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For Trusted Advisors

Business Planning

Building a business: Entity selection and forms of organization

By David R. Toups, JD, MBA, CFA®, CFP®, CTFA

For business owners, the type of entity selected, or not selected, will have far reaching implications for the owners and the business. Serious consideration should be given to this important decision because later modifications or changes may trigger tax or liability issues or even transfer problems for successors, heirs, or loved ones. This article reviews the forms of business organization for entities and non-entities that are commonly encountered doing business in the United States.

SOLE PROPRIETORSHIP. When businesses start small, often the expense and administrative burden of creating an entity separate and apart from the owner is not worth the effort. The income generated by the sole proprietorship is reported on the owner's personal income tax return and is taxed at the owner's personal income tax rate. If the business remains small and the owner's assets remain modest, a sole proprietorship, which is the default non-entity mode of operating a business, may suffice until the business's or owner's assets grow. Once the owner's assets grow past the state's judgment exemption amounts—which is an amount of property set by statute that a judgment debtor may retain in the event of a substantial adverse judgment or bankruptcy—the business owner at this point is no longer "judgment proof." The more property the business owner has, the more he or she becomes an attractive target for predatory litigation and stands to lose as a result of an adverse life or business event. Since no distinction is made between the business and the owner, a sole proprietorship provides no liability protection to the business owner. The owner's personal assets are subject to both personal and business liabilities. A similar scenario exists, but further compounds the liability issues, if the business owner has another person working with him or her as a partner.

GENERAL PARTNERSHIPS. General partnerships are a type of default entity formed by two or more people operating a business together. The income produced by the general partnership is reported on each partner's individual income tax return according to his or her share. In this type of arrangement, each partner is considered a general partner of the business, each has agency for the other, and the personal assets of each are available to cover liabilities generated by the business. Each general partner also has agency for the business, which means each can bind the business to contracts and potential liabilities. Each partner's personal assets are subject to the business's liabilities. Therefore, in the event one partner exercises poor judgment, the other partner may have to pay for it with his or her own personal assets. Such a proposition often leads the owners to seek improved liability protection once the business grows from its infancy.

Before discussing entities that limit an owner's liability to his or her investment in the firm, a brief discussion is in order regarding taxation. An entity may exist under state law and be recognized as being separate and apart from its owners to other businesses, vendors, customers, and the state and local governments; however, the federal government may treat the entity differently for tax purposes than its form suggests. Federal taxation may vary based upon options selected by the business or by the number of people who own it. This is most clearly shown by limited liability companies.

LIMITED LIABILITY COMPANIES. A limited liability company (LLC) is a type of entity permitted in some states, which is most characteristically known for its simplicity of administration. LLCs do not require the administration maintenance which is typically associated with C corporations. Since C corporations provide a more formal structure for complex companies, the administrative burdens required to address the needs of a large shareholder base do not exist for an LLC. An LLC may opt to be taxed as a C corporation, an S corporation, or as a partnership. An LLC with only one owner is referred to as a single-member LLC, and the federal government disregards the entity for taxation purposes and treats it as a sole proprietorship. Since an LLC has light administration requirements and enjoys flexibility in choosing a taxation structure, this has become a mainstay entity form for small to medium sized businesses. Prior to states adopting the LLC form as a type of entity authorized by their statutes, business owners often formed C corporations to obtain liability protection for their personal assets.

C CORPORATIONS. C corporations, as discussed, provide the framework and flexibility necessary to accommodate large publicly traded firms with enormous shareholder bases and the associated administration burdens that would accompany such numbers. C corporations are subject to their own tax rates under the federal tax laws. Under these laws, when viewed from a shareholder's perspective, the revenue generated by the corporation is taxed twice—once at the corporate level and once again at the shareholder's personal level when the corporation pays that shareholder's portion in the form of a dividend. At one point in time, C corporations were one of the only forms available for business owners to utilize. The double taxation paired with the inability for the corporation to pass-through losses that normally occur in the initial years of a fledgling business made liability protection an expensive proposition for those early business owners choosing this entity form. These hurdles to small to medium sized businesses prompted the subchapter S election.

S CORPORATIONS. The term S corporation is really a misnomer. No state grants charters or organization letters for an S corporation. An S corporation is actually a C corporation (or an LLC) that has filed a subchapter "S" election with the IRS. By filing such an election, the organization agrees to certain restrictions as to ownership and governance in exchange for being taxed as a pass-through entity or taxed at the personal income tax rates of its owners. The owners of the S corporation report their respective portion or share of the company's income or the losses on their personal income tax returns. C corporations with an S election were a common structure form prior to states adopting the use of LLCs as an alternate entity form.

LIMITED PARTNERSHIPS. The unpleasant consequence of being held responsible for a fellow general partner's errors or omissions, as discussed above, gave rise to the adoption of limited partnership forms. A limited partner's liability risk in the organization is limited to his, her, or its investment in the partnership. A limited partnership requires at least one general partner to manage the partnership and remain subject to personal liability for the partnership's liabilities; however, another entity providing liability protection may serve as a general partner and mitigate the risks associated with this requirement.

Partnerships also enjoy great flexibility in allocating income and losses to its partners. Partnerships are pass-through entities having the assets or losses reported and accounted for on each of its partners' personal income tax returns according to their allocated share.

Although liability protection is an essential component to selecting a business organization's form, taxation and structure considerations may make one form a better fit over anonther for differing business and economic realities. Consultation with advisors familiar with your state's business environment is always a smart first step in the planning process.

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Charitable Planning

Donor advised funds: the Swiss Army knife of charitable planning.

By Bryan K. Clontz, Ph.D., CFP®, CLU®, ChFC®, CAP®, AEP®, RICP®, CBP

Donor advised funds (DAFs) are a longstanding and versatile tool for charitable giving. However, many charitably inclined people (and even some financial and tax professionals) do not know they exist or why they are so popular. The flexibility of DAFs means that they can achieve many different goals and have significant benefits for charities and donors alike. This article gives an overview of DAFs, including the history, status, planning options, and applications of the vehicle.

To begin with – what is a DAF? The IRS states in a straightforward manner that it "is a separately identified fund or account that is maintained and operated by a section 501(c)(3) organization."[1] Simply put, it is an individual fund owned and maintained by a public charity, which is funded by an individual donor (or sometimes multiple donors).

Since the contributions to the DAF are charitable, the donor no longer has legal ownership or control, although he or she "retains advisory privileges with respect to the distribution of funds and the investment of assets in the account."[2] The investment of DAF assets means that they can grow over time before eventually being granted out with the advice of the donor. Of course, that same contribution is generally tax deductible, since the asset is being given irrevocably to a charity.

A Brief History and Current Status of DAFs

The first donor advised fund is usually credited to the New York Community Trust in 1931.[3] Compared to modern DAFs, the fund was unregulated and administered similarly to other charitable funds at then-contemporary community foundations.[4] The category of DAFs was further distinguished from other charitable funds (particularly private foundations) in the Tax Reform Act of 1969. That reform added strict regulations for private foundations, which were often created by individuals or families. Public charities, meanwhile, maintained a certain degree of latitude in their operations.[5] Since DAFs are always administered and maintained by public charities, this opened the door for the use of DAFs rather than private foundations.

However, in the early 1990s, large brokerage houses began establishing standalone DAFs as independent charities.[6] In the decades since that time, DAFs have grown in popularity to the point where they are among the largest charities in the United States.[7] Nearly every large bank, brokerage house, community

1 Internal Revenue Service, "Donor-Advised Funds," https://www.irs.gov/charities-non-profits/charitable-organizations/donor-advised-funds (last accessed July 13, 2020).

2 Id.

3 The New York Community Trust, "Our History: Nine Decades of Making New York Better," https://www.nycommunitytrust.org/about/history/ (last accessed July 13, 2020).

4 Berman, L.C. (October 2015), "Donor Advised Funds in Historical Perspective," Boston College Law Forum on Philanthropy and the Public Good, 13.

5 Id.

6 Olen, H. (December 13, 2017), "Is the New Way to Give a Better Way to Give?," The Atlantic, available at https://www.theatlantic.com/business/archive/2017/12/donor-advised-funds-deduction-charity/548324/.

7 Id.

foundation, and Jewish federation offers a DAF option. By 2018, over $120 billion in assets were held in DAFs.[8]

The incredible growth of DAFs applies across seemingly every metric. This includes the number of individual funds, the total dollars granted out from DAFs to other charities, the total contributions to DAFs, and the total assets held in DAFs.[9] This growth has drawn scrutiny and criticism from inside and outside of the charitable world, usually driven by a perception that the charitable dollars are sitting within the DAF structure and not being deployed for charitable purposes.[10] DAF supporters respond that annual grants from the funds are typically about 20% of total assets.[11] Further, they argue that DAFs allow for more participatory, democratized charitable giving – making long-term charitable planning and growth available to donors of all backgrounds. Regardless, DAFs appear to be here to stay, considering they are the "fastest growing form of charitable spending" in the country.[12]

DAF Planning

When can a DAF be a useful option for someone who is charitably inclined? How can a budding philanthropist deploy a DAF? There are a number of situations where a DAF may be a wonderful solution.

Any time a person has a large spike in income is usually a good time to consider charitable giving. The reasoning is twofold. First, a spike in income means that the donor in question has more income than usual and may be more able to make charitable donations. Secondly, higher income usually means higher taxes, so a donation makes more sense from an accounting perspective – the deduction is often more valuable in high income years.

Funding a DAF during such a time can allow for many years of charitable giving following the higher-income year.

Similarly, a person with highly appreciated noncash assets can utilize that illiquid portion of their balance sheet for tax efficient charitable giving. Donating cash is simple, but appreciated assets given to charity means that the donor is not paying capital gains on the appreciation – simply because they contributed the asset to a tax-exempt organization. If the DAF is able to accept the noncash asset (not all can or will), it will usually sell the asset, which can then be reinvested or granted out just like a normal DAF funded with cash or public stock.

The DAF can be a wonderful solution for donors considering a very long term, multigenerational charitable plan. DAFs can and do change advisors over time within families. As discussed above, the DAF has advantages over a private foundation, but it can also provide the collaborative, long-term charitable experience that some families look for. Nearly every DAF has simple mechanisms to designate successor advisors for individual funds. To a similar end, a DAF can easily be funded through testamentary language in a will. That can be either initial funding or additional contributions (including noncash contributions from the estate, where allowable).

Key Attributes of DAFs

If a donor does create and fund a DAF, what advantages does it offer after the money is in the DAF? How can a donor fulfill their charitable goals? This is where DAFs shine – they are remarkably flexible when it comes to charitable grantmaking.

As discussed above, DAFs can be a long-term charitable fund. This is a

8 National Philanthropic Trust, "The 2019 DAF Report," https://www.nptrust.org/reports/daf-report/ (last accessed July 13, 2020).

9 Id.

10 Hobson, W. (June 24, 2020), "Zombie Philanthropy: The Rich Have Stashed Billions in Donor-Advised Charities — but It's not Reaching Those in Need," The Washington Post, https://www.washingtonpost.com/lifestyle/style/zombie-philanthropy-the-rich-have-stashed-billions-in-donor-advised-charities--but-its-not-reaching-those-in-need/2020/06/23/6a1b397a-af3a-11ea-856d-5054296735e5_story.html.

11 National Philanthropic Trust's "2019 DAF Report" cites that grant payout in 2017 was 22.8% and in 2018 was 20.9%.

12 Hobson, W.

major part of their appeal for many donors. Unlike private foundations, DAFs are not required to grant out a set percentage of their assets every year. That means grants can be very small relative to the size of the fund. This may work well for donors hoping to provide small amounts of support for a period of years before making larger grants in the future.

Similarly, DAFs are not endowed funds. Endowed funds are permanent charitable funds that make grants solely based on income and appreciation only – no grants may be made from principal. DAFs are generally not intended to be permanent and are able to make grants from principal (as well as from income and appreciation).

The latitude with grantmaking from DAFs extends to the recipient charities as well – any U.S. public charity in good standing with the IRS is generally eligible to receive a grant from a DAF. In practice this means donors can support the same charities from their DAF that they could support by writing a check. Some DAF sponsors also allow international grants as long as they are to IRS equivalent charitable programs.

Which charities cannot receive grants from DAFs? Most private foundations, foreign charities (except where noted above), or charities that have lost their tax-exempt status. DAFs also will not generally make grants to fulfill the legally binding pledge of a donor, or where the donor would receive some tangible benefit in exchange.

Another advantage is that grants can be made anonymously. Some donors have a strong preference to maintain privacy in their giving. DAFs are typically able to accommodate these concerns by making anonymous grants. Further, a donor can have a DAF without any identifying features or traits.

Conclusion

Donor advised funds are an extremely versatile tool for the charitably inclined. Although DAFs have been around for many decades, they have grown exponentially in number, value, contributions and general popularity over the last twenty years. The funds may be appealing for donors with some combination of appreciated assets, unusually high income, or with long-term charitable goals. This is particularly true given the significant latitude that DAFs allow when it comes to grantmaking.

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Income tax reduction strategies using non-grantor trusts.

By Ari Marin, JD., LL.M, CFP®, CLU®

The passage of the 2017 Tax Cuts and Jobs Act (TCJA) changed the nature of planning for many individuals. Many expenses that taxpayers were able to deduct on their annual income tax returns prior to the TCJA have been permanently eliminated, suspended, or limited until 2026. Changes brought by the TCJA include:

- The mortgage interest deduction is limited to $750,000 of mortgage indebtedness.
- The deduction for state and local income, sales and property taxes is limited to $10,000.
- The standard deduction increased to $24,000 for married couples filing jointly, and $12,000 for individual taxpayers.
- The applicable exclusion amount is temporarily increased (in 2020, the exclusion is $11,580,000).

Changes to the tax code as a result of the TCJA impacted the tax returns for many individuals. In fact, according to the IRS, only 14.6 million returns were itemized in 2019, compared with 42.1 million in 2018.

As a result of the TCJA, the focus of many individuals has shifted from estate tax planning strategies to income tax planning strategies.

How non-grantor trusts can help

A non-grantor trust is an irrevocable trust that pays taxes on its income. For income tax purposes, non-grantor trusts have some, but not all, of the tax attributes of an individual. For example, both a non-grantor trust and an individual can deduct property, state and local taxes.

However, unlike an individual, a non-grantor trust does not have a standard deduction; a non-grantor trust can deduct "distributable net income" (DNI); and a non-grantor trust has an unlimited amount of charitable deductions.

Some income tax reduction strategies that many advisors are focusing on as a result of the TCJA include:

- Shifting taxable income to beneficiaries in lower tax brackets.
- Avoiding state income tax.
- Basis step-up optimization.
- Exchanging ordinary income tax rates for capital gains tax rates.
- Creating tax-free income.
- Maximizing deductions.

Although non-grantor trusts can assist with many of these techniques, this article focuses on maximizing available deductions.

State and local tax deductions

Under pre-TCJA law, some individuals justified the economic cost of owning a vacation home based on the benefit of being able to deduct mortgage interest and property taxes on the property. However, as described above, the TCJA limited the deduction for state and local income tax to $10,000 per year. To compensate for the reduction in deductible state and local taxes, some individuals may consider transferring their vacation home to one or more non-grantor trusts so as to maximize their state and local tax deduction.

Non-grantor trusts can enable an individual to maximize state and local income tax deductions because the new $10,000 limit on deductions applies per taxpaying entity. Since non-grantor trusts are their own taxpaying entity, each trust funded with real estate is eligible to deduct up to $10,000 for state and local taxes (provided the trust has enough income to offset the deduction).

Example 1

In 2020, a husband and wife incur $40,000 of property taxes and other state and local taxes.

- Under prior law, if husband and wife itemized their deductions, they could generally deduct all state and local taxes.
- Under current law, their itemized deduction for state and local taxes would be limited to $10,000 (resulting in no tax deduction for $30,000 of incurred state and local taxes).
- If, however, two separate non-grantor trusts each own 25% of the property that generates the state and local taxes, each trust could deduct $10,000 of property taxes and husband and wife could include $10,000 of state and local income tax in their itemized deduction (reducing the wasted deduction for taxes incurred from $30,000 to $10,000).

Example 2

Assume, instead, property taxes and other state and local taxes on the residence are $50,000 a year.

- Husband and wife could create five non-grantor trusts, one for each of their five children, and transfer 20% of the real estate to each trust (along with sufficient assets to produce at least $10,000 of taxable income each year). This strategy would likely involve first transferring the property to an LLC and then transferring LLC interests to each trust.
- Each of the five trusts would be able to deduct $10,000 of state and local taxes, completely offsetting 100% of incurred state and local tax.

Though transferring property to a trust usually involves the loss of ownership and use by the transferors, husband and wife can preserve access to and use of the trust-owned property by continuing to hold some interest as co-tenants in common. Co-ownership gives each co-tenant the right to use, occupy, and possess each part of the property, with an undivided right of possession.

Deductions for charitable contributions

Individuals are subject to limits on the deductibility of donations to charity based on the individual's adjusted gross income (AGI). Charitably inclined individuals who are unable to fully deduct charitable gifts may benefit from utilizing non-grantor trusts since non-grantor trusts are not subject to the same AGI limits.

An individual could gift a portion of their non-qualified securities portfolio to a non-grantor trust. The trustee could use income generated from the portfolio to either (i) make distributions to the children/grandchildren of the individual who created and funded the trust, or (ii) make distributions to charitable entities.

For distributions made to children/grandchildren, the income tax liability resulting from the distributed income would flow through to the recipient child/grandchild's tax return. If the child/grandchild is in a lower income tax bracket than the individual who created and funded the trust, less tax liability will result. For distributions to charity, the trust is eligible to fully deduct the charitable distribution, thereby offsetting income tax associated with the distributed income.

Example 3

Husband and wife are charitably inclined, but their deductions are unlikely to ever exceed the new standard deduction amount ($24,000 for married couples).

- Husband and wife could gift $250,000 of marketable securities to a non-grantor trust. The trust would name husband and wife's children as well as charities that husband and wife regularly donate to as trust beneficiaries.
- Assume that the $250,000 portfolio generates $10,000 of taxable income a year. The trustee can distribute $5,000 to charity and $5,000 to the children. The trust can deduct $5,000 for the charitable distribution, and $5,000 of taxable income passes through to the children's tax returns.
- The trust would pay $0 in taxes.
- The trust also could have paid all income to charity and then made discretionary distributions of other trust assets to the children. In this instance, the children would have no taxable income as a result of distributions from the trust.

Other deduction enhancement opportunities

Other deduction enhancement opportunities with non-grantor trusts are described below.

TAX PREPARATION FEES. While these fees are no longer deductible by individuals, trusts can continue to deduct tax preparation fees in full.

INVESTMENT AND ADVISORY FEES. As with individuals, investment advisory fees for trusts are not deductible. However, trusts can deduct expenses "not commonly incurred by individuals," such as trustee fees and other trust administration costs. If a trustee also provides investment advisory services, he or she may be able to "unbundle" these fees and provide extra deductions.

SECTION 199A DEDUCTION FOR PASS THROUGH ENTITIES. A pass-through entity owned by a non-grantor trust may assist business owners in obtaining full use of this deduction.

SECTION 1012A QUALIFIED SMALL BUSINESS STOCK DEDUCTION (QSBS). Each non-grantor trust can claim its own $10 million QSBS gain exclusion, separate from any QSBS that the investor retains.

Caveats

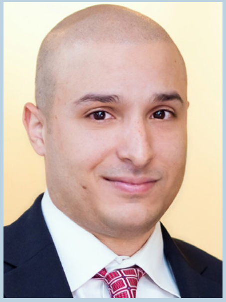
Using these strategies is not without disadvantages.

- A trust will need enough income to offset any deduction for which it is eligible. Ideally, the nature of a trust's income is ordinary (as opposed to long term capital gain or qualified dividends). Furthermore, the transfer will require coordination between the amount of income and the deduction because non-grantor trusts are subject to the highest tax bracket of 37% at $12,500 of income. Thus, to the extent there is no 100% income offset, the strategy may only work if the clients are already in the highest tax bracket.
- Property transferred to a non-grantor trust will not be eligible for the step-up in cost basis upon death of the individual who created and funded the trust. A step-up in cost basis is beneficial to an individual's heirs to the extent they may desire to sell the property in the future (since a step-up in basis would reduce the income tax liability an heir would be subject to when the asset is sold).
- A transfer to a non-grantor trust could result in the loss of IRC Section 121 home sale exclusion and homestead protection.
- If real estate is subject to debt, the transfer may accelerate payment of the debt unless consent of the debt holder is obtained.

Conclusion

These complex trusts that pay income tax contrast with the pervasive use of grantor trusts that was the standard in planning for many years. Today, non-grantor trusts may be ideal in helping to reduce income tax, especially for individuals who own vacation properties, are charitably inclined, or who are otherwise capped in terms of deductions.

Setting up non-grantor trusts is not without cost, however, and even though most individuals will no longer benefit from itemizing deductions, this may not be a wise strategy for everyone. An individual should always work with professional advisors when undertaking any tax reduction or estate planning strategies.



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