EES Newsletter April 2019

Key Ingredients for a Succession Plan
Considerations by small business owners

It takes dedication, innovation and a little luck—or perhaps a lot of luck—to turn a vision into a successful business. This might be your life story or the story of someone you are close to. But what will happen to the small business when the owner is no longer able to chart the course?

According to a recent article in the Boston Globe, more than eight out of ten family-run businesses do not have a succession plan in place. And that could be a recipe for future failure.

Essentially, such a plan is a **road map** for heirs and business associates to follow in the event of death, disability or retirement. It may include provisions to distribute stock and other assets, acquire or amend life and disability insurance policies, arrange buy-sell agreements, divide responsibilities among successors and tie up any other loose ends. The plan can also establish the value of the business for various purposes.

Where do you start? First, the owner must clearly establish his or her **objectives** and define the financial circumstances. Next, several critical questions must be answered, such as whether the owner intends to retain some level of control in retirement, whether there is a capable successor within the ranks and if there are sufficient assets to pay any estate tax, distribute assets and still keep the business running. This also requires some frank and honest discussions with co-owners or partners, family members and key employees and stakeholders.

Following are several other points to consider:

- The plan should be flexible. Business, family and health situations are ever-changing, so make the plan relatively easy to modify.

- It is important to designate the best person (or people) to take over the reins. This can be a difficult process if there are several viable candidates among the children, siblings or business associates. Similarly, dividing up business assets in an equitable fashion can be a challenge if you hope to preserve family harmony.

- Develop a basic understanding of the prevailing **federal and state estate tax laws**. On the federal level, the tax law currently provides a generous $10 million estate tax exemption (indexed to $11.4 million 2019) with a top tax rate of 40%. Thus, most small business owners can shield their estates from federal tax, but there may be other consequences on the state level.

- Be aware of gift tax benefits. Under the annual gift tax exclusion, a donor can gift up to $15,000 per year to each recipient ($30,000 for joint gifts by a married couple). The exclusion is allowed in addition to the lifetime gift tax exclusion (which is unified with federal estate tax exemption).

- Consider establishing the **fair market value** (FMV) of your company. The FMV is usually defined as the amount that a buyer would be willing to pay under the usual circumstances. It can be incorporated in a buy-sell agreement that will keep the business afloat in the event of a sudden death or disability.

Final words: Creating a succession plan is generally not a do-it-yourself proposition. Seek guidance from your professional advisors.

IRS Explains 199A Rules for Real Estate
New final regs provide guidance

The massive tax legislation signed over a year ago, the Tax Cuts and Jobs Act (TCJA), authorized a brand-new deduction for qualified business income (QBI) of **pass-through entities** and **sole proprietors**. This deduction under Section 199A of the tax code provides opportunities for a wide range of taxpayers, but has also caused confusion, especially as it relates to triple net leases and other real estate activities.

The 199A deduction is first available on 2018 returns. Fortunately, the IRS recently issued some-much needed guidance in the form of new final regulations.

Background: The TCJA allows a qualified taxpayer to deduct up to 20% of QBI earned during the tax year. However, the deduction is phased out at certain income levels, depending on whether or not you work in a "specified service trade or business" (SSTB). This includes most personal service providers like attorneys, physicians and consultants.

But the law still leaves room for interpretation. Notably, if you participate in a **rental real estate activity**, it may not be clear if you qualify for the 199A deduction. There is no bright-line indicator in the TCJA, but now the IRS has established a new safe-harbor rule.

How it works: Under the new regs, a rental activity (including multiple rental activities where the taxpayer elects to combine them in a single enterprise) is treated as trade or business for 199A deduction purposes if these requirements are met:

- You maintain separate books and records for each rental activity (or the combined enterprise);
- You perform 250 hours or more of rental services for the activity (or combined enterprise); and
- You maintain contemporaneous records showing (1) hours of services performed, (2) a description of all services performed, (3) dates on which services are performed and (4) identities of the parties performing the services.

Rental services include advertising rentals; negotiating and executing leases; verifying tenant applications; collecting rent; daily operations and maintenance; real estate management; purchase of materials; and supervision of employees and independent contractors. The services may be performed by the owner(s), employees or agents and/or independent contractors.

On the downside, certain rental activities are **excluded** from the safe-harbor rule. This includes two key situations.

1. You use the real estate as a residence for any portion of the year; and

2. You rent out the property on a triple net lease basis.

The IRS defines a "triple net lease" as a lease agreement requiring the tenant or lessee to pay (a) taxes, fees and insurance, (b) expenses for maintenance and (c) rent and utilities. These requirements are often stated in rental agreements.

However, the final regulations preserve a special **"self-rental" exception** from the proposed regulations. Under this exception, rental or licensing of property to a related trade or business is treated as a trade or business if the activities are commonly controlled (i.e., more than 50% common ownership), even if the rental is on a triple net lease basis.

Practical advice: Consult with your professional advisors for ways to maximize the tax benefits for your real estate activities.

Overview of Charitable Remainder Trusts
Key tax benefits for itemizers

The charitable remainder trust (CRT), which has been a valuable estate planning tool for decades, has not been forgotten. Currently, the usual 15% tax rate on long-term capital gains is increased to 20% for upper-income investors, while a 3.8% surtax may also apply to a portion of your investment income. Thus, CRTs remain a popular way to shield assets from adverse tax consequences in the wake of the Tax Cuts and Jobs Act (TCJA).

How it works: You transfer appreciated property like a business interest to the CRT and designate a beneficiary to receive income from the trust for life or a period of years. For instance, you might name yourself or your spouse as the income beneficiary of the trust. The beneficiary pays tax on the amounts received from the trust. At the end of the trust term, the property goes to the charity named in the trust documents.

This can accomplish both long-term and short-term objectives. For instance:

- A donor who itemizes deductions can claim a **current tax deduction** for the value of the remainder interest that passes to the charity. The value of the donation is based on special government tables.

- The donor may also avoid a potentially large capital gains tax on the sale of appreciated property.

- The designated beneficiary can rely on a **steady stream of income** from the CRT to sustain him or her in retirement.

- The CRT may be combined with a "wealth replacement trust" to achieve additional estate planning benefits.

Suppose the tax savings generated by the CRT fund a wealth replacement trust in whole or in part. The trust can then use the money to purchase life insurance to replace the wealth donated to charity. When all is said and done, your heirs come out even with or ahead of where they would have been if you had not set up the CRT in the first place.

Although there are several variations, the two main types of CRTs are **charitable remainder annuity trusts** (CRATs) and **charitable remainder unitrusts** (CRUTs). No matter which one you use, the income beneficiary must be entitled to an annual payment each year for life or for a period of no more than 20 years.

With a CRAT, the payment must be a fixed amount at least equal to 5% of the initial value of the trust property, while a CRUT requires payment of a fixed percentage (not less than 5%) of trust assets. In either event, a trust will not qualify as a CRT if the annual payout exceeds 50%. Also, it must be clear that the charity will receive at least 10% of the fair market value of the donated assets.

Finally, be aware that a CRT is **irrevocable**. In other words, you can’t change your mind and take your assets back. Also, there are fees for establishing and maintaining the trust.

Of course, CRTs are not for everyone, especially in view of other changes in the TCJA. When it makes sense, coordinate this technique with all aspects of your estate plan.

Season’s Greetings: Dirty Dozen Tax Scams
Annual list released by IRS

Every year, the IRS posts a list of the “Dirty Dozen tax scams” during tax filing season. The list has changed little in the past few years, but the IRS has shuffled things a little in 2019. Here is a brief rundown on the latest Dirty Dozen.

1. Phishing: Taxpayers should be alert to potential fake emails or websites looking to pry into your personal affairs. Be wary of emails and websites that may be nothing more than scams to steal valuable personal information. **Reminder:** The IRS will never initiate contact with taxpayers via email about a bill or tax refund.

2. Phone Scams: Phone calls from criminals impersonating IRS agents are a threat. In recent years, the IRS has seen con artists threaten taxpayers with police arrest, deportation and license revocation, among other things.

3. Identity Theft: Criminals engage in tactics aimed at stealing taxpayer identities all year long. The IRS has made major improvements in detecting ID theft, but the problem persists.

4. Return Preparer Fraud: Be on the lookout for unscrupulous return preparers. The vast majority of tax professionals provide honest, high-quality service, but dishonest preparers may try to scam you or ratchet up fees.

5. Promises of Inflated Refund Claims: Take note of anyone promising inflated tax refunds. Crooked preparers may ask clients to sign a blank return and promise a big refund without any justification.

6. Falsifying Income and Creating Bogus Documents: Con artists often convince unsuspecting taxpayers to invent income to erroneously qualify for tax credits. In addition, some scams use fake forms, including 1099s, to derive mortgage or other financial benefits.

7. Inflated Deductions and Credits: Avoid the temptation to "pad" deductions or credits on tax returns. Think twice before going down this path. There is nothing wrong with claiming all the tax breaks you are entitled to, but your return should not include fraudulent items.

8. Bogus Charities: Groups masquerading as charitable organizations solicit donations from unsuspecting contributors for **disaster relief** and other causes. Be wary of charities with names similar to familiar or nationally-known organizations. Take a few minutes to check out charities.

9. Excessive Claims for Business Credits: The fuel credit, which is not available to most taxpayers, is often claimed falsely. Similarly, misuse of the research credit is prevalent. And many taxpayers mess up on the Earned Income Credit (EIC).

10. Offshore Tax Avoidance: Successful enforcement actions against offshore cheating show it is a bad choice to hide money and income offshore. People involved in offshore tax avoidance are best served by voluntarily meeting their tax obligations.

11. Frivolous Tax Arguments: Promoters of frivolous schemes encourage taxpayers to make unreasonable and outlandish claims about the legality of paying taxes even though such claims are repeatedly thrown out in court. The penalty for filing a frivolous tax return is $5,000.

12. Abusive Tax Shelters: Abusive tax structures are sometimes used to avoid paying taxes. The IRS is committed to stopping complex tax avoidance schemes, including abusive micro-captive insurance shelters and syndicated conservation easements, and the people who create and sell them.

The message is clear: The IRS is encouraging taxpayers to remain vigilant. Watch out for scams through tax filing season and the rest of the year.

A Tax Wash on Vacation Home Rental

Generally, when you rent out a vacation home to strangers, you must pay tax on the rental income, but you are then entitled to some offsetting deductions.

Special rule: There are no tax consequences for a rental lasting two weeks or less. In other words, you do not owe any tax, but you cannot deduct expenses either.

This “tax wash” often applies to homeowners who rent out homes located near sporting events such as the Masters golf tournament in April.

Facts and Figures
Timely points of particular interest

Turning the Tide—Nick Saban, the coach of the University of Alabama football team, has scored a victory in a new Tax Court case. Saban deducted a **bad debt** resulting from a real restate investment that ran into trouble. Although he received a partial transfer of other property, the Court ruled that this did not fully satisfy the loan obligation. Thus, the bad debt deduction was allowed (2590 Associates, TC Memo 2019-3, 1/31/19).

Keep It Fresh—If you are not moving forward, your business can falter. Even if you have been successful in the past, keep making improvements. It could be as simple as adding new information to your website or, on a larger scale, expanding the product line. On the flip side, if you continue doing things the same old way all the time, your clients may look for “something new” elsewhere.