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# Business Planning: Minimizing Tax on Annual Operations

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# Review of Materials

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- Slides
- Few thousand page PDF, which can be downloaded from the link in the yellow box in the middle of the newsletter
- [Link to materials from 3<sup>rd</sup> quarter 2023 newsletter](#)

# Navigate between Slides and Big PDF

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- Open both documents
- Highlight cross-reference in slides
- Ctrl-c to copy
- Go to FULL TABLE OF CONTENTS in big PDF
- Ctrl-f to find
- Ctrl-v to paste
- Click ENTER to execute search (might need to specify “exact” or “whole word” search)
- Warning: search works only for to the fifth level of the heading, not the sixth, which ends in parentheses. For the latter, use the fifth level of the heading and scroll down just a little.

# Overview – Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

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- Compare the overall tax burden when a C corporation distributes none, half, or all of its earnings and how that stacks up against a pass-through entity
- Consider how these issues affect planning for distributions and inform estate planning as well as what entities are best for your clients

# Overview – Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

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- If capital gain rates are repealed for high income taxpayers, that will be horrible for trusts that accumulate capital gains
- Review practical tools for passing capital gains from trusts to beneficiaries – much more flexibility exists than most people think

# Overview – Planning for Business Owners and Trusts in Light of Changing Income Tax Rates

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- Compare the overall tax burden when a C corporation distributes none, half, or all of its earnings and how that stacks up against a pass-through entity. Consider how these issues affect planning for distributions and inform estate planning as well as what entities are best for your clients.
- If capital gain rates are repealed for high income taxpayers, that will be horrible for trusts that accumulate capital gains. Review practical tools for passing capital gains from trusts to beneficiaries – much more flexibility exists than most people think.
- Potential big increases capital gain rates may make portfolio turnover becomes much more expensive. Consider how variable life insurance may reduce that tax burden.

# Type of Entity

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- Corporation
  - C Corporation
  - S Corporation
- Partnership
  - Limited Liability Company
  - Limited Partnership
- Limited Liability Company
  - Partnership or Disregarded Entity
  - S or C Corporation

# Distributing 100% of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

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Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	\$100,000	\$100,000
Federal and State Income Tax	<u>-26,000</u>	<u>-26,000</u>
Net Income after Income Tax	\$74,000	\$74,000
Income Taxes at 28.8% or 20%	<u>-21,312</u>	<u>-14,800</u>
Net Cash to Owner	<u>\$52,688</u>	<u>\$59,200</u>



# Distributing 50% of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

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Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	\$100,000	\$100,00
Federal and State Income Tax	<u>-26,000</u>	<u>-26,000</u>
Net Income after Income Tax	\$74,000	\$74,000
Distribution to Owner	\$37,000	\$37,000
Income Taxes at 28.8% or 20%	<u>-10,656</u>	<u>-7,400</u>
Net Cash to Owner	<u>\$26,344</u>	<u>\$29,600</u>
Corporate Cash Plus Shareholder Cash	<u>\$63,344</u>	<u>\$66,600</u>

# Distributing None of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

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Distributing None of Corporate Net Income After Income Tax	\$100,000
Federal and State Income Tax	<u>-26,000</u>
Net Income after Income Tax	<u>\$74,000</u>

# Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities – Moderate State Income Tax (II.E.1.)

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	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

C corporation deducts state income tax on business operations; pass-through owners have limited state income tax deduction (but unlimited business property tax deductions). Reinvested C corporation earnings will be taxed later when the company is sold, which just changes the timing of the 47.3% or 40.8% rate above, unless held until death or qualify for Code § 1202 exclusion (II.Q.7.k.). Reinvested pass-through earnings add to tax basis.

# Declaring Dividends

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- Personal holding company tax (II.A.1.e.)
- Accumulated earnings tax (if not a personal holding company) (II.Q.7.a.vi.)
- Professional firms tend to distribute all profits

# Declaring Dividends

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- Sale to irrevocable grantor trust (II.E.2.a., III.B.2.b.)
- Entity makes “tax distribution” to trust, which does not pay tax and therefore uses the distribution to pay down the note.
  - Grantor uses note payment to pay tax, making the note a disappearing asset
  - C corporations pay tax instead of making tax distributions; any dividends undermine favorable C corporation taxation
  - Grantor not taxed on C corporation income

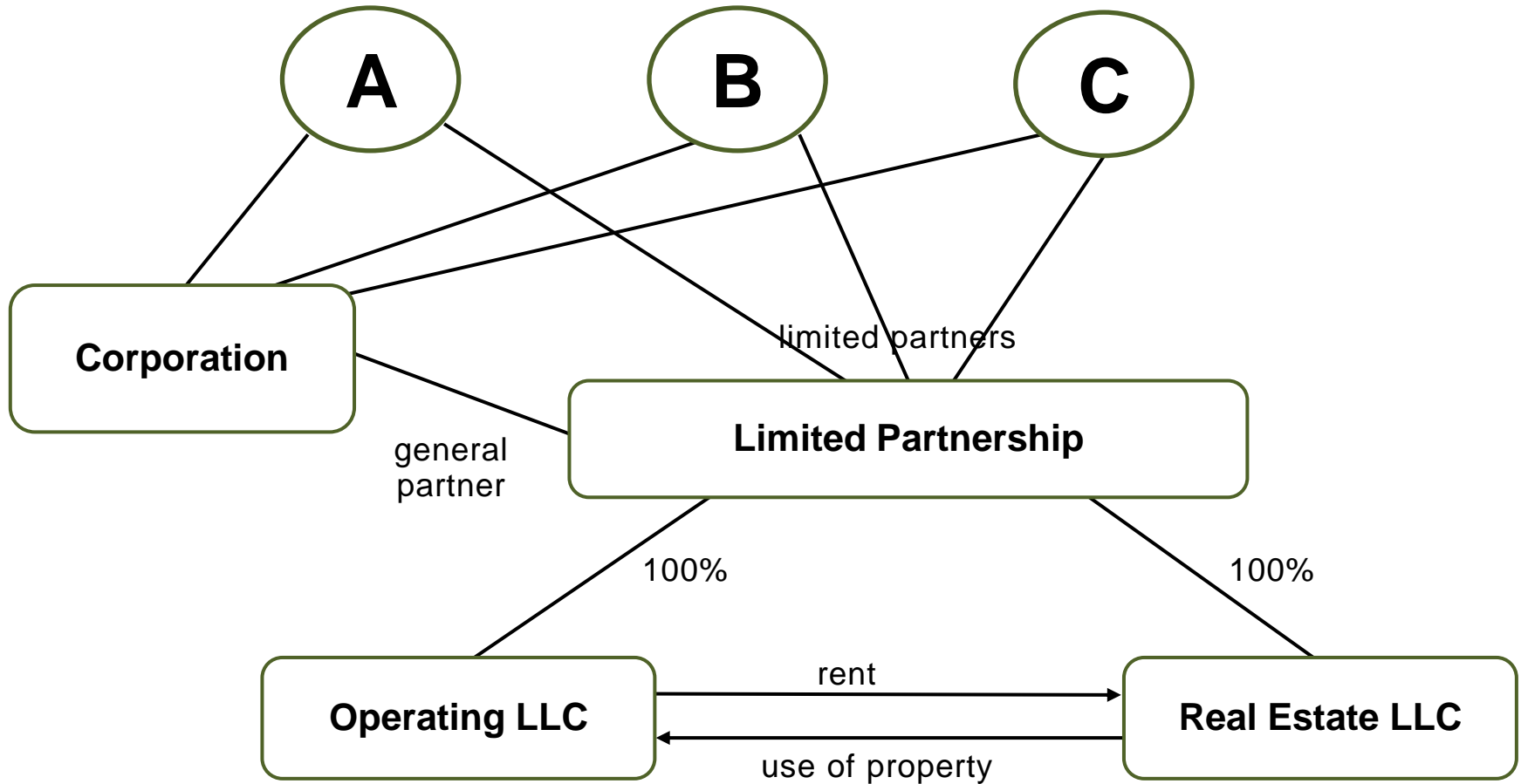
# Which Entity for Which Stage

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- Simple LLC (II.E.3.)
  - Start-Up Losses (II.G.4.b.-II.G.4.f.)
  - Profitable, But Not Overly So
    - ❑ Little or No Earnings in Excess of Taxable Wage Base (II.L.2.a.i.) (\$168,200 in 2023 and \$168,600 in 2024)
    - ❑ Generous Equipment Write-Offs (II.G.5.)
- Transition to Limited Partnership When Significant Earnings in Excess of Taxable Wage Base

# Recommended Structure

(II.E.5. and II.E.6.)



# Material Participation for Business or Rental Activities (II.J.4.e.)

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- Passive (II.K.) = NII (II.I.8.)
- Document trustee's participation
- Even if trust taxed to deemed owner under grantor trust rules, consider having trustee participate (discussed below)
- Beneficiary's participation can trigger depreciation (II.J.11.a.ii.(b).)



# Qualified Subchapter S Trust (QSST)

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Similar to marital deduction trust (III.A.3.e.i.(a).):

- All income must be distributed annually to sole beneficiary
- Not as protective as trust that accumulates income
- No distribution of principal during life of sole beneficiary to anyone other than sole beneficiary

# Qualified Subchapter S Trust (QSST)

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Beneficiary taxed as deemed owner of S corporation stock **except** for gain on sale of stock or business assets

- Allows beneficiary to run through all the lower brackets before getting to higher brackets
- For sale of business, see II.J.15, II.J.16., and II.J.17.

# Material Participation for Trusts

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## Trust Type

## Participant

QSST (normal operations)

Beneficiary

QSST (stock or asset sale)

Trustee\*

ESBT

Trustee

\* Per proposed regulations and IRS' litigation position on trust material participation

See II.K.2.

## Electing Small Business Trust (ESBT) (III.A.3.e.ii.)

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- Can be a sprinkle trust
- All S corporation income taxed at highest income tax bracket
  - Limited deductions
  - No income distribution deduction for S corporation items
- Flexible Trusts (III.A.3.e.iv.) discussion follows

# ESBT Income Taxation (III.A.3.e.ii.(b).)

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- Grantor trust rules supersede, so these rules applies only to extent taxed as nongrantor trust
- S corporation income taxed as separate trust, at highest individual rate, with no distribution deduction, and with no exemption
- S corporation income includes ONLY all K-1 items, any gain or loss on sale of stock in the corp., state or local income taxes or administrative expenses to the extent allocable to the above, and any interest expense on debt to acquire that stock

## Flexible Trust Design – Spouses (III.A.3.e.iv.)

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- In many cases, do ***not*** use sprinkle credit shelter trust, which locks one into ESBT
- Bequeath all assets into a QTIP-able trust to toggle between QSST and ESBT as appropriate
- Quick funding of QSST for spouse?
- Automatic QSST on spouse's death?

III.A.3.e.i.(b).

## Flexible Trust Design – Children (III.A.3.e.iv.)

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- At drafting stage, make flexible as described above but only one beneficiary
- Can give beneficiary inter vivos power of appointment
- Might be able to modify ESBT and split into one or more QSSTs (III.A.3.e.v.)
- See materials for strategic advantages and disadvantages and implementation steps

# Flexible Trust Design

## Multiple Trusts (III.A.3.e.iv.)

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- ESBT portion holds only S stock
- Hold any reinvested distributions in separate investment trust
- Distributions from S corporation trust do not carry out income
- Distributions from investment trust do carry out income
- Caution - multiple trust rules



# Toggleing Between QSST and ESBT

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- First time toggleing – no time restrictions
- Subsequent toggleing – 36 month wait

## Capital Gain Elections (II.J.4.b)

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- Tax preparation software traps unless take special steps
- Next slides discuss strategic issues, law, and practical issues (II.J.8.)

# Additional 5% Capital Gain Tax

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	<u>2023</u>	<u>2024</u>
Single	\$492,300	\$518,900
Married filing jointly	\$552,850	\$583,750
Trust	\$ 14,650	\$ 15,450

# 3.8% Tax on Net Investment Income (II.I.3.)

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Single	\$200,000
Married	\$250,000
Trust	\$ 15,200 for 2024 \$ 14,450 for 2023

Indexed for trusts but not individuals

# Capital Gain is DNI Unless Excluded (ll.J.8.a.)

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Code § 643(a)(3): capital gain excluded only if:

- From sale of capital asset
- Allocated to corpus
- Not paid, credited, or required to be distributed to a beneficiary
- Paid, permanently set aside, or to be used for charitable purposes

## Capital Asset (ll.J.8.a.i.)

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Not a capital asset:

- Code § 1231 property
- Amortized goodwill (self-created goodwill not amortizable is a capital asset)

# Mechanism for Distributing Capital Gain: Reg. § 1.643(a)-3(b) (ll.J.8.c.)

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1. Allocated to income
2. Allocated to corpus but distributed consistently
3. 65-day rule distribution

## Allocated to Income (II.J.8.c.i.)

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- “Power to adjust” principal
- Uniform Principal & Income Act reflects Prudent Investor Rule; UPIA becoming UFIPA (Uniform Fiduciary Income & Principal Act) (Uniform Law Commission adopted in 2018)
- No duty of consistency from year to year except unitrust



# Materials

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- Uniform Law Commission:  
<https://www.uniformlaws.org/home>
- Web site for UFIPA:  
<https://www.uniformlaws.org/committees/community-home?CommunityKey=1105f9bb-eb93-4d4d-a1ab-a535ef73de0c>
- Web site for UFIPA has a Documents tab, with a link to the [Enactment Kit](#) that includes mapping Principal & Income Act to its UFIPA counterparts
- ACTEC/ALI-CLE: [Fun, Flexible, and Fair: Drafting and Administering Trusts Under UFIPA](#)

## Power to Adjust (II.J.5.b.ii.(a).)

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Under the Uniform Principal and Income Act, a trustee may adjust between principal and income to the extent the trustee considers necessary if:

- The trustee invests and manages trust assets as a prudent investor,
- The trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and
- The trustee determines that the adjustment is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

## Power to Adjust (II.J.5.b.ii.(a).)

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- UFIPA § 203(a) requires only that the trustee determine that “the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially.”
- Thus, UFIPA requires only that the power to adjust will be helpful, not necessary.
- UFIPA - trustee not liable for failing to exercise the power
- UFIPA - trustee not liable for decision in good faith

# Power to Adjust (II.J.5.b.ii.(a).)

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Factors a fiduciary must consider (adjust or unitrust):

- the terms of the trust
- the nature, distribution standards, and expected duration of the trust
- the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7
- the desirability of liquidity and regularity of income
- the extent to which an asset is used or may be used by a beneficiary
- the increase or decrease in the value of principal assets, reasonably determined by the fiduciary

# Power to Adjust (II.J.5.b.ii.(a).)

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Factors a fiduciary must consider (adjust or unitrust):

- whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal
- the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods
- the effect of current and reasonably expected economic conditions
- the reasonably expected tax consequences of the exercise of the power

## Power to Adjust (II.J.5.b.ii.(a).)

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A fiduciary cannot adjust if would:

- Reduce the amount payable to a current income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries
- Change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the trust
- Affect charitable set-aside

# Power to Adjust (II.J.5.b.ii.(a).)

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A fiduciary cannot adjust if would:

- Cause a person to be treated as the owner of all or part of the trust for federal income tax purposes (but can appoint special trustee)
- Cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes (but can appoint special trustee)
- Cause an individual to be treated as making a gift for federal gift tax purposes (but can appoint special trustee)
- Be done by fiduciary who is not an independent person
- Affect eligibility for public benefits
- Change a unitrust

# Unitrust (II.J.5.b.ii.(b).)

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- A fiduciary cannot convert to, modify, or turn off unitrust if would violate certain tax rules
- If trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%
- Terms of the trust may write rules, in whole or in part
- Trustee adopts unitrust policy, including:
  - the unitrust rate or the method for determining the unitrust rate
  - the method for determining the applicable value
  - the application of certain mandatory or permissive rules



# Unitrust (II.J.5.b.ii.(b).)

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Unitrust policy may include:

- Provide methods and standards for:
  - Determining the timing of distributions;
  - Making distributions in cash or in kind or partly in cash and partly in kind; or
  - Correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;
- Specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or
- Provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

# Comparing Power to Adjust to Unitrust (II.J.5.b.ii.(c).)

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- Generally, a fiduciary exercises the power to adjust annually and the power to modify a unitrust only once or occasionally
- Exercising a power to adjust generally is included in annual reports, whereas adopting, modifying, or revoking unitrust provisions requires specific notice to the beneficiaries
- However, UFIPA allows a power to adjust to apply to all future periods and also authorizes frequent changes to a unitrust policy, so the above generalization about frequency is not necessarily accurate
- Unitrust probably generates capital gain on distribution in kind (definitely does for CRUT)
- Power to adjust more flexible for tax planning

# Allocated to Income

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- Trust agreement can allocate capital gain to income
- Cannot “depart fundamentally from traditional principles of income and principal” per Reg. § 1.643(b)-1
- 3%-5% should be OK

## Allocated to Corpus But Distributed Consistently (II.J.8.c.ii.)

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- Existing trusts – probably did NOT allocate capital gain to DNI
- New trusts – generally allocate capital gain to DNI unless beneficiary in higher federal & state combined bracket (including phase-outs)

## Actual or Deemed Distribution (II.J.8.c.iii.)

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- Tracing actual distribution often not practical unless terminate trust
- Referring to capital gain suffices – 65-day rule distribution when trustee refers to capital gain
- Can be inconsistent from year to year

## Fairness Issues (II.J.8.c.vi.)

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- Fair for cash distribution to carry out taxable income
- If not, “gross up” distribution for taxes paid by distributee
- “Gross up” payment costs remaindermen less than if the trust paid the tax

# Are distributions advisable?

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- Are distributions available?
- Protective nature of trust

# Are distributions available?

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- Support vs. welfare
- Consider or not consider other resources



# Additional Tax Issues

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- Estate tax on beneficiary's estate
- Distribution in kind to include in beneficiary's estate for basis step-up  
(ll.J.8.d.)

# Protective Nature of Trust

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- Very real creditor or spousal issues
- Burning a hole in the beneficiary's pocket
- Beneficiary saves but might one day have creditors

# Conclusion

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- Free quarterly newsletter includes the most recent version of fully searchable PDF of Gorin business structuring materials (a few thousand pages). Completing form at <https://www.thompsoncoburn.com/forms/gorin-newsletter> gets you the newsletter, which includes a link to the PDF. It also includes an offer to subscribe to blog or Heckerling commentary (below).
- Blog that is less technical is at <http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions>.
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