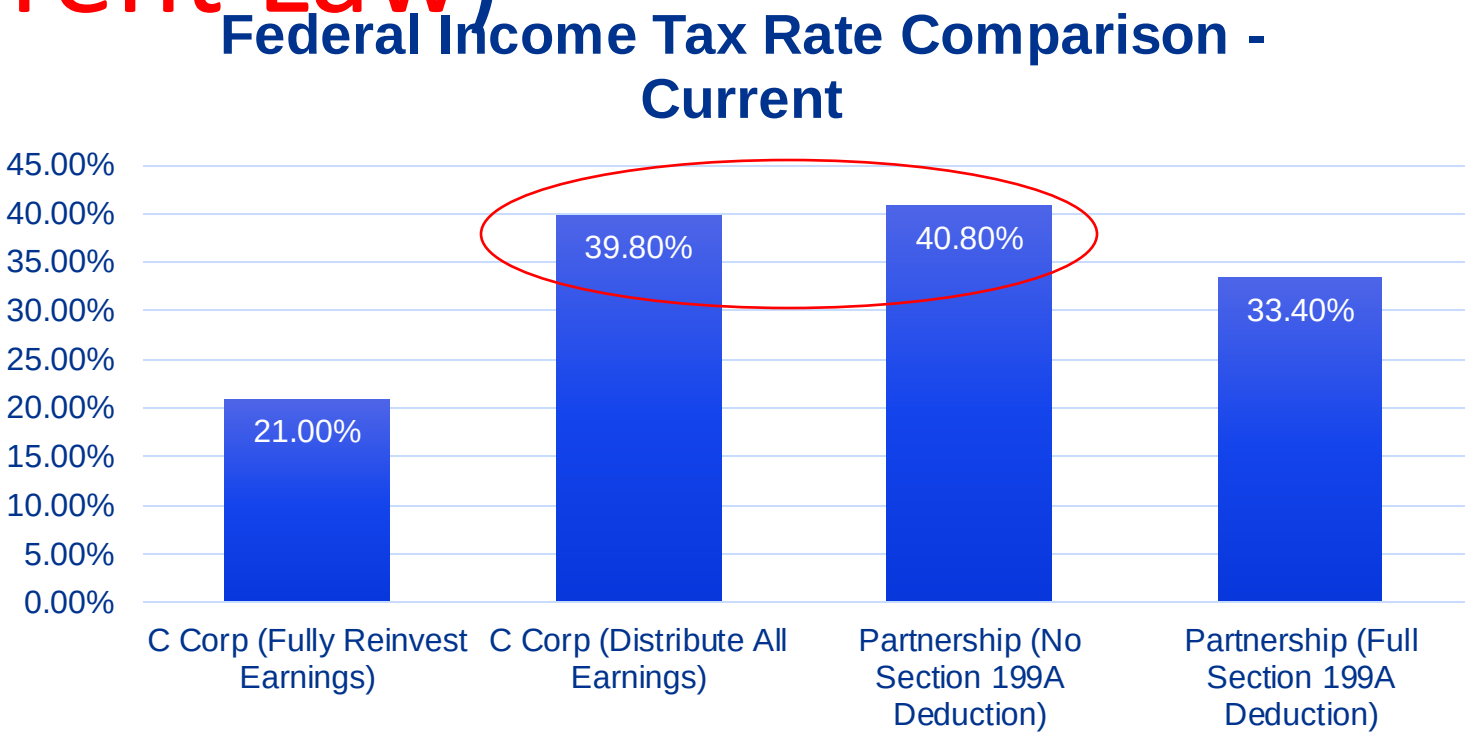
- Top rate bracket of 37%
- For married filing joint, top rate effective on taxable income in excess of $600,000
- 20% rate for Qualified Dividends / Long Term Capital Gains

Qualified Business Deduction as a Rate Driver

- New section 199A adds a potential 20% deduction for certain income for individuals, trusts, and estates that own passthroughs and sole proprietorships.

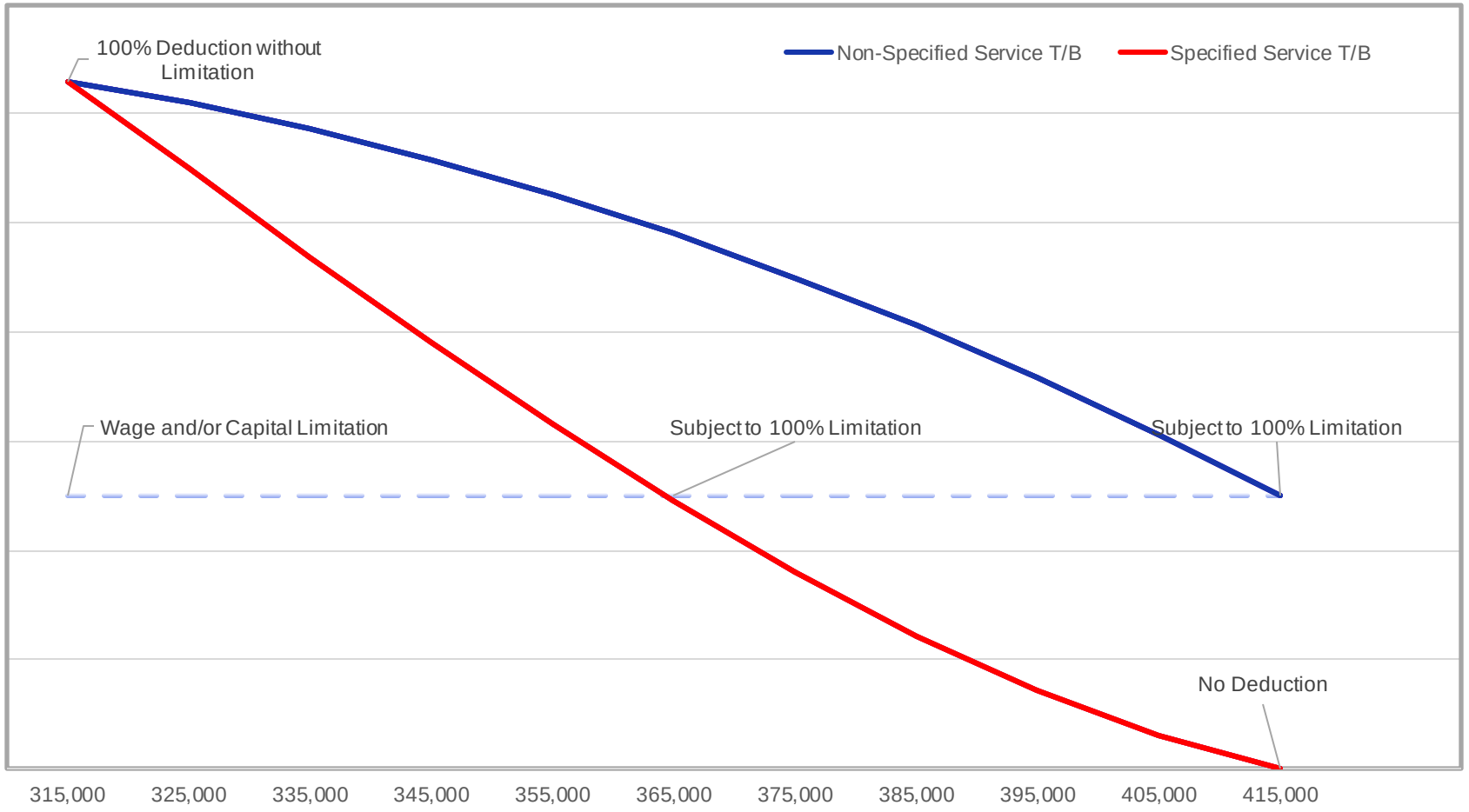
- Results in potential reduction in effective tax rate to 29.6%
  - *But . . . only for certain trades or businesses*
  - *And . . . subject to certain wage and basis limitations*
  - *And . . . sunsets for tax years beginning after December 31, 2025*

# Federal Income Tax Rate Comparison (Current Law)




- **Notes & Assumptions:**
- Does not take into account state or employment taxes.
- Each partner or shareholder is subject to the net investment income tax on its distributive share of income or dividend
- Corporate dividends are subject to tax at the qualified dividend rate.
- Does not take into account the deduction for state taxes

# Section 199A Benefit Phase-Out (TCJA)




*** Married filing jointly or surviving spouses, using 2018 rates. Threshold numbers above are inflation adjusted after 2018.**

# Race to Convert from Passthrough to C Corporation?

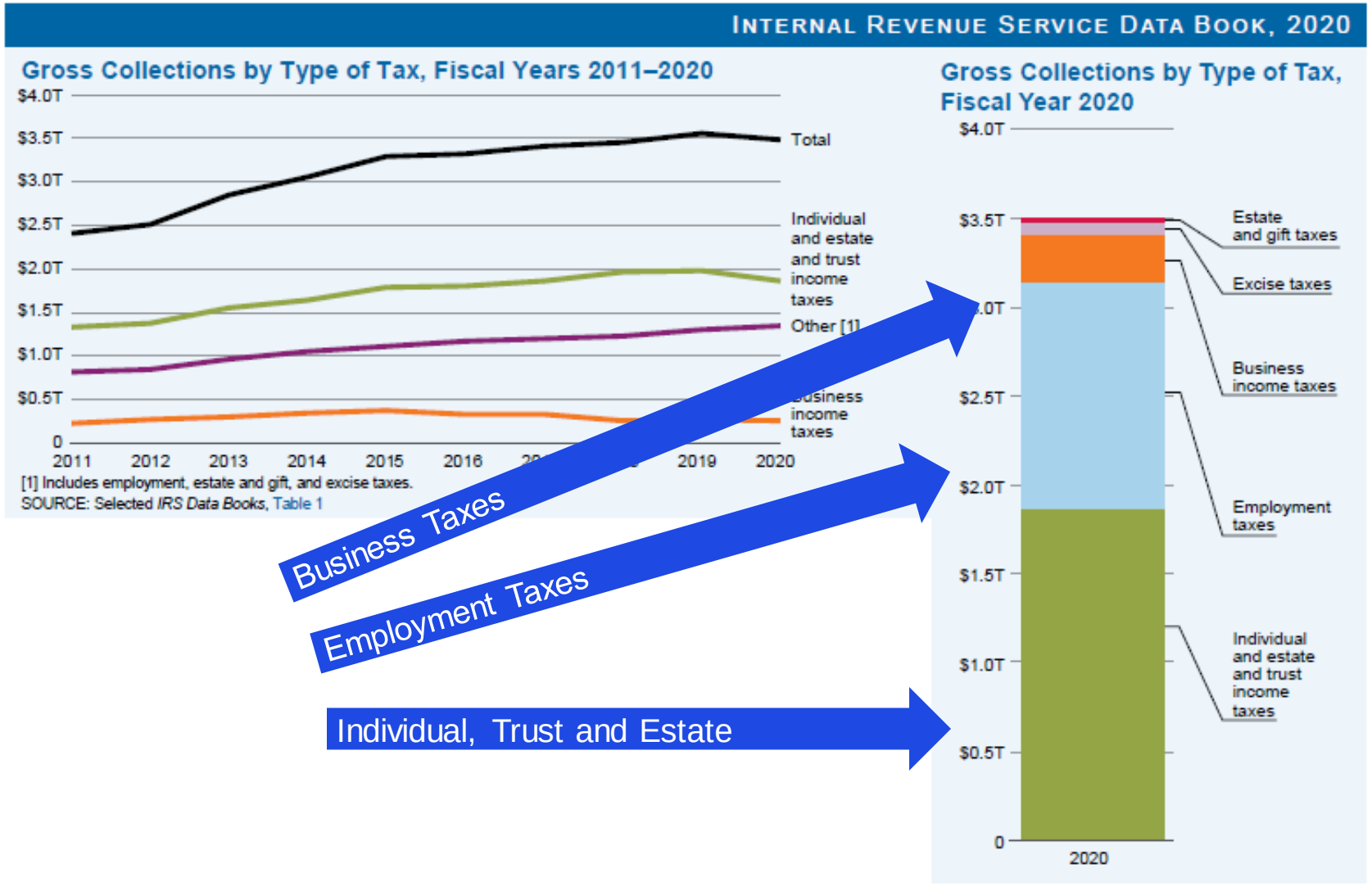
INTERNAL REVENUE SERVICE DATA BOOK, 2020 Download XLSX

**Table 2. Number of Returns and Other Forms Filed, by Type, Fiscal Years 2019 and 2020**

[For Fiscal Year 2020 data by State, see Table 3]

| Type of return or form | 2019 | 2020 | Percentage change |
|---|---|---|---|
| | (1) | (2) | (3) |
| **United States, total [1]** | **253,035,393** | **240,160,843** | **−5.1** |
| **Income taxes, total** | **191,471,082** | **189,562,923** | **−1.0** |
| **C or other corporation [2]** | **2,146,904** | **1,819,301** | **−15.3** |
| **S corporation, Form 1120–S** | **5,186,557** | **5,044,303** | **−2.7** |
| **Partnership, Form 1065** | **3,946,342** | **4,470,095** | **13.3** |
| **Individual, total [3]** | **154,094,555** | **157,195,302** | **2.0** |
| Forms 1040, 1040–A, 1040–EZ, 1040–SR | 153,130,682 | 156,580,123 | 2.3 |
| Forms 1040–C, 1040–NR, 1040NR–EZ, 1040–PR, 1040–SS | 963,873 | 615,179 | −36.2 |
| **Individual estimated tax, Form 1040–ES** | **22,225,590** | **17,579,898** | **−20.9** |
| **Estate and trust, Form 1041** | **3,116,479** | **2,820,317** | **−9.5** |
| **Estate and trust estimated tax, Form 1041–ES** | **754,655** | **633,707** | **−16.0** |
| **Employment taxes [4]** | **31,566,173** | **28,028,002** | **−11.2** |
| **Estate tax [5]** | **25,742** | **15,023** | **−41.6** |
| **Gift tax, Form 709** | **239,618** | **158,095** | **−34.0** |
| **Excise taxes [6]** | **1,073,183** | **902,342** | **−15.9** |
| **Tax-exempt organizations [7]** | **1,590,421** | **1,360,719** | **−14.4** |
| **Supplemental documents [8]** | **27,069,174** | **20,133,739** | **−25.6** |

# Gross Collection by Type of Tax



# TCJA Changes Looming

# Post 2017 TCJA Environment?

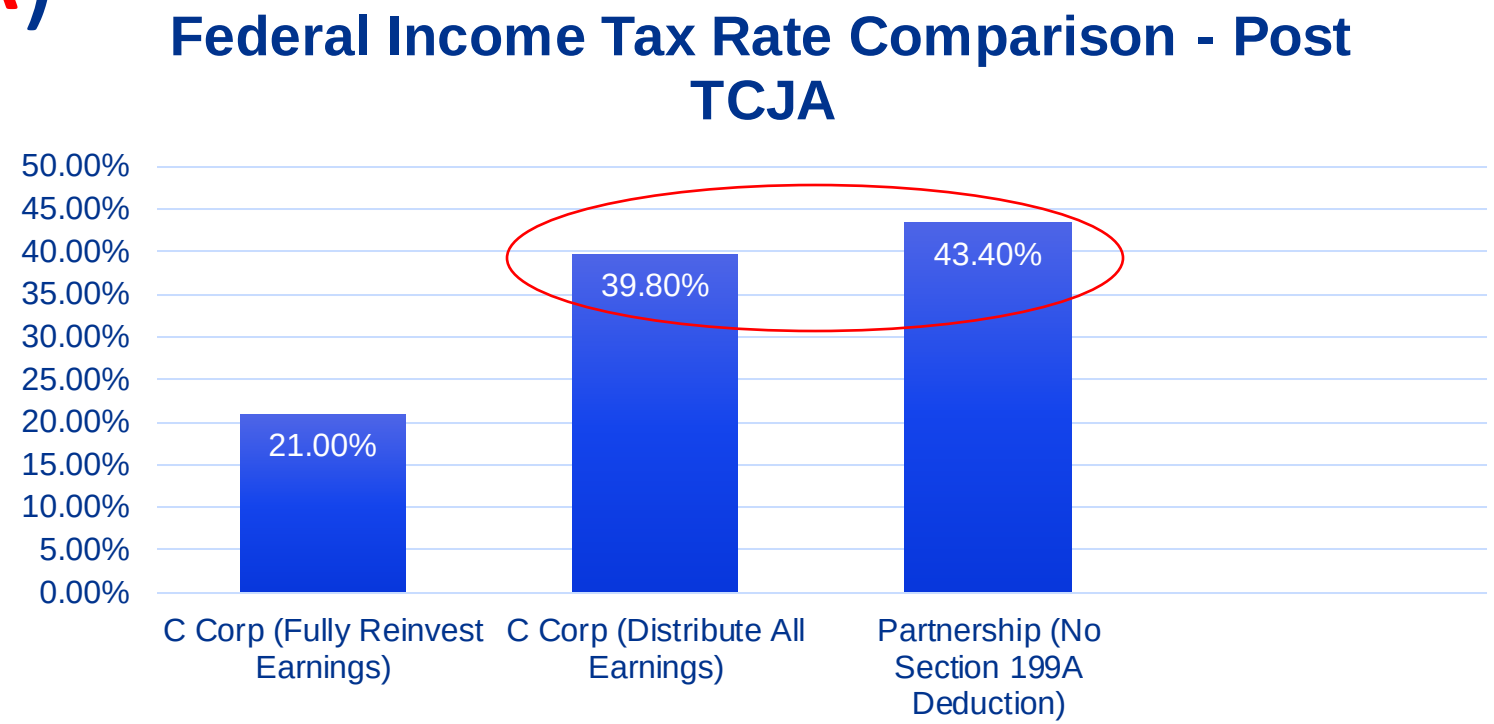
Corporate Rate

- Non-graduated 21 percent rate?

Individual Rates / Passthrough Entities

- Top rate bracket return of 39.6% with return to decreased income level at which increased rate with apply?
- 20% rate for Qualified Dividends / Long Term Capital Gains
- Sunset of section 199A?

# Federal Income Tax Rate Comparison (Post TCJA)

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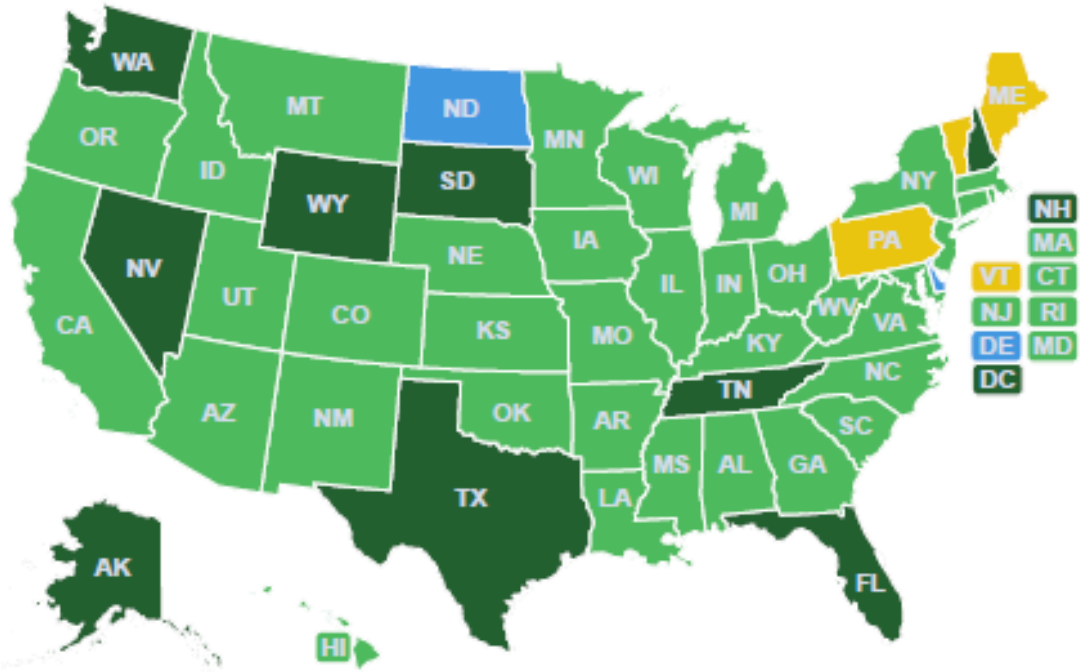
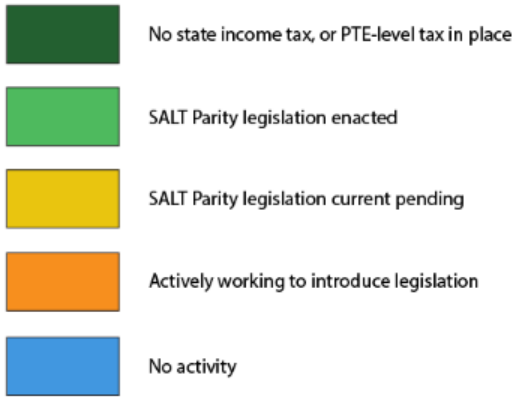
# Passthrough Entity Taxes (PTETs)




Source: Main Street Employers coalition
https://mainstreetemployers.org/salt/

# Notice 2020-75 (Overview)

- I.R.C. Section 164
  - Schedule A (itemized deduction)
  - Reporting as part of net income from a passthrough entity
- Tax Cuts and Jobs Act: I.R.C. Section 164(b)(6)
  - Deductibility follows present law. H.R. Conf. Rep. No. 115-466, n. 172 (December 15, 2017).
  - Sunsets after 2025 - future of limitation?
- Notice 2020-75 (November 2020)
  - Noted awareness of elective passthrough taxes and owner state tax credit / income backout
  - Regulation shall generally provide that a "Specified Income Tax Payment"
    - Means any amount paid by a domestic partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction,
    - Is deductible by the partnership or S corporation in computing its taxable income,
    - Deduction does not constitute an item of deduction that a partner or shareholder takes into account separately under sections 702 or 1366 and that the Specified Income Tax Payment will be reflected in the "distributive or pro-rata share of non-separately stated income or loss reported on a Schedule K-1," and
    - Will not be taken into account in applying the SALT Cap to any partner or shareholder.

# TCJA Provisions Set to Sunset – Additional Items

1. Mortgage and Home Equity Interest Deduction Limitation
   - Under TCJA, mortgage interest deductions limited to debt up to $750,000 and deduction for interest on home equity loans eliminated (both, for 2018-2025). After the 2025 sunset, mortgage interest will be deductible on debt up to $1,000,000 and home equity interest will be deductible on debt up to $100,000.

2. Miscellaneous Itemized Deductions and PEASE Limitation
   - Under TCJA, miscellaneous itemized deductions were temporarily eliminated. After the 2025 sunset, miscellaneous itemized deductions can again be claimed to the extent exceed 2% of Adjusted Gross Income (AGI).
   - Under TCJA, the overall limitation on some itemized deductions ("Pease limitation"), was also temporarily eliminated. After the 2025 sunset, this limitation will be reinstated, and at certain income levels there will be a cap on total allowed itemized deductions.

3. Standard Deduction
   - Under TCJA, the standard deduction increased to approximately double the amount for 2019-2025. After the 2025 sunset, the standard deduction will lower back down to about half the amount, adjusted for inflation.

4. Alternative Minimum Tax (AMT) Exemption and Phaseout
   - Under the TCJA, AMT exemptions and phaseout amounts were increased. After the 2025 sunset, such temporary increases will be eliminated.

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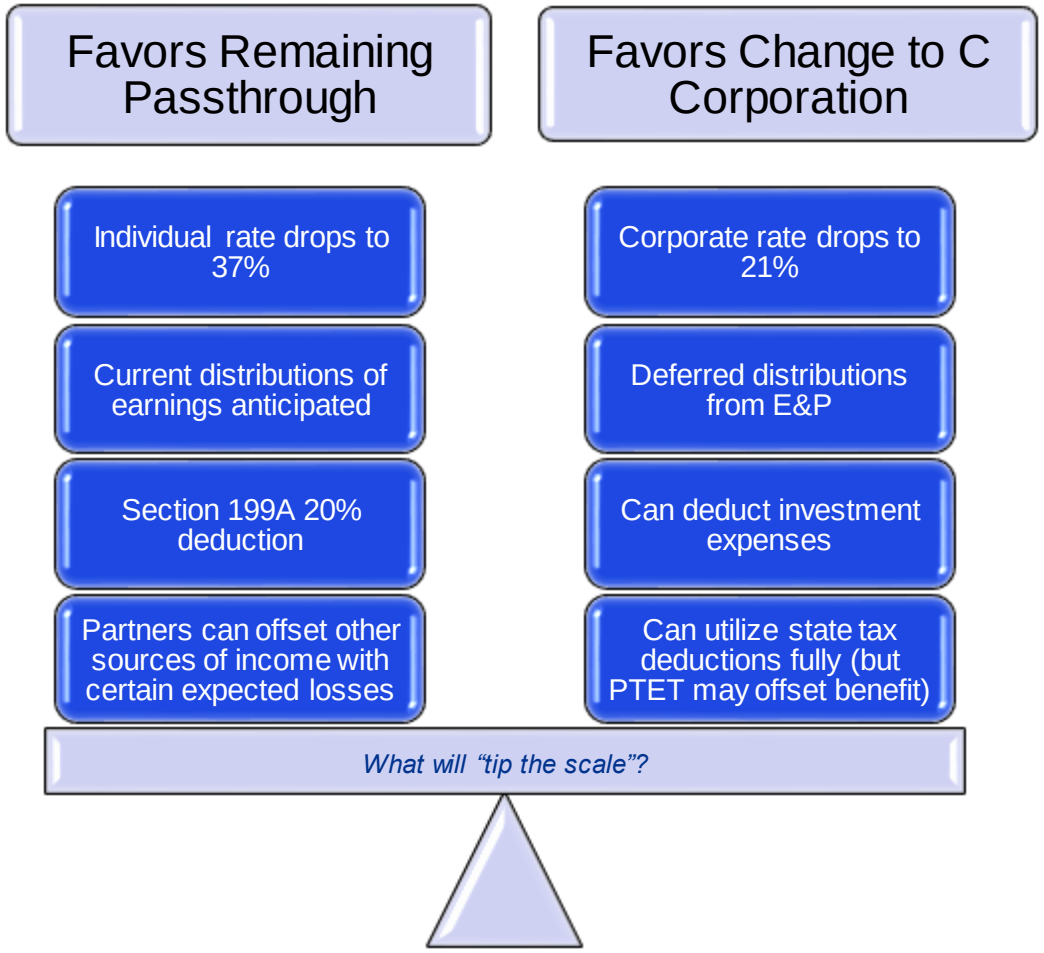
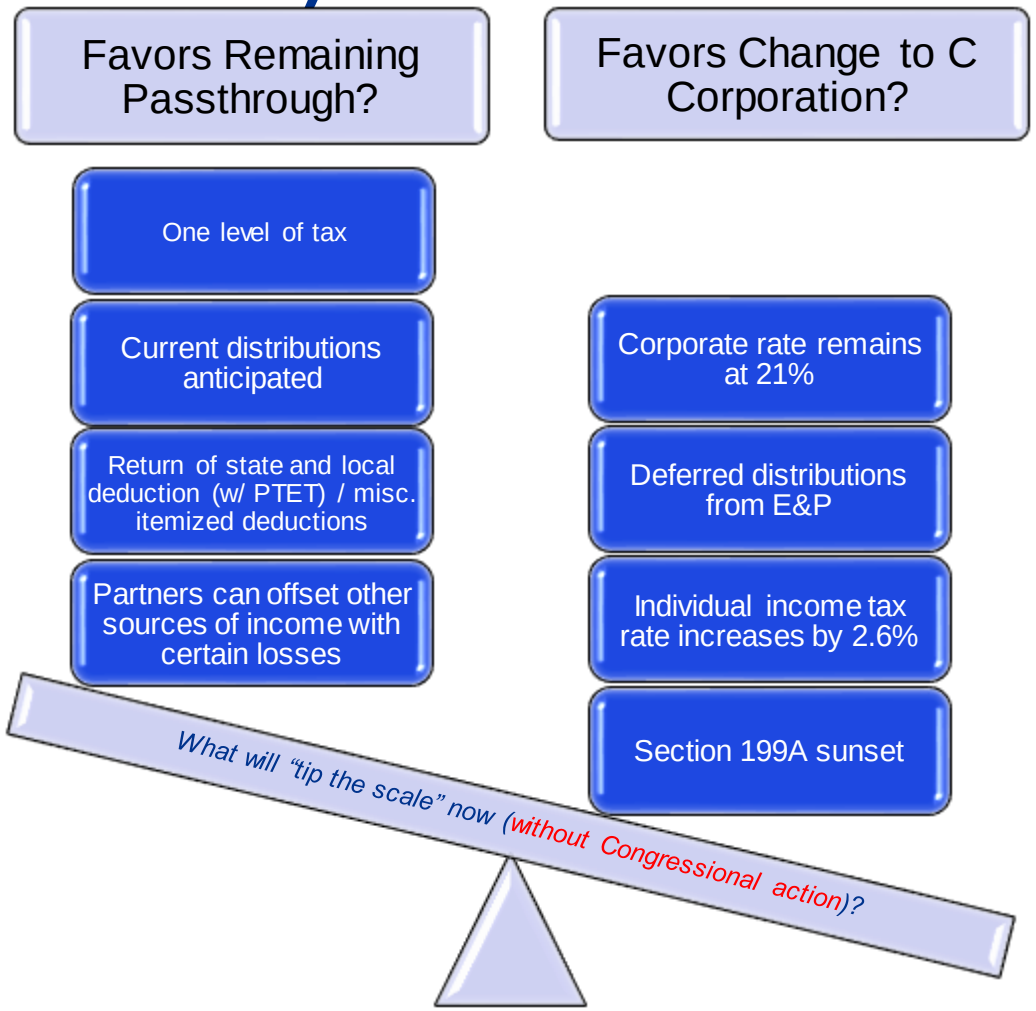
# Choice of Entity Considerations – Balancing Act

# Balancing Considerations in Choice of Entity (Current Law)



# Balancing Considerations in Choice of Entity (Post TCJA)



# Additional Domestic Considerations (Not Exhaustive)

- Net Investment Income Tax?
- Estate tax planning considerations?
- Ability to remunerate with different types of equity compensation?
- Appreciating assets in corporate form?
- Section 1202 gain exclusion potential?
- State and local footprint considerations?
- Section 163(j) considerations?
- Toll charges for conversion from one entity to another?
- Owner attribute considerations when shifting entity type?
- Ability to convert back if new regime change?
- Compliance costs between operating as different entities?
- Opportunities to access tax-free reorgs, or to go public?
- Ability to exit through sale while creating basis step-up for buyer?

# Expiring TCJA Provisions – Lifetime Exemption Considerations

# Enhanced Lifetime Exemption – Use it or Lose it

- The Tax Cuts and Jobs Act of 2017 increased the basic exclusion amount (aka lifetime exemption amount) from $5 million to $10 million
  - Applies to estates of decedents dying or gifts made after 2017 (and generation-skipping transfers made or GST exemption allocated after 2017)
  - Indexed for inflation occurring after 2011
  - For 2023, the lifetime exemption is $12.92 million per person ($25.84 million per couple)

- Use it or Lose it
  - Under current law, the enhanced lifetime exemption will only be available for transfers made by the end of 2025
  - Individuals who can afford to part with $12.92 million of wealth (or wealth equal to their remaining exemption amount, if less than $12.92 million) should consider making lifetime gifts in the near term to use up any remaining exemption

# Other Benefits of Transferring Assets Today

- Making gifts now in order to benefit from the larger exemption before it is gone may have additional advantages
  - Ability to remove future appreciation from the estate – choose assets that will best leverage exemption
  - Continued availability of valuation discounts – regulations withdrawn
  - Continued viability of sales to intentionally defective grantor trusts
  - Historically low (but rising) interest rates – maximizes wealth transfer
  - Non-tax benefits of trusts – e.g., asset protection, asset management, control over disposition
  - State tax benefits of non-grantor trusts resident only in state with no or low income tax – depends on relevant state tax regimes
- However, individuals should consider:
  - Loss of step-up in basis on assets gifted during life
  - Possibility of death before the sunset
  - Possibility of full repeal or deferral of the sunset

# Examples of How to Use Lifetime Exemption

- Equalizing gifts to children or grandchildren
- Forgiveness of outstanding loans to children or grandchildren
- Gifts to dynasty trusts (or allocation of GST exemption to previously created dynasty trusts)
- Gifts to new intentionally defective grantor trusts in connection with a subsequent sale to the trust for a note – benefits can be magnified since gift of the seed property can be much larger now without any additional gift tax exposure
- Gifts to trusts that have pre-existing sales in place to improve the equity to debt ratio or allow beneficiary guarantees to be terminated or allow the note balance to be paid off in full
- Gifts in trust to individuals with modest estates in order to obtain a basis increase in the gifted assets at their death without increasing collective transfer tax
- Gifts to trusts that allow the grantor or the grantor's spouse to retain some access to the funds if they are otherwise concerned about giving away $25.84 million of assets (for example, self-settled asset protection trusts or spousal limited access trusts)

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# The Rise (and Fall?) of Formula Clauses

# The Origin of Formula Clauses

- Estate planning involves making gifts during life to family members or trusts for their benefit in order to minimize transfer tax
- Gift tax is imposed on the value of the property transferred (in excess of any consideration received)
- It is relatively easy to quantify your gift tax exposure when you make gifts of cash or marketable securities
- It is much more difficult to determine the value of assets like real estate and closely held business interests
- In addition, the IRS frequently challenges the values reported on gift tax returns and may be successful in convincing a court that the true value is much higher than the appraised value
- As a result, there is typically some level of uncertainty and concern about how much value you have gifted and how much gift tax you will owe when making transfers of these hard-to-value assets

# The Origin of Formula Clauses

- Many donors wish to avoid gift tax entirely by limiting their gifts to the lifetime exemption amount
  - Under current law, the enhanced lifetime exemption ($12,920,000 for 2023) will only be available for transfers made by the end of 2025
  - Individuals who can afford it, should consider making lifetime gifts in the near term to use up any remaining exemption
- If a donor has already used their exemption, they may want to avoid gift tax entirely by selling assets for full and adequate consideration
- Other individuals may be willing to pay some limited amount of gift tax but do not want to be on the hook for a blank check
- When transferring hard-to-value property, various clauses can be included in gift or sale documentation in an effort to avoid the risk of unanticipated and undesirable gift tax exposure
- The IRS has resisted the use of these formula clauses, but taxpayers have prevailed in some cases

# Formula Clauses and Their Effectiveness

- Formula Transfer Clause –
  - States that donor is transferring only a certain defined value/dollar amount of a particular asset as finally determined for federal gift tax purposes
  - Example: "I gift $12m worth of shares as finally determined for federal gift tax purposes to my trust."
    - Donor has $12m of exemption and shares are appraised at $120,000 per share – 100 shares go to trust in accordance with formula and no gift tax because of exemption
    - IRS/Courts determine value is $240,000 per share – gift tax due on $12m that exceeds exemption
    - Result of Formula Clause – 50 shares owned by trust and 50 shares owned by donor – no gift tax because of exemption
  - Upheld by the Tax Court in the *Wandry* case (2012) because the donees were entitled to a predefined interest and the clause merely served to correct the allocation between donor and donees because the appraisal understated the value
  - The IRS ended up not appealing to the 10th Circuit, but announced their non-acquiescence to the decision

# *Sorenson v. Commissioner*

# Sorensen v. Commissioner

- In December of 2014, each of the two Sorensen brothers gifted non-voting shares of Firehouse Subs to their trust
- The transfer documentation provided that the gift was of shares "**with a fair market value as finally determined for federal gift tax purposes equal to exactly $5,000,000**" – in essence, a *Wandry* clause
- The shares were valued by an appraiser at $532.79/share – thus, it was believed that each trust owned 9,384.56 shares (which the parties rounded to 9,385)
- In March of 2015, each brother sold 5,365 shares (with a value of $2,858,418 based on the December appraisal) to their trust (without using a formula clause)
- Although the gifts were reported on Form 709, the sales were not disclosed
- The description of the gift on the Form 709 did refer to the formula but also concluded that the number of shares transferred was 9,385
- In November of 2021, the company was sold and each trust received $153m in proceeds (i.e., $10,372.88 per share)

# Sorensen v. Commissioner

- The IRS appraised the gifted shares at $2,076.86 and the sold shares at $2,228.62 and assessed each brother with $13.57m in gift tax plus $5.43m in penalties
- In addition, the IRS argued that the *Wandry* formula clause did not control the gift of the shares – instead, the brothers had given up dominion and control over 9,385 shares in December of 2014 because
  - The company stock ledger and income tax returns showed the trusts as the owner of that number of shares
  - The trusts received distributions based on that number of shares
  - The trusts did not agree to transfer shares back based on the formula
  - The trusts sold that number of shares to the third-party purchaser and received the purchase price
- The IRS argued that the formula clause is an invalid condition subsequent and *Wandry* had been wrongly decided – but distinguished formula allocation clauses

# Sorensen v. Commissioner

- The IRS and the taxpayer ultimately reached a settlement
  - The defined value clause did not control the number of shares transferred
  - The brothers each gifted 9,385 shares valued at $1,640 each such that the taxable gift was over $15m – no penalties applied
  - The value for the shares sold was $1,722 each such that the taxable gift attributable to the sale transaction (after factoring in consideration) was over $6m each – 10% penalty applied
    - Unclear if penalty for sale was because it was not disclosed on 709 or based on a three-month old appraisal or otherwise
  - Total gift tax due from each brother (after factoring in exemption) was $6.5m plus penalty of around $250,000
- The taxpayers were probably fairly content with this result – payment of $6.5m but a trust funded with $153m of sale proceeds
- If the formula clause had been respected, each trust would only have had $87m

# Sorensen by the Numbers

**The below does not account for the sale portion of the transaction (no formula clause was used) and assumes death of the taxpayer in 2021 prior to any additional appreciation of the stock when the lifetime exemption had increased to $11.7m. It also does not account for the opportunity cost associated with the dollars used to pay the gift tax upon settlement and any interest and penalties that might be assessed.**

| | Formula Clause Ineffective | Formula Clause Effective |
|---|---|---|
| Number of Shares Gifted to Trust | 9,385 | 3,048.78 |
| Total Value of Gifted Shares in Trust When Sold in 2021 (at $10,372.88/share) | $97,349,479 | $31,624,629 |
| Value of Remaining Shares in Estate | $0 | $65,724,850 |
| Gift Tax Attributable to Transfer of 9,385 shares | $4,156,272 | $0 |
| Estate Tax Attributable to Transfer of 9,385 shares | $0 | $23,609,940 |
| Total Transfer Tax | $4,156,272 | $23,609,940 |
| Effective Tax Rate | 4% | 24% |

# Planning with Formula Clauses

- The IRS has not given up on this issue
- The *Wandry* case is a helpful indication of the Tax Court's view – that *Wandry* formula transfer clauses can work
- But there is only one case and there are no appellate court decisions addressing this specific type of clause
- It may be safest to use a formula allocation clause (with overage earmarked for a charity)
- *Wandry* clauses nonetheless appear to be very popular with taxpayers

# Planning with Formula Clauses

- Language in the transfer documents should be carefully crafted
- Point of reference for adjustment should be “as finally determined for federal gift tax purposes” – not appraised value as in *Nelson*
- Have donees countersign the transfer documentation
- Helps to use a wholly-owned grantor trust as donee - income tax consequences stay constant even if ownership of shares is changed pursuant to formula
- Description on gift tax return should be similar to language in transfer documents and reflect gift of a dollar value not certain property
- Be sure to meet adequate disclosure requirements so statute of limitations begins to run

# Planning with Formula Clauses

- Make all related documentation consistent with the formula clause by including an explanation of uncertain nature of ownership
  - stock ledger or schedule of partners
  - capital accounts
  - tax returns (including relevant K-1s)
  - distribution records
- If distributions are made, have donees sign receipt for distributions acknowledging potential refunding requirement
- If there is a subsequent sale to a third party, have buyer acknowledge that the ownership is based on formula and the parties will reallocate the proceeds if it is finally determined to be otherwise

# Planning with Formula Clauses

- Both the Deed of Gift and the Purchase and Sale Agreement contain a *Wandry* formula clause describing what is gifted/sold as $12m/$108m of S corp stock "as finally determined for federal gift tax purposes"
- Both the gift and the sale for full and adequate consideration are adequately disclosed on the grantor's gift tax return – the description of the gift must be consistent with the formula clause (i.e., $X of S corp stock, not X shares of S corp stock or X% interest in the S corp)
- If the appraisal concludes that each share of S corp stock is worth $100,000, the parties proceed on that basis by treating 1,200 shares as being owned by the IDGT and noting conditional nature of ownership in:
  - stock ledger
  - tax returns (including relevant K-1s)
  - distribution records

# Planning with Formula Clauses

- If distributions are made or if there is a subsequent sale to a third party, have trust/buyer acknowledge that the ownership is based on formula and the parties will reallocate the distribution/proceeds if it is finally determined to be otherwise
- If the IRS audits the transaction before the statute of limitations has elapsed and successfully argues that the S corp stock is worth more than what the appraiser concluded, in accordance with the formula clause, the parties will reallocate the shares/distributions/sale proceeds and amend tax returns and other documentation
- For example, if the value of a share was finally determined to be $200,000, the trust would only own 600 shares, the grantor would still own the other 600 shares, and no taxable gift would have been made

# Thank you!

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