

ATTENTION BUSINESS OWNERS: NEW BUSINESS PLANNING OPPORTUNITIES UNDER THE 2017 TAX ACT

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The 2017 Tax Cuts and Jobs Act (the “Act”) was rushed in order to make it effective as of January 1, 2018. Anything that is rushed certainly will create opportunities for creative estate planners who will exploit the new tax laws for the benefit of their clients. **The greatest opportunity business owners received from the Trump Tax Act is the new IRC 199A pass-thru business deduction. This deduction allows certain taxpayers to deduct 20% of their “Qualified Business Income” (subject to limitations discussed below). In other words, the Act creates a new income tax deduction for individuals, trusts and estates that own pass-through businesses.** Pass-through businesses include sole proprietorships, partnerships, limited liability companies taxed as partnerships and S-corporations. The deduction equals 20% of Qualified Business Income and is taken against the pass-through owner’s taxable income.

The overarching policy here is that, because the Act cuts the income tax rate for corporations that are taxed separately (C-corporations) from 35% to 21%, pass-through businesses also deserve some tax relief. The 20% deduction means that the maximum effective income tax rate for pass-through income is 29.6% for a taxpayer in the top 37% income tax bracket.

1. **U.S. business** - The pass-through income must be “effectively connected” with the conduct of a U.S. trade or business (including Puerto Rico). There is no deduction for foreign business income. This rule is designed to reward businesses operating in the U.S., rather than abroad.
2. **Non-investment income** - Investment income earned through a pass-through entity, including capital gains, dividends and interest, does not give rise to a deduction. This means that a taxpayer cannot simply transfer his investment portfolio into a pass-through entity in order to get a lower tax rate.
3. **Non-compensation income** - If the owner of the pass-through entity receives wages, a guaranteed payment or other form of reasonable compensation from the entity, this compensation income does not give rise to a deduction. This rule reinforces the idea that the 20% deduction only applies for business income, not compensation income.
4. **Income threshold for services business** - If the owner of a pass-through entity (a) earns income from a service business and (b) has taxable income over \$207,500 (single/married filing separately) or \$415,000 (married filing jointly), adjusted for inflation, then he does not get the 20% deduction. If the pass-through owner’s taxable income is between \$157,000 and \$207,500 (single/married filing separately) or \$315,000 and \$415,000 (married filing jointly), adjusted for inflation, he can take a partial deduction, but not the full 20% deduction. This rule reflects the



notion that tax reform incentivizes small businesses and capital investment, rather than returns to labor. Also, these figures are for total income, not just based on Qualified Business Income.

A services business is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. It also includes any trade or business which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interest or commodities. Engineers and architects were originally included in the list of services businesses, but they were removed from the final version of the Act.

5. **Income threshold for non-specified service businesses** - If the owner of a pass-through entity has taxable income over \$207,500 (single/married filing separately) or \$415,000 (married filing jointly), adjusted for inflation, then his 20% deduction is capped. The deduction cannot exceed the greater of (a) 50% of the wages that the business paid in the taxable year or (B) 25% of W-2 wages that the business paid in the taxable year plus 2.5% of the unadjusted basis of business property (i.e., certain depreciable property such as buildings and equipment). If the pass-through owner's taxable income is between \$157,500 and \$207,500 (single/married filing separately) or \$315,000 and \$415,000 (married filing jointly), adjusted for inflation, the cap still applies, but is a little more generous. This rule reflects the notion that tax reform incentivizes small businesses creating jobs and making investments domestically.
6. **Overall limitation** - In any event, the 20% deduction is capped at 20% of the pass-through owner's taxable income (excluding capital gain income). This rule is designed to prevent erosion of the tax base.

Exploiting IRC 199A using Multiple Taxpayers

Business planning in 2018 and beyond has now changed drastically. The goal now is to separate the business interests into as many different owners as possible, often using separate non-grantor trusts in order to create as many different owners as possible to each receive up to \$157,500 of taxable income.

There are many options:

Single Persons - \$157,500

Married Couples - \$315,000

Estates - \$157,500

Incomplete Gift Non-Grantor Trusts - \$157,500



Completed Gift Non-Grantor Trusts - \$157,500

Completed Gift Non-Grantor Domestic Asset Protection Trusts - \$157,500

Children of the Client - \$157,500

Beneficiary Defective Trusts - \$157,500

In many cases, the client has multiple children and grandchildren so the number of separate trusts can be further magnified! Do the math! The 20% pass-through business deduction is huge. For a Specified Service Business that can be transferred to different owners, the otherwise unobtainable pass-through deduction can be taken simply by using enough separate owners.

Beware of IRC Section 643(f)!

All planners should read **IRC Section 643(f)** before doing IRC Section 199A planning. Under this Code Section, the IRS will combine trusts that have substantially the same grantor and primary beneficiary where the principal purpose of the separate trusts is to avoid income tax. This certainly doesn't stop the creative planning. However, it does restrict it somewhat, so planners must be careful to consider these rules when creating structures that are designed to exploit the new rules.

Summary

The new IRC Section 199A pass-through business rules are the greatest gift that tax and estate planners could have ever received from Congress. Creative planners who make use of these new rules can save their clients significant income taxes! For more information, contact an attorney in our [Wealth Preservation Planning practice group](#) for an initial consultation to evaluate your planning options.



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Sol is a Director in the Dallas office, with over 30 years' experience in trusts and estate planning law. He counsels clients on estate planning, with a philosophy that estate planning is a process of planning for the accumulation, conservation and distribution of wealth between the generations. He is admitted to the U.S. Tax Court.

Sol has received the designation as an Accredited Estate Planner from the National Association of Estate Planners, 1995, and was selected to "5-Star" Wealth Manager in 2010-2017 and to the Texas Super Lawyers list in 2011-2017.

Admitted

- Texas, 1980
- U.S. Tax Court

Education

- LL.M. Estate Planning, 1982, University of Miami in Miami, Florida
- J.D., 1980, Southwestern University
- B.A., *cum laude*, 1974, The University of Texas

Affiliations

- Dallas Bar Association
- American Bar Association
- Dallas Estate Planning Council
- National Association of Estate Planners

Honors and Awards

- Accredited Estate Planner
- Named to the Texas Super Lawyer list in the area of Trusts and Estates, 2011-2017
- Selected as a "5 Star" Wealth Manager, 2010-2017



Publications and Presentations

- “Auld Lang Syne for Professional Personal Service Corporations,” State Bar of Texas, Texas Bar Journal (May 1983)
- “Section 401(k) Plans-An Alternative to an IRA,” Warren, Gorham & Lamont, The Review of Taxation of Individuals (Spring 1985)
- “The Foreign Sales Corporation-An Analysis of Its Impact, Attributes and Planning Opportunities after the 1984 Tax Reform Act,” Prentice-Hall, Tax Ideas (Fall 1985)
- “Choosing a FSC Jurisdiction,” Prentice-Hall, U.S. Taxation of International Operations (September 25, 1985)
- “Structural Considerations for a FSC,” Prentice-Hall, U.S. Taxation of International Operations (October 9, 1985)
- “Are Living Trusts for You,” T.A.L.S. Docket (March 1991)

Activities

- Adjunct Professor in Estate Planning, School of Business, University of Texas-Dallas (2015-present)
- Estate Planning Instructor, SMU Certificate Program for Financial Planning, 2010-present
- Estate Planning Instructor, Graduate School of Business at the University of Dallas, 1995-2010
- Professional Development Institute at the University of North Texas (May 1993-June 2010)
- Southeastern Paralegal Institute (June 1992 – May 1998).
- Judicial Law Clerk for Judge Jack Swink in the Probate Court of Los Angeles (1979)