

2016 End of Year Tax Planning for Business Owners In Light of New Tax Law, Proposed Regulations, November Elections and Other Overlooked Tax Strategies for Business Owners



Financial Executives International Oct 18, 2016

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Today's Speaker



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Topics Discussed

- 2016 Tax Changes under the PATH Act
- The 2016 Election – What's the Impact on Tax Policy?
- Improving *net* ongoing after-tax income for business owners
 - Avoiding owner-compensation audit risk
 - IC-DISC – cutting tax rate in half for qualifying export income
 - DPAD – overlooked deduction for qualified domestic producers
- Asset protection, charitable and estate planning for owners
 - Congress expands captive insurance companies effective 2017
 - New Ohio Legacy Trusts offer protection from rogue judgment
 - Congress expands charitable gifts by S Corporations (incl. CRT)
 - Congress expands small business stock exclusion (100%!)
 - Proposed gift/estate tax regulations threaten family business
 - Other year end tax planning tips for business owners

About Key Private Bank...

Key Private Bank serves individuals and entities with over \$1 million in investable assets, and provides wealth management solutions using a planning-based approach, delivered through a local credentialed client-advisory team.

Key Private Bank Facts

- \$36 billion in assets under management
- Impartial fiduciary for over 150 years
- Local advisory teams servicing 25 offices in 13 states
- 300+ highly credentialed advisors (JD, CFP, CFA, CFTA, AIFA, CPA, CIMA) averaging 19+ years of experience

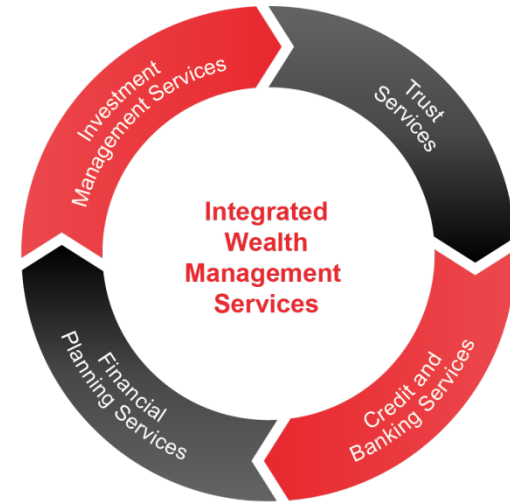
Clients

- Business Owners
- Charitable Organizations
- Corporate Executives
- Endowments
- Attorneys
- Retirees
- Healthcare Professionals
- CPAs
- Multi-Generational Families
- Consultants

Investment Philosophy

- *Diversity Is a Winning Strategy*: No single investment approach works all the time. That's why our investment teams employ a thoughtful combination of solutions to deliver solid results.
- *Windshields Are Better than Mirrors*: An investment's future is what matters – more than its historical track record. Selecting investments based solely on past performance is the equivalent of a “buy high, sell low” strategy that can lead to disappointment.

Key Private Bank Services



Investment Management Services

- Asset Allocation Strategies
- Traditional Investments
- Alternative Investments
- Risk Mitigation Strategies

Credit and Banking Services

- Customized Credit Solutions
- Mortgage Lending
- Leasing
- Deposit Solutions

Financial Planning Services

- Retirement Planning
- Succession Planning
- Education Planning
- Insurance Planning

Trust Services

- Estate/Legacy Planning
- Trust/Administration
- Charitable Giving
- Asset Protection Strategies

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This piece is not intended to provide specific tax or legal advice; you should consult with your own advisors about your particular situation.

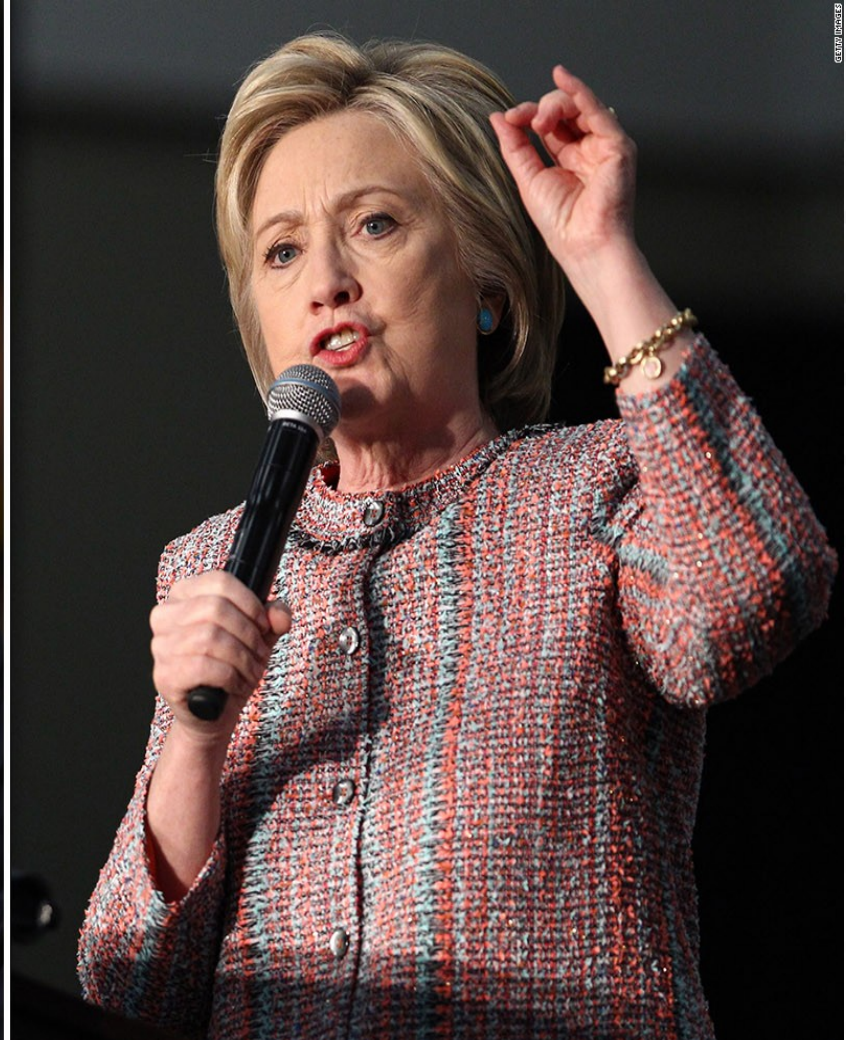
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Key PATH Act Changes Affecting Business Owners

- Section 179 expensing at \$500,000 made permanent
- Bonus depreciation (more important for larger companies) extended through 2019, but **not** made permanent.
- Reduction in S corporation recognition period for built-in gains tax is made permanent (for C to S conversions).
- Exclusion of 100% of gain on certain small business stock is made permanent.
- Lower shareholder basis adjustment for charitable contributions by S corporations (including to CRTs) is made permanent.
- Small captive insurance companies expanded, with safe harbor deductible contributions under §831(b) expanding from \$1.2 to \$2.2 million in 2017

Trump v. Clinton – The Tax Differences



Trump v. Clinton on Income Tax Reform

- Trump proposes to reduce the top tax rate and establish three tax brackets with rates of 12%, 25% and 33%. 3.8% Medicare net investment income surtax on AGI over \$250,000 would be eliminated. Appears to be entirely deficit funded - no explanation of revenue offset.
- Clinton proposes to keep existing rates but add a 4% surtax above \$5 million. “Buffett rule” – minimum 30% tax for income over \$1 million/yr. To use for college tuition, infrastructure spending rather than to decrease deficit.
- Both have argued against taxation of “carried interest” used by private equity firms to have gains taxed at long term capital gains tax rates.

Trump v. Clinton on Estate and Gift Tax Reform

- Trump (along with majority of Republicans in Congress) proposes to eliminate the estate tax.
- Clinton proposes to revert to \$3.5 million exemption with a 45% rate (as opposed to \$5.45 million and 40% rate today), with the addition 50% rate > \$10 million, 55% rate >\$55 million, 65% rate bracket for estates > \$500 million.
- Note that even die-hard Republican proposals on estate tax keep the gift tax intact to avoid gaming the income tax system through unlimited tax-free gifts. Trump has not mentioned any difference here.

Trump v. Clinton on Corporate Income Tax Reform

- Trump proposes to reduce the top tax rate applicable to C corporations from 35% to 15%.
- Clinton has not made any specific proposals
- Both Republicans and Democrats have proposed and agree in principal (and have for years) on lowering the corporate tax rate and “closing loopholes” – but they can’t agree on which ones, and whether the changes should be “revenue neutral” (Democrats) or be deficit funded (favored by Republicans).

Control and Composition of the House and Senate

- Arguably, Congress is more important for tax reform than the Presidency. In June, Republicans in the House of Representatives released their “Tax Reform Blueprint.”
http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf
- The proposal would eliminate the estate and gift taxes. It would also raise the standard deduction for individual income taxes, which would *reduce the number of taxpayers itemizing their deductions from 33% to 5%*. The proposal would also eliminate all itemized deductions other than the mortgage interest deduction and the charitable contribution deduction.

House Proposals

- The House proposals would eliminate taxation of corporate income on overseas income earned outside of the U.S.
- The House proposals would eliminate the Alternative Minimum Tax (AMT), cap business income at 25%, top capital gain tax rate at 16.5%; eliminate domestic production activity deduction.
- Simplify the multiple education credits/deductions
- House “Blueprint” would lower top income tax bracket to 33%, with seven brackets narrowed to three: **INDIVIDUAL INCOME TAX BRACKETS UNDER THE BLUEPRINT**
Current Law
→ Blueprint 10%/15% → 0%/12% bracket 25%/28% → 25%
33% 35% 39.6% → 33%
- Propose consumption tax similar to European VAT
- Democrats counter it would explode the deficit; benefit wealthy.

House Proposals – Effect on Financial Planning?

- The House is not going to get everything it wants, without Senate and Presidential approval, but it is a starting point
- The prospect of *lowering rates and adding a consumption tax* (like a sales tax, similar to European value added tax) *would change a lot of planning dynamics* – should you make that Roth conversion, or defer as much into retirement plans now since your tax rate may be *lower* in future years? Buy muni bonds v. taxable corporate bonds (analysis which relies on tax rates)?
- Similarly, if only 5% of taxpayers would itemize, reducing the importance of mortgage interest deduction and possibly charitable deduction, this would clearly affect how fast you may pay off your mortgage, or whether you “bunch” charitable deductions into certain years to get the tax benefit.

Clinton/Trump Proposals – Effect on Financial Planning?

- Just as the House will not get everything, neither would a President Clinton or Trump, but some of what they ask for could be part of a bipartisan compromise
- Clinton compromises would likely have some form of cap on itemized deductions or minimum tax for those making over \$1 million, popularized as the “Buffett rule”. This may lead to more use of certain trusts to spread the income over more taxpayers
- Trump would likely follow more of the House reform, but his focus and policies tend to change. It’s hard to predict where he would land in many areas. Witness his recent shift, against most Republicans, advocating for six weeks paid maternity leave, even more than what most Democrats advocate.

Improving net after-tax income for business owners

A few overlooked (and in some cases abused) ideas:

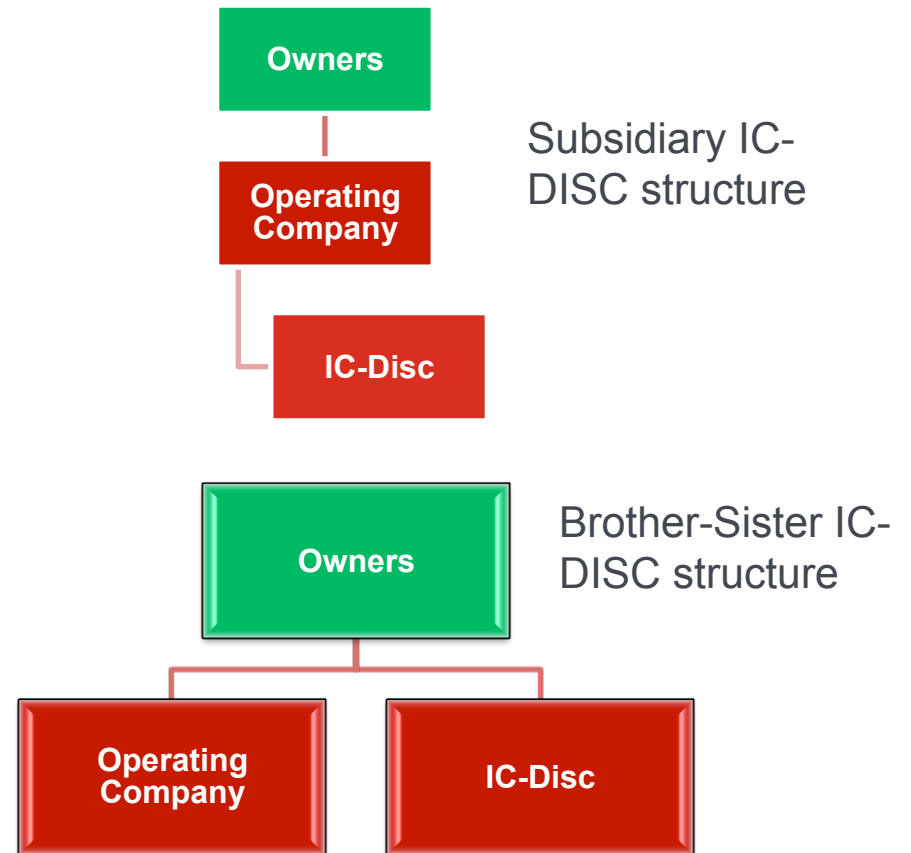
- Reducing compensation for S corp owners, increasing compensation for C corp owners (within reason!)
- IC-DISC for export income
- Domestic Production Activities Deduction
- Captive Insurance Companies (new rules are a huge tax benefit, but there are new compliance rules)
- Shifting Income to family via salary, LLCs/irrevocable trusts

Owner-Compensation Issues

- S corp owners paying only minimal “reasonable compensation” to themselves enables remaining profit to escape 3.8% Medicare tax (in theory, it could avoid other employment tax); but paying “unreasonably low” salary to owner/employee is a hot IRS audit area.
- Similarly, C corporation owners who conveniently zero out income via end of year bonuses can be targeted (even with multiple owners, like a law firm) – five factors include:
 - The employee’s role in the company
 - An external comparison with other companies
 - The character and condition of the company
 - Potential conflicts of interest
 - Internal consistency of compensation
- *Lesson central to all cases: pigs get fat, hogs get slaughtered. Don’t be too greedy.*

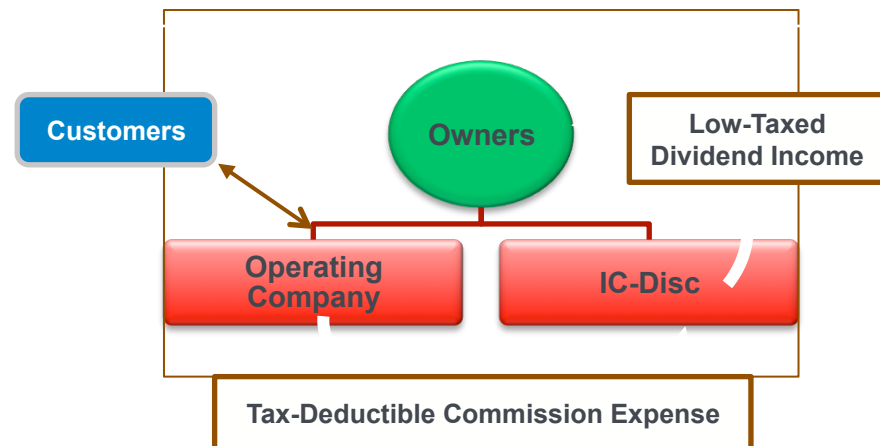
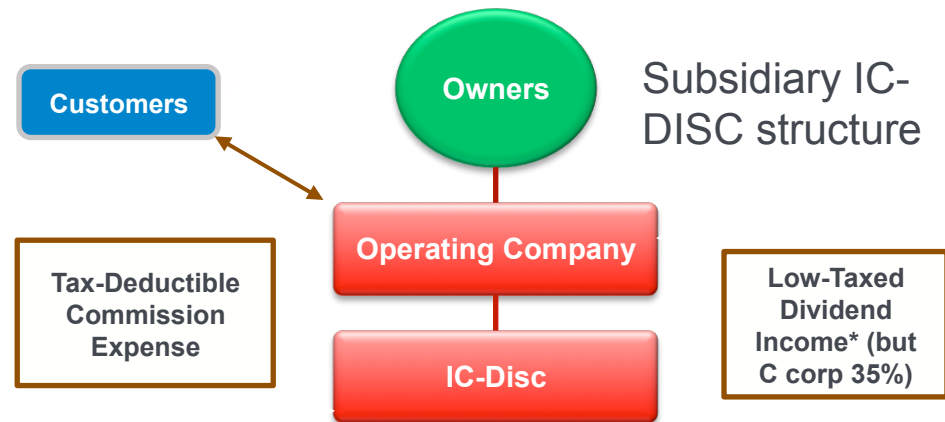
What is an IC-DISC?

- ▶ The IC-DISC is a “paper” company that has very limited substance. Customers do not need to know that the operating company has an IC-DISC. This is **intended** by Congress.
- ▶ IC-DISCs do not require office space, employees, tangible assets or contracts with customers.
- ▶ Any company or individual – domestic or foreign – can be a shareholder of an IC-DISC.



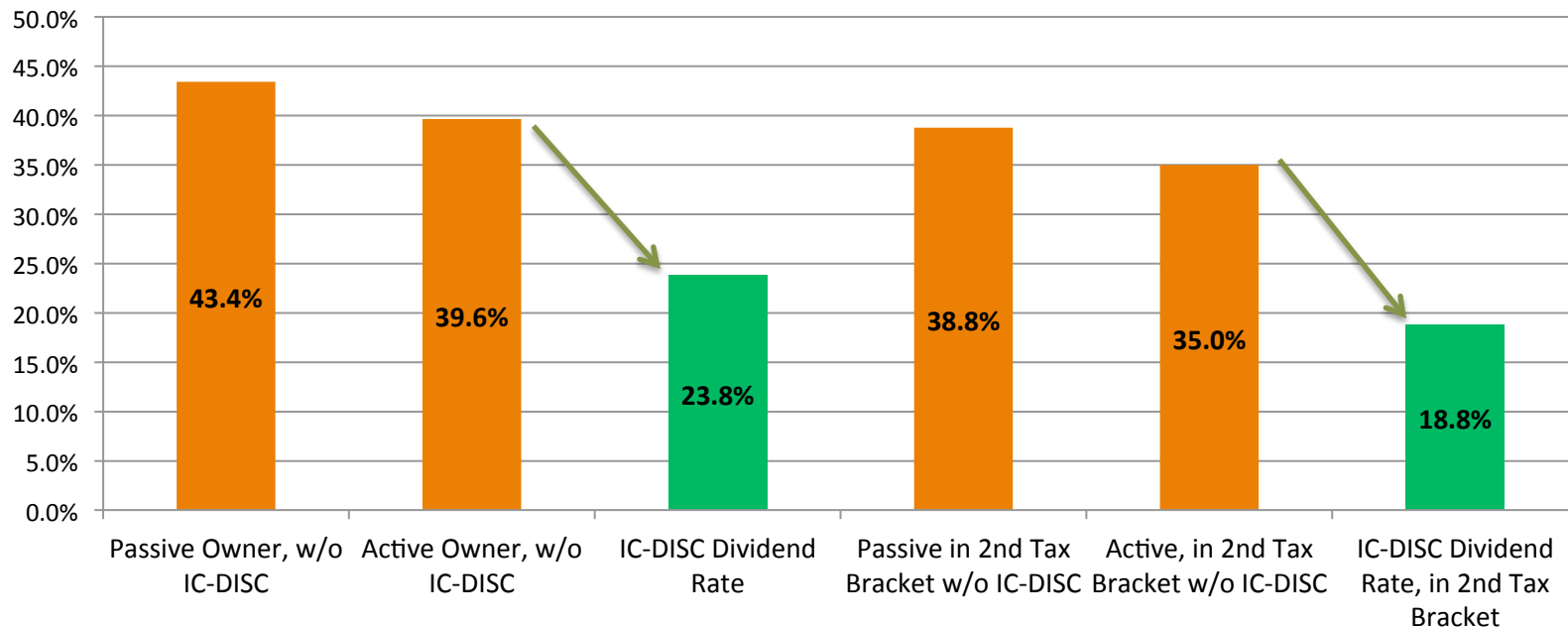
What is an IC-DISC?

- ▶ The Operating Company deals directly with customers, just as it always has.
- ▶ The parent company **deducts** commission payments to DISC with reference to the taxable income derived from the Operating Company's export transactions.
- ▶ IC-DISCs are C Corps, but do **not** typically pay federal tax per IRC §991 (no "double tax"). S/Hs get K-1.
- ▶ Dividends from IC-DISCs to individual owners (or LLC/S corp/trust) qualify for Qual. Div. tax rates if stock held 61 days (0%, 15%, 18.8%, 23.8%) that are lower than rates that apply to owner's ordinary income (39.6% or 43.4%).



Tax Savings from an IC-DISC

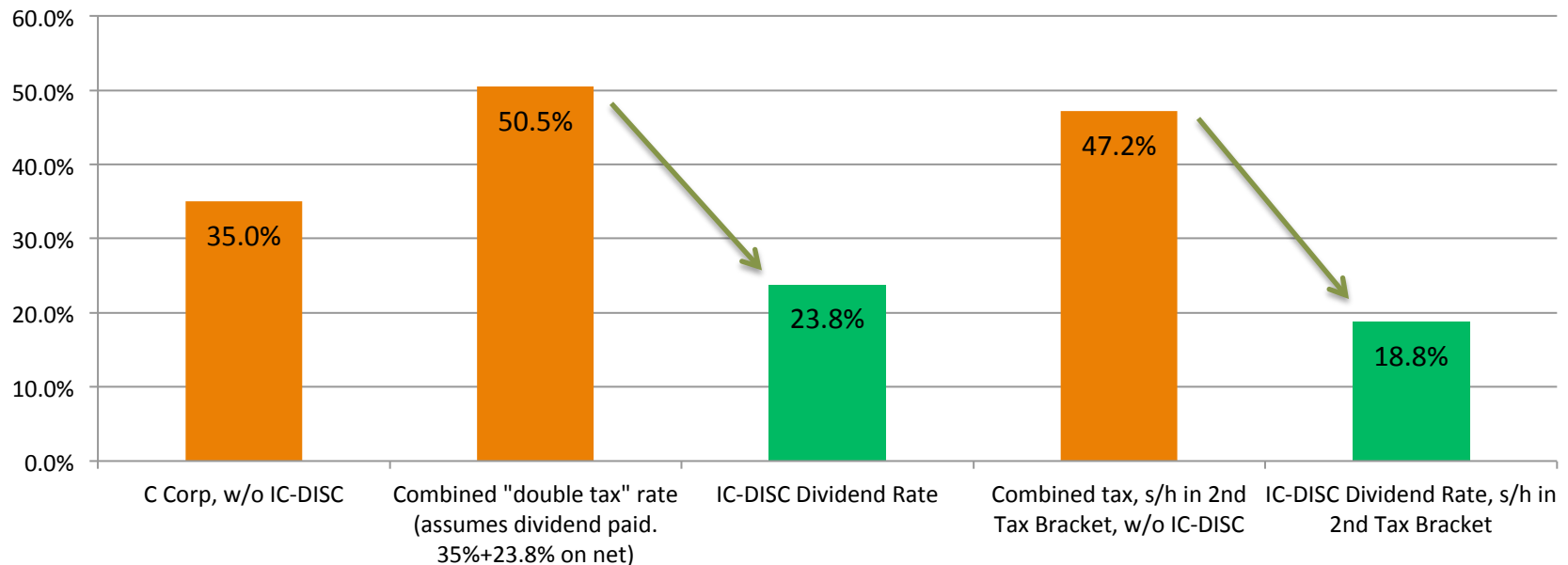
Federal Tax Rates on High Tax Bracket Business Owner's Export Income (assumes S Corp, LLC/partnership)



If child making under \$72,500 taxable income (MFJ, \$36,250 if single, \$48,600 HH) owns IC-DISC shares, tax rate may go from 18.8% -> 0%!!!

Tax Savings from an IC-DISC – C Corp

Federal Tax Rates on High Bracket C Corp Business Owner's Export Income



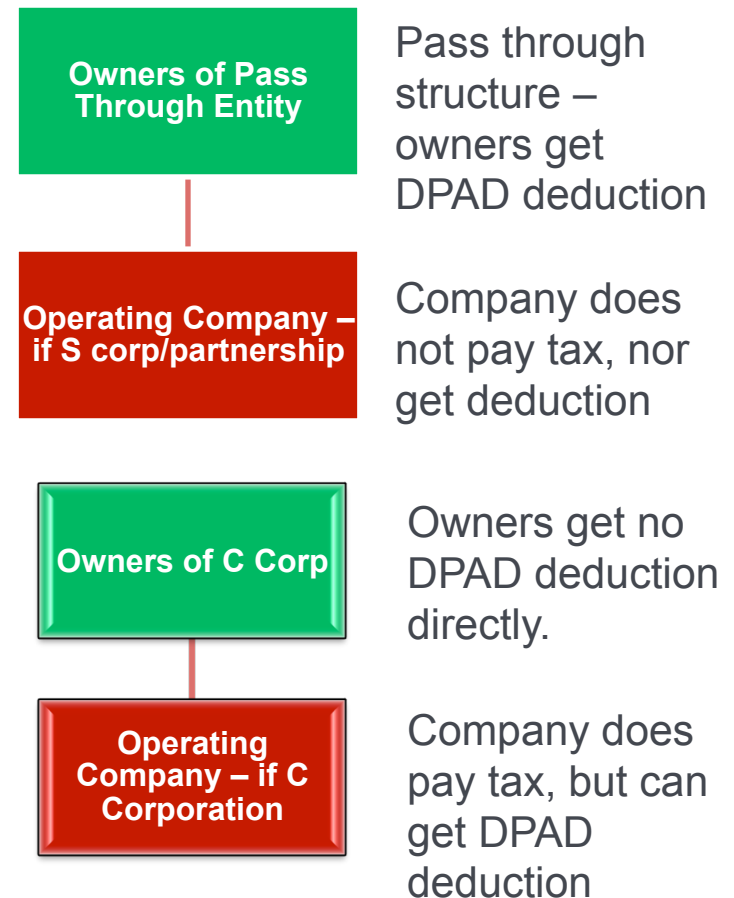
If child making under \$72,500 taxable income (MFJ, \$36,250 if single, \$48,600 HH) owns IC-DISC shares, tax rate may go from 18.8% -> 0%!!!

What is the Domestic Production Activities Deduction (“DPAD”)?

- In 2004, as part of the American Jobs Creation Act, Congress phased in a new tax deduction related to qualified domestic production. Congress wanted to enact a tax law that helped the ability of particular domestic businesses, domestic producers in particular, to compete in the global marketplace. The new tax deduction, domestic production activities deduction (“DPAD”), is available for a broad range of domestic manufacturing and production businesses, as well as companies engaged in activities not traditionally seen as manufacturing, e.g. agriculture.
- 3% for 2005-2006.
- 6% for 2007-2009.
- 9% for 2010-current

What is the Domestic Production Activities Deduction (“DPAD”)?

- ▶ The DPAD is a deduction designed to encourage production of U.S. made goods. It does not matter if goods are exported or not and this deduction may be taken in addition to using an IC-DISC. This is **intended** by Congress.
- ▶ Owners of S corps, partnerships or LLCs taxed as partnerships, S corps or sole proprietorships claim the deduction on their 1040. It is an “above the line” deduction (see line 35 on page 1 of Form 1040) that reduces adjusted gross income (AGI). Estates/trusts are eligible.
- ▶ C Corporations claim the deduction on line 25 of Form 1120.



What is the DPAD Worth?

- DPAD has increased since 2004 and is now nine percent (9%) *of the lesser of:*
 1. The qualified production activities income (QPAI) of the taxpayer for the year; **or**
 2. The taxable income of the taxpayer (but in the case of an individual, this limitation is applied to AGI).
- The deduction cannot exceed 50% of the W-2 FICA wages of the employer for the taxable year.
- Thus, sole proprietors and partnerships with no employees that issue no W-2s will have the deduction eliminated under this restriction. Those with W-2 employees (even owner/spouse) are eligible.
- Thus, this 9% deduction may reduce the top tax rate such income for C corps from 35% to 31.85% (91%x35%) and for active pass through owners from 39.6% to 36.036% (91%x39.6%).

Example of Tax Savings from DPAD (pass-through entity, not C Corp)

Example 1: George, a sole proprietor widget maker, reports \$170,000 of net income on his 2013. Thus, his production deduction could equal \$15,300 (9% x 170,000). However, George must have at least \$30,600 in qualifying Form W-2 wages to claim the full \$15,300 deduction ($\$30,600 \times 50\% = \$15,300$).

If George is in a 28% bracket, this \$15,300 deduction could save \$4,284 (not counting potential state and local tax savings).

Tax Savings from DPAD (pass-through entity, not C Corp)

Example 1a: What if George had no W-2 wages, but changed to an S corp and paid himself or spouse \$30,600?

His employment tax would be approximately the same. He may have to pay unemployment and worker's comp, however. These should be much less than the amount saved by qualifying for an additional \$15,300 deduction. It may be worth exploring.

Reducing AGI has a positive beneficial effect in a number of tax deductions and credits where benefits are phased out for higher AGI- taxation of social security, student loan interest deduction, deduction for IRA contributions, Schedule A "Pease limitations", personal exemptions phase out and many more credits/deductions.

Tax Savings from DPAD (C Corporation)

Example 2: Same as above, but George owns/operates as a C Corp

The *corporation* can take the deduction on the Form 1120 and reduce its taxable income, which may also indirectly reduce George's income.

If George had been conveniently “zeroing out” the C corp's income with year end bonuses, he would not be as compelled to bonus out so much, which reduces his W-2 and AGI, which has a beneficial side effect of reducing the risk of the IRS recharacterizing the bonus as a disguised dividend.

Example of Tax Savings from DPAD (pass-through entity, not C Corp)

Example 3: Elizabeth and John own an S corporation that makes widgets. The company reports \$1,000,000 of net income. Additionally, they own an LLC that generates \$200,000 of rental income. They have \$50,000 of other miscellaneous income. All of their S corp net income is attributable to qualifying production activities. Thus, their production deduction could equal \$90,000 ($9\% \times 1,000,000$). However, the company must have at least \$180,000 in qualifying Form W-2 wages to claim the full \$90,000 deduction ($\$180,000 \times 50\% = \$90,000$).

If they are in a 39.6% bracket, this \$90,000 deduction could save \$35,640 (plus, potentially state income tax depending on the state).

What income is eligible for DPAD?

Domestic Production Gross Receipts (DPGR) (Section 199(c)(4)(A)) generally includes gross receipts from the lease, rental, license, sale, exchange or other disposition of:

- Qualifying production property (QPP) manufactured, produced, grown or extracted (MPGE) by the taxpayer, in whole or significant part, in the U.S. QPP includes:
 - Tangible personal property (aka “making stuff”), incl. computer software and sound recordings.
 - Construction or substantial renovation of real property in the U.S. (includes residential and commercial property and infrastructure) (but see exception on next slide)
 - Engineering and architectural services performed in U.S. and relating to the construction of real property
 - Film production in certain circumstances
 - Production of electricity, natural gas, or potable water in the U.S.

What income is ineligible for DPAD?

Domestic Production Gross Receipts (DPGR) (Section 199(c)(4)(B)) *excludes*:

- (i) The sale of food and beverages prepared by the taxpayer at a retail establishment,
- (ii) The transmission or distribution of electricity, natural gas, or potable water, or
- (iii) The lease, rental, license, sale, exchange, or other disposition of land.

Asset Protection for Business Owners/Execs

- Captive insurance companies can be complicated, but valuable for the right business
- Unfortunately, some promoters have abused them and the IRS has initiated some audits
- However, Congress recently expanded their use under the PATH Act – 831(b) smaller captive premiums permitted up to \$2.2 million, to be adjusted for inflation, starting in 2017

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BUSINESS ADVISORY SERVICES

Strategies & Solutions for Business Owners

Captive Insurance

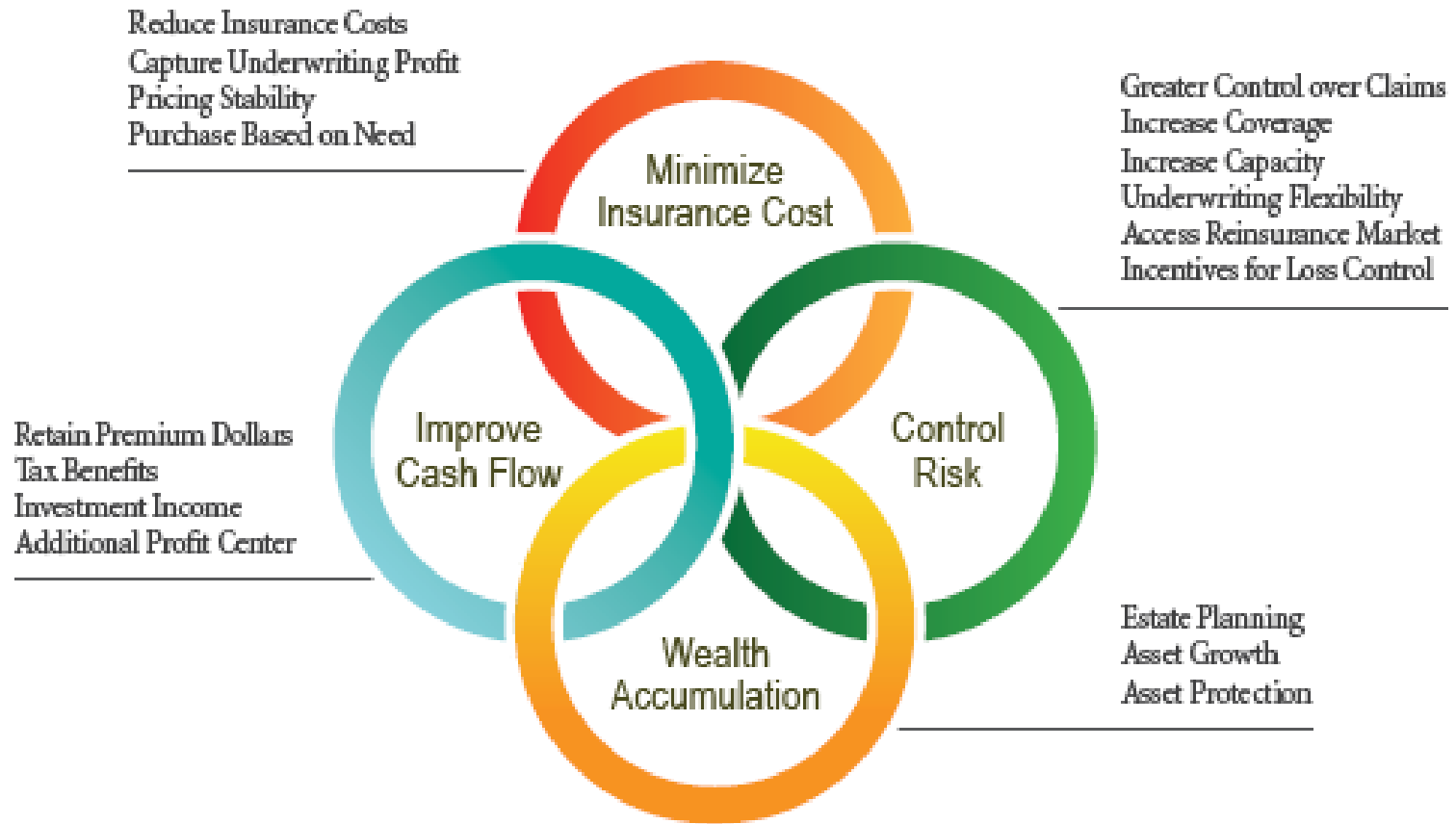
What Is A Captive?

- A captive insurance company is a corporation formed in either a U.S. or foreign jurisdiction for the purpose of writing property and casualty insurance to a small, usually related, group of insureds.
- The focus of a captive is to economically assume risk that is currently self-insured. This may include increasing deductibles on existing policies, assuming all or some of the risk of traditional insurance, or merely taking on the risks of existing deductibles and exclusions.
- Certain types of coverage are unavailable or difficult to obtain, often due to historic loss experience for a sector or industry, such as medical malpractice, or conditions such as environmental, construction defect, earthquake, or wind and weather.

Why?

- Improved risk management and risk financing
- Lower first dollar insurance costs
- Plugging gaps in commercial insurance coverage
- Improved cost control and internal cost tracking
- Gaining access to the reinsurance market
- Creating a profit center
- Unlike simply establishing a sinking fund, which is not deductible, premium payments to captive insurance companies can be deductible

Captive Benefits



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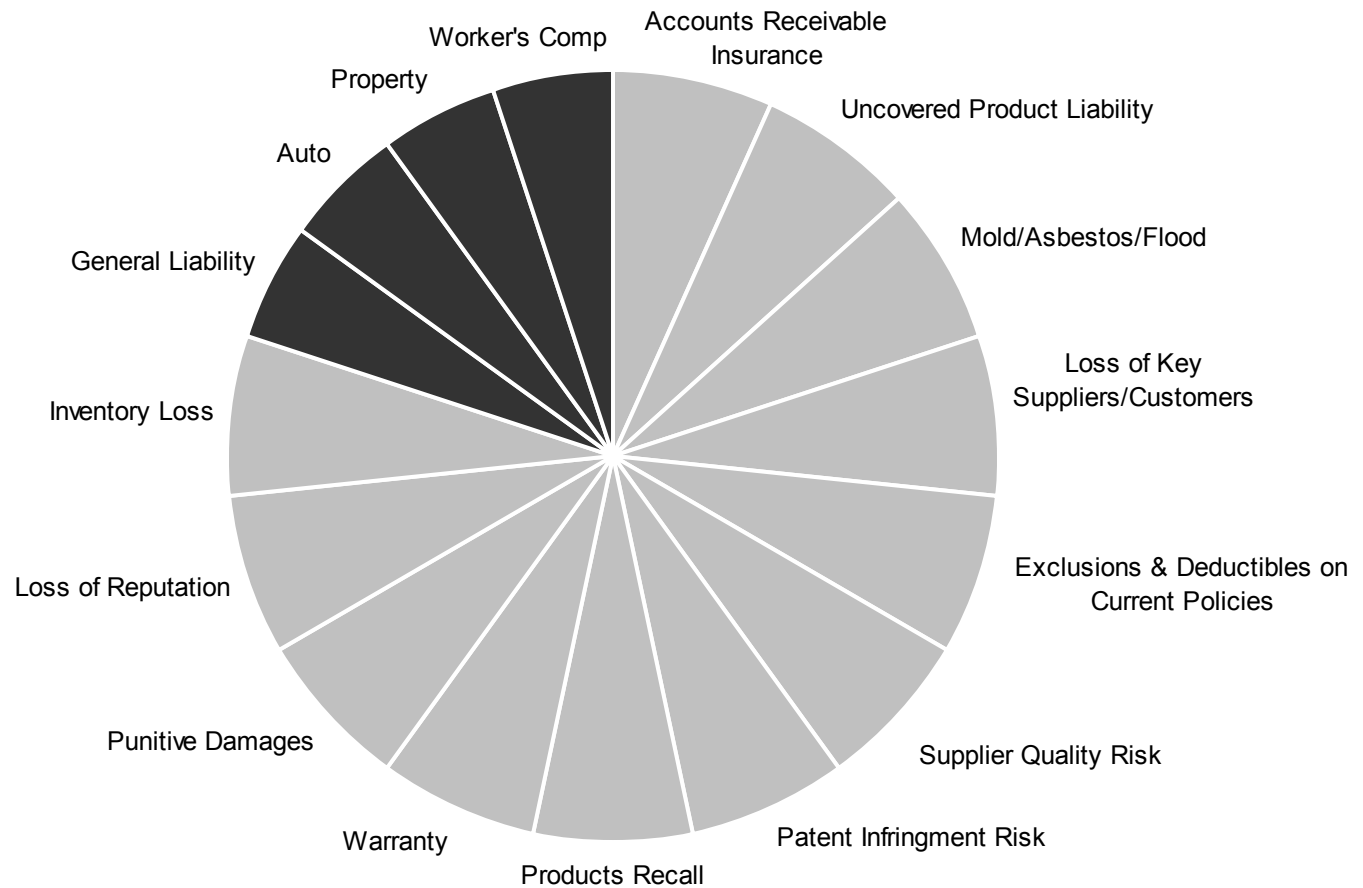
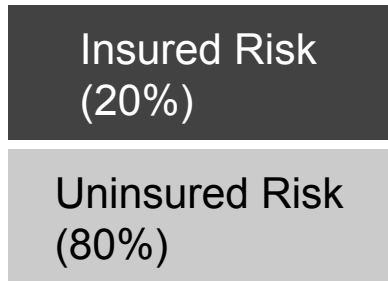


831(b) Taxation

- Federal:
 - If an insurance company receives less than \$1.2 million of premiums each year (\$2.2 million adjusted for inflation starting in 2017), it may elect to be taxed only on its investment income.
 - This allows the captive to accumulate surplus from underwriting profits free from tax; however, the owners of the captive are taxed on dividends later received from the company similar to large property and casualty companies (at qualified dividend rates)

What Does a Typical Captive Insure?

[Lloyd's Type Risk]

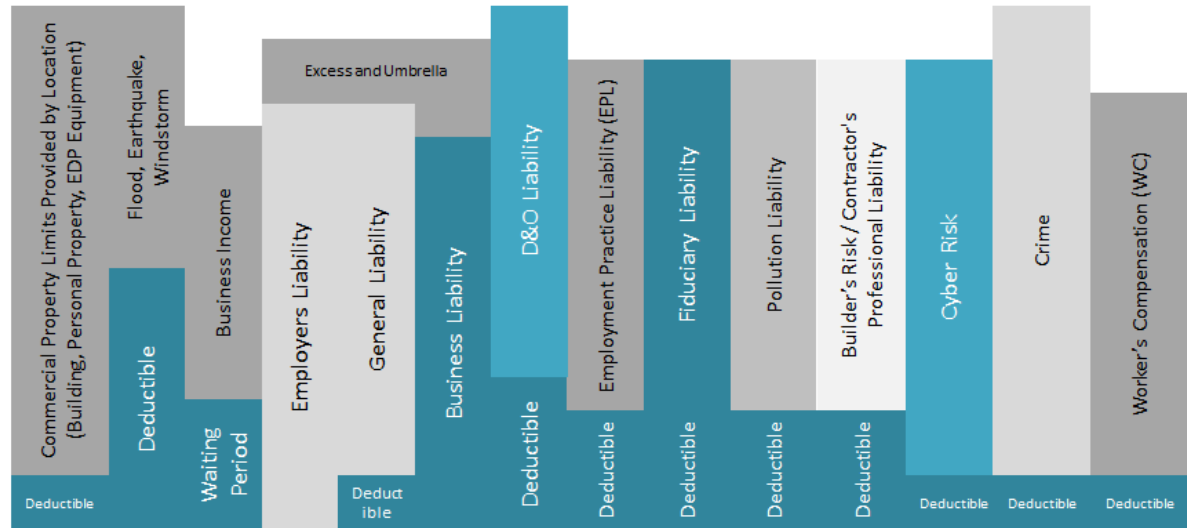


Examples of Captive Insurance Policies Written

- Professional Liability Gap Coverage
- HIPAA/Billing Audit Liability
- Contractual Liability
- General Liability Gap
- General Liability Retention
- Cyber Liability
- Environmental Liability
- Excess Environmental Liability
- Labor Shortage/Strike Loss Reimbursement
- Employment Practices
- Employee Dishonesty
- Patent Infringement/Intellectual Property
- Property Management Professional
- Professional Misconduct
- Product Recall
- FDA Administrative Actions Liability
- Product Liability Gap
- Directors and Officers Liability
- Punitive Damages
- Loss of Key Employee
- Deductible Reimbursement (Property,

Forming a Captive Insurance Company...

Risk Management *without* a Captive:



Risk Management *with* a Captive:



Rules of Thumb

- Actuarial Test: Premium represents 15% or less the operating business gross revenue.
- CPA Test: Ratio of premium to taxable income should not exceed the ordinary, necessary and reasonable test (Captive premium should be no more than 40% of net income)
- Common Sense Tests:
 - Genuine business purpose / actual risk management tool.
 - Premiums priced reasonably / e.g. terrorism in non-tier 1 cities and hurricane insurance in Kansas City.
 - Legitimate pool / types of risk or size of deductible.
 - Circular cash flow / enough surplus to pay claims
 - Actual claim activity
 - Life insurance is NOT purchased within captive

Who is an Ideal Candidate?

Good candidates generally meet one or more of the following criteria:

- \$10M+ gross revenue
- Pre-tax profits of at least \$1MM
- Stable cash flow
- Substantial self-insured / uninsured business risk
- Privately held
- Entrepreneurial
- Willing to take a measured degree of insurance risk

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Investment and insurance products are:

Asset Protection for Business Owners/Execs

- Irrevocable Trusts for family can “take the chips off the table” in the event of lawsuits
- Good insurance, umbrella, E&O insurance is the first line of defense, but there are holes and limits in coverage
- Ohio Legacy Trust Act now allows you to get essentially the same asset protection as your IRA/401k or life insurance for a trust in which you can remain beneficiary, not just spouse/children.

Congress expands charitable gifts by S Corporations

- S corporations have always been able to make charitable gifts, which pass to owner on K-1.
- However, basis rules previously greatly reduced the benefit of gifting any assets in kind with basis less than fair market value
- PATH Act makes permanent a more favorable basis rule that encourages in-kind gifting to charity, including to charitable remainder trusts (CRT)
- Example: S corp buys land for \$70,000 to expand, but changes strategy. Land now worth \$200,000. S corp could contribute land to 20 Year CRT, sell, and the \$130,00 gain is effectively deferred over the term of CRT. Owner gets partial tax deduction. No need to sell or distribute from S corp first.

Advanced Tax Planning Ideas for Year End 2016

- Tax Loss Harvesting, including coordination with sales of real estate and other assets; Asset *Location* and Asset Allocation Reviews
- Creation of qualified defined benefit plan to maximize retirement savings for closely held business with few employees
- Planning for taxable estates in light of the proposed IRS regulations on business valuation that may indirectly penalize family businesses with higher estate/gift tax. Are buy-sell agreements and estate plans affected?
- Why closely held business owners with non-taxable estates (\$5.45 million single, \$10.9 million married couple) should consider revisions to their operating agreements to remove “discounts”.
- Other Exit Planning Ideas – should some business owners reconsider C corporation status due to opening up tax-free sales for small business stock, tax free sale to ESOP, tax-free merger and/or tax deferred transfer to and sale by Charitable Remainder Trust? What is the exit strategy?

End of Year Tax Planning – Investment Related

Tax planning ideas– maximizing the tax benefit of losses, minimizing the tax detriment of gains:

Holding Period

Pay attention to which stocks are sold, since stocks lots (unlike partnerships!) can have different basis as well as holding periods (one year holding is important for short-term v. long-term gain rate)

Tax Loss Harvesting

Tax loss harvesting can add significantly to *after tax return* over time. Often, an individually owned portfolio of large cap stocks can still yield tax loss harvesting even when the overall market is flat or slightly up for the year. E.g. if I have a simple S&P 500 ETF that is flat or slightly up for the year, I cannot sell to take any loss, but if I have a bucket of 30-40 large cap stocks that net the same return, there are sure to be some winners, some losers. Selling the losers can offset other capital gains, plus up to \$3,000 of ordinary income annually. Especially valuable for short-term gains.

Wash Sale Rule

Be careful of the “wash sale” rule for *substantially identical* securities purchased 30 days before or after the security which is sold for a loss – even if purchased in an IRA! – it causes the loss to be suspended. **Some rules are still unclear** – what if I sell one S&P 500 ETF and buy another from another ETF that is substantially similar? Strategies to avoid wash sales when someone wants to keep the same allocation include: wait 31 days, purchase a strongly correlated security, or sometimes even using puts/calls can accomplish this (but be careful, buying a call on a stock triggers a wash sale similar to buying the security!)

End of Year Tax Tips – Investment Related

Tax Planning Ideas for Investment Portfolio – Maximizing the tax benefit of losses, minimizing the tax detriment of gains:

Be careful selling closely held businesses between family to take losses, or even when there is no tax motivation at all and it triggers gain! Losses may be prevented between related parties and capital gains may be converted to ordinary income when selling depreciable/amortizable property between related parties

Remember – capital gains from sales of collectibles and assets subject to depreciation (e.g. real estate §1250 gain) have higher federal tax rates (28% and 25%, plus 3.8% surtax) – in many circumstances, ordinary capital losses may be able to offset those higher rate capital gains. *Even better – offsetting short-term capital gains taxed at up to 43.4% federal plus state (approximately 5%)!*

End of Year Tax Tips – Investment Related

Review asset location as well as asset allocation

Assets better suited for tax deferred or tax free accounts (e.g. IRA, Roth)

- High yield bonds
- REITs
- High-turnover, actively managed funds

Assets better suited for taxable accounts

- Other assets, such as cash yielding practically no return
- International funds kicking out foreign tax credits
- Individual stocks, tax-efficient low turnover funds, ETFs
- Municipal bonds
- Limited partnerships

End of year tax tips – retirement plan related

Tax planning ideas for maximizing the tax deferral of retirement plans:

- You can pay investment management/planning wrap fees/trustee fees attributable to IRAs (but not sales commissions, charges) from outside taxable accounts, enabling the IRAs to grow more. This indirectly adds to your contribution limits! Over time, this adds up. Be careful of the reverse - you cannot pay Roth or taxable investment management fees from traditional IRA accounts!
- High income taxpayers often cannot contribute to a Roth IRA – directly. However, you may be able to contribute to a non-deductible traditional IRA, which can later be converted to a Roth IRA (conversions no longer have an income limitation). Be careful with later Roth IRA conversions – the IRS considers the basis for ALL IRAs when evaluating the tax on Roth conversions, not each IRA separately. Or, contribute to an IRA for a non-working spouse.
- Roth IRA conversions are unique – they have an “undo” button until Oct 15 of the following year. If you want to convert \$250,000, you can divide your \$1 million IRA into four accounts of differing assets, then cherry-pick the best performing one to keep as a Roth, and “undo” the other three!
- While large companies are killing their traditional pensions and defined benefit plans, small business owners are embracing them. Why? ***A small business owner age 62 with 6 employees may be able to defer up to \$255,000 a year in a defined benefit plan!*** You can establish such a plan even if family members are the only employees in the business!

Key Private Bank



Who Wins and Who Loses if Proposed Business Valuation Regulations Under §2704 Are Made Final

Who Loses? Anyone with a taxable estate (\$5.45 million single, \$10.9 million married), who owns or might have established an entity, which the family could control if aggregated together (50%+)

Who Wins? Hopefully, anyone with a **non**-taxable estate who owns business entities which the family could control together (since they benefit from higher valuations, since this should increase basis - but there is a lot of uncertainty here). *Indirectly*: valuation firms, law firms, accountants

Who is not affected? Those who do not own closely held business interests nor would ever establish one, or those families with non-controlling (<50%) interests in closely held business (aggregated).

Effective Dates

- Some of the regulations become effective upon immediately after the regulations are published as final, but the most substantial and far-reaching rules will not take effect until 30 days after that. Prop. Reg. §25.2704-1(c)(1). They could be made final in December, January, or even months later. The important point is that we have ***time to plan***.
- There is a possibility that regulations may be modified or even overturned, but it may take years – safest to plan for the worst.



Planning Opportunity Before the Proposed Regulations Become Final: Example of Impact

- Example: John owns 100% of Widget Co., an S corporation, valued at \$20 million. He gifts 20% interests each to three trusts for his children.
- **Current law:** John's gifts must be "discounted" for gift tax purposes, from \$12 million (60% x \$20 million) to approximately \$8.4 million (assume 30% conservative discount). Moreover, when John dies, his remaining 40% in his estate would also receive a 30% discount (from \$8 million to approx. \$5.6 million).

Planning Opportunity Before the Proposed Regulations Become Final: Example of Impact

- Example: John owns 100% of Widget Co., an S corporation, valued at \$20 million. He gifts 20% interests each to three trusts for his children.
- **Law if Proposed Regulations Become Final:** John's gifts are might not be "discounted" for gift tax purposes, or perhaps not as much, and the gifts use the full \$12 million (or very close to it) for gift tax purposes. Moreover, when John dies, his remaining 40% in his estate would also be valued at the full \$8 million (or very close to it) for estate tax purposes.
- A potential difference of \$6 million \times 40% = **\$2.4 million** estate tax (perhaps more, depending on the state, and not counting additional savings from growth on gift outside estate, paying income tax)

Planning Opportunity Before the Proposed Regulations Become Final: Example of Impact

- Example: John owns 100% of Widget Co., an S corporation, valued at \$20 million. He gifts 20% interests each to three trusts for his children.
- **Law if Proposed Regulations Become Final – *Effect of Three Year Rule***: Even if John's gifts were permitted a discount at the time of gift (e.g. if they were made in 2014-16), if he dies within three years of the gift after the proposed regulations are made final, the difference **may be** added back into John's estate, eliminating the benefit of the prior discount. Thus, to ensure best exploitation of pre-regulation planning, business owners should *outlive any gift of interests in a closely held business by 3 years!* This three year rule includes sales!

Old Buy-Sell Agreements May be Ticking Time Bomb

- If the gift or estate tax value of the business artificially increases because of any new §2704 regulations, is the buy-sell buyout tied to that number – does the buy-sell reference *estate tax* value?
- If it is not, should it be - in some family contexts? Phantom estate value occurs if \$X is in estate, but estate only receives \$.64X.
- There is no obvious answer, other than that parties should make sure they agree on result.
- The difference can be staggering and may lead to expensive non-tax litigation involving the business!
- Buy-sells, especially those where other family members or trusts are or may become owners, should be reexamined
- Buy-sells with unrelated parties usually do not use a discounted value or reference value as determined for estate/gift tax purposes, but they might – if cannot hurt to check.

Other Factors Impacting the Decision to Gift or Sell Business Interests to Family/Trusts in 2016

- The election – Secretary Clinton has proposed estate/gift tax changes that would decrease the estate/gift tax exclusion from \$5.45 million (current) to \$3.5 million, and increase the gift/estate tax rates from 40% to 45%
- Current historically low applicable federal rates – August 2016 is only 0.56% (short term), 1.18% (mid-term) and 1.9% (long-term) – 7520 rate only 1.4% - these favor techniques that include intra-family/trust loans
- Many taxpayers made large gifts in 2012 before the “cliff” and the *statute of limitations on the gift tax return has safely passed*, giving them more comfort level to make additional gifts

Business Owners with Non-Taxable Estates Should Plan to Maximize Basis Increase/Valuations

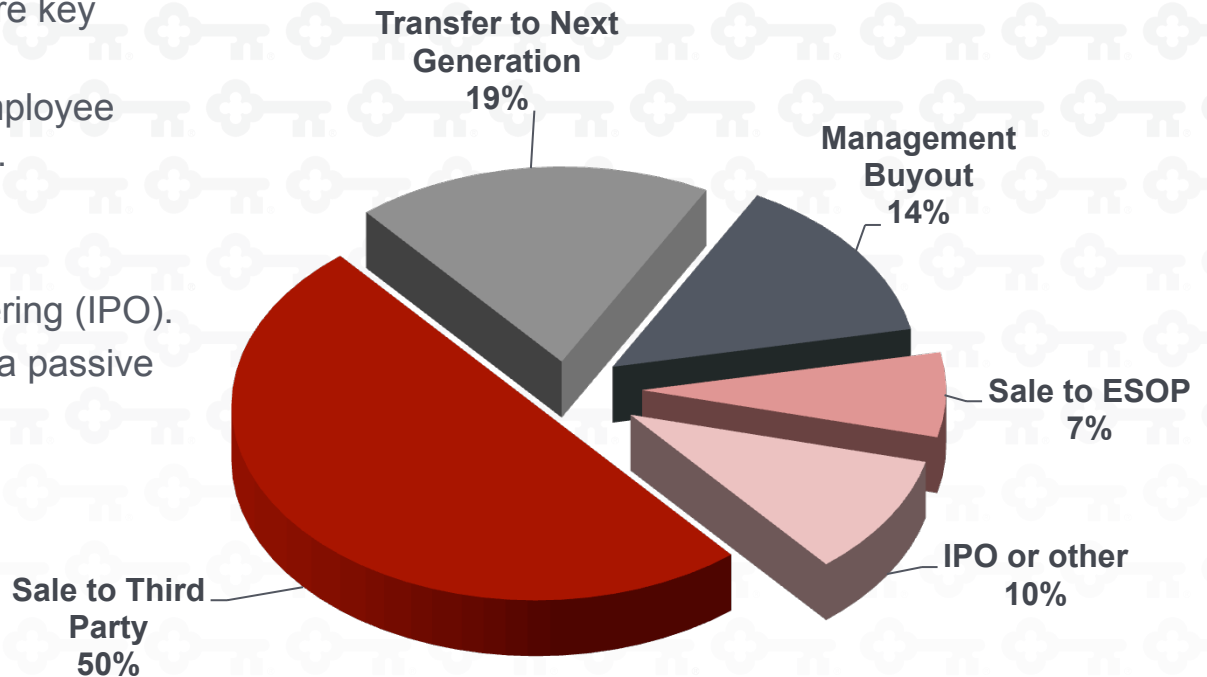
- Very often, family owned businesses may get a “discount” for estate tax valuation purposes, but not be large enough to pay estate tax
- Generally, discounts cause a decrease in basis, which reduces depreciation and/or increases capital gains upon later sale by beneficiaries.
- Owners can take steps to amend operating agreements to remove factors that lead to valuation discounts, enabling a higher basis at death for heirs.

Exit Strategies for Business Owners

8 Possible Exit Routes

- Transfer the company to family member(s).
- Sell the business to one or more key employees.
- Sell to employees using an Employee Stock Ownership Plan (ESOP).
- Sell to one or more co-owners.
- Sell to an outside third party.
- Engage in an Initial Public Offering (IPO).
- Retain ownership but become a passive owner.
- Liquidate.

What exit route do owners anticipate?*



*Price Waterhouse Coopers survey

Exit Strategies for Business Owners

If a SALE is likely, pre-sale planning can in many instances:

- Enable gains to avoid state income tax if the deal is a “stock” rather than “asset” deal (see Ed Morrow’s article on the *Corrigan v. Testa* case)
- Enable gains to be deferred by using charitable remainder trusts (not for S corps)
- Enable gains to be completely excluded, for certain businesses, if stock held at least five years, with the small business capital gains tax exclusion (must be C corp, but a partnership/LLC could elect to be taxed as C corp and start the five year holding clock ticking); there is a similar provision that also permits tax-free rollovers to other qualifying small business stock
- Enable stock to be sold to an ESOP (must be a corporation under federal tax law)
- Enable stock to be sold to an ESOP tax-free if reinvested in qualifying investments (must be a C corporation)
- If gifted or sold to irrevocable trusts, enable stock gains to pass free of estate/gift tax
- If sold to irrevocable trust via installment sale at least 2 years prior, enable bulk of stock gains to continue to be deferred and taxed on installment method even if the business is sold to an outside party outright in lump sum
- Enable stock gains to be avoided via certain corporate mergers (may depend on buyer)

Exit Strategies for Business Owners

If keeping the business in the family via gift or bequest is likely, planning can in many instances:

- Avoid the impact of the newly proposed Section 2704 business valuation regulations discussed, that may increase gift, estate and generation skipping transfer tax
- Achieve maximum discounts for taxable estates
- Avoid discounts for non-taxable estates to enable higher step up in basis
- Enable “inside basis” step up via 754 election for partnerships/LLCs after death
- Avoid disputes about tax apportionment, which can be common whenever specific bequests are made
- Avoid will and trust contests, even about valuation of the business
- Avoid having the business become “marital” property of spouse/children after inheritance, by keeping property as “separate” in a designated trust (like a de facto prenup)
- Minimize employee turnover at death by incentivizing key employees to continue after ownership transition