Tax Impact

Are your business interest expenses deductible?

BDIT lets you give away property without losing control

Relax, but don't forget about taxes
Owning a vacation home requires tax planning

Tax Tips

Are your business interest expenses deductible?

Before Congress passed the Tax Cuts and Jobs Act (TCJA), most business-related interest expense was deductible, although corporations couldn't deduct interest paid to or guaranteed by a related party under certain circumstances. But for tax years beginning after 2017, the TCJA imposes a limit on business interest deductions, with exceptions for "small businesses" and electing real estate and farming businesses.

All businesses should evaluate the impact of the new deduction limit on their tax liability, and plan accordingly.

Do you qualify for the small business exemption?

The business interest deduction limit doesn't apply to small businesses, defined as those whose average annual gross receipts for the preceding three years is $25 million or less. Certain related businesses must aggregate their gross receipts for purposes of the $25 million threshold. This requirement is designed to prevent larger businesses from splitting themselves into several smaller entities to avoid the limit.

How do you calculate the limit?

If the limit applies to your business, your annual deduction for business interest expense can't exceed the sum of 1) your business interest income, if any, 2) your floor plan financing interest, if any, and 3) 30% of your adjusted taxable income. In other words, you can use an unlimited amount of business interest expense to offset business interest income, and you can fully deduct floor plan financing interest (commonly used by vehicle dealers and large appliance retailers to finance their inventories).

Any interest in excess of those amounts is limited to 30% of adjusted taxable income. Be aware that business interest income and expense don't include investment interest income or expense. Disallowed interest expense may be carried forward indefinitely.

Adjusted taxable income means taxable income, computed without regard to:

- Nonbusiness income, gain, deduction or loss,
- Business interest income or expense,
- Net operating loss deductions,
- The 20% deduction for qualified business income of pass-through entities and sole proprietorships, and
- For tax years beginning before 2022, depreciation, amortization or depletion.

For tax years beginning after 2021, depreciation, amortization and depletion will be subtracted in computing adjusted taxable income, shrinking business interest deductions even further.

Special rules apply to pass-through entities. For partnerships, the business interest limit applies at the entity level, but any interest in excess of the limit is passed through to the partners and carried forward on their individual tax returns. The partnership also passes through "excess taxable income" — that is, the amount by which the deduction limit exceeds actual interest expense. Partners can offset this amount against unused interest deductions. For S corporations, the limit also applies at the entity level, but unused deductions are carried over at the entity level until they can be offset against corporate income.

Should you opt out?

Certain real property and farming businesses may elect not to apply the limit on business interest expense deductions. Real property businesses include development, construction, reconstruction, acquisition, conversion, rental, operation, management, lending and brokerage businesses.

If you're eligible to opt out of the deduction limit, doing so can yield significant tax benefits. But these benefits come at a price: After you make the election, which is irrevocable, you must depreciate certain business property under the alternative depreciation system (ADS). This means longer recovery periods and lower depreciation deductions. For real property businesses, ADS applies to nonresidential real property, residential rental property and qualified improvement property. For farming businesses, it applies to any property held by the business with a recovery period of 10 years or more.

To determine whether making the election is right for your business, you need to weigh the benefits of unlimited business interest deductions against the cost of lower depreciation deductions.

Have a plan

If your business is subject to the business interest limitation, be sure to evaluate the impact of reduced interest deductions on your tax liability. If it's significant, you might consider strategies for reducing your interest expense, such as relying more heavily on equity financing instead of debt.

Another option, if your business owns debt-financed real property, is to transfer such property to a separate entity — such as a partnership you control — in a sale-leaseback transaction and have the entity opt out of the interest limitation as a real property business. For this strategy to work, however, there must be a legitimate business purpose for the transaction (such as liability protection) other than tax avoidance. ■

IRS guidance is on the way

The IRS plans to issue regulations on the application of the business interest limit. In the meantime, the IRS has issued Notice 2018-28, which provides interim guidance on several issues, including:

Pre-Tax Cuts and Jobs Act interest. The guidance suggests that disallowed interest carried forward under prior law will be treated as business interest expense in the first tax year after 2017 and subject to the new limit.

Corporations. According to the guidance, the regs will provide that, for purposes of the business interest limit, *all* C corporation interest expense and income, even if investment-related, will be treated as business interest expense and income.

Pass-through entities. The guidance provides rules to avoid double counting of income and expense by pass-through entities and their owners.

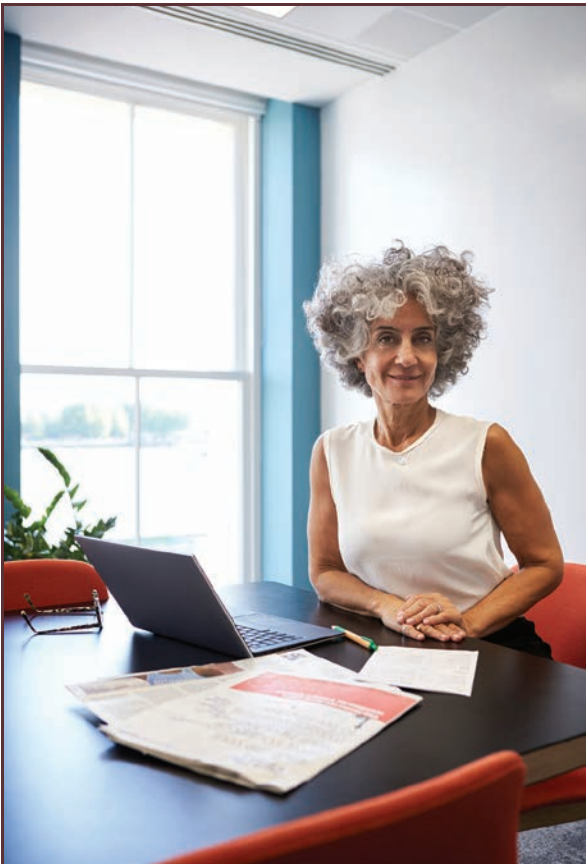
Consolidated groups. The net interest expense limitation is determined on a consolidated basis, without considering obligations between group members. The regs will provide technical rules.

Earnings and profits. The guidance clarifies that disallowed interest expense will nevertheless reduce a corporation's earnings and profits.

BDIT lets you give away property without losing control

By temporarily doubling the gift and estate tax exemption, the Tax Cuts and Jobs Act (TCJA) opened a window of opportunity for affluent families to transfer assets tax-free. To take advantage of the higher exemption amount, many families that own businesses or other assets worth more than the pre-TCJA exemption amount are planning substantial gifts to their children or other loved ones during the next seven years.

Traditionally, parents use trust-based gifting strategies to transfer assets to their children. Even though these strategies offer significant tax-planning benefits, they also have a major drawback: They require you to relinquish much of your control over the assets, including the right to direct the ultimate disposition of the trust assets. One strategy for avoiding this drawback is to use a beneficiary defective inheritor's trust (BDIT).



The tax code prevents you from transferring assets in trust to your children on a tax-advantaged basis if you retain the right to use or control those assets.

It's better to receive than to give

The tax code prevents you from transferring assets in trust to your children or other beneficiaries on a tax-advantaged basis if you retain the right to use or control those assets. But similar restrictions don't apply to assets you *receive* as beneficiary of a third-party trust. This distinction is what makes a BDIT work. The strategy is best illustrated with an example:

Let's say Mollie owns a business valued at $12 million (just over the exemption amount) and it's organized as a limited liability company (LLC). She'd like to take advantage of the exemption by transferring ownership of the business to her three children, but she's not ready to relinquish control over the business. Mollie arranges for her parents to establish three BDITs, each naming her as primary beneficiary and one of her children as contingent beneficiary. She then sells one-third interests in the LLC to each trust for $3 million. The sale price of each interest reflects a 25% minority interest discount.

As a result, Mollie:

- Removes the value of the business and all future appreciation from her estate without triggering gift tax liability,
- Provides the trust assets with some protection against creditors' claims,
- Retains the right as beneficiary to manage the trust assets, to receive trust income, to withdraw trust principal for her "health, education, maintenance or support," and to receive additional distributions in the independent trustee's discretion,
- Retains the right to remove and replace the trustee, and
- Enjoys a special power of appointment to distribute the trust assets (so long as it's not for her benefit).

For this strategy to pass muster with the IRS, a couple of things must happen. First, to ensure that the BDITs have economic substance, Mollie's parents should "seed" each trust with cash — typically at least 10% of the purchase price, in this case $300,000 per trust.

Second, to avoid negative tax consequences for Mollie's parents, the trusts must be "beneficiary defective," ensuring that Mollie is treated as grantor for income tax purposes. Typically, this is accomplished by granting Mollie lapsing powers to withdraw funds from the trust.

A powerful tool

If you're looking for ways to take advantage of the current gift and estate tax exemption without ceding complete control, consider a BDIT. Implementing this strategy is complex, but it offers significant tax benefits. Your advisor can provide additional information. ■

Relax, but don't forget about taxes

Owning a vacation home requires tax planning

A vacation home can be many things to different people. For example, it can be a relaxing refuge for friends and family, or the property can serve as an income-producing investment if you choose to rent it out when you're not using it.

However you plan to use your vacation home, it pays to understand the tax rules regarding income and expenses associated with the property. And to ensure that the home stays in the family, it's important to be familiar with specific estate planning strategies.

Personal use

You can generally deduct interest on up to $1 million in combined acquisition debt on your main residence and a second residence, such as a vacation home. Note, however, that the $1 million amount may be limited to $750,000, depending on when the debt was acquired. In addition, you can also deduct — though possibly subject to limitation — property taxes on any number of residences.

If you (or your immediate family) use the home for at least 14 days and rent it out for less than 15 days during the year, the IRS will consider the

property a "pure" personal residence, and you don't have to report the rental income. But any expenses associated with the rental — such as advertising or cleaning — aren't deductible.

Rental use

If you rent out the home for more than 14 days *and* you (or your immediate family) occupy the home for more than the greater of 14 days or 10% of the days you rent the property, the IRS will still classify the home as a personal residence (in other words, vacation home), but you will have to report the rental income.

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In this situation, you can deduct the personal portion of mortgage interest, property taxes and casualty losses as itemized deductions. In addition, the rental portion of your expenses is deductible up to the amount of rental income. If your rental expenses are greater than your rental income, you may not deduct the loss against other income.

If you (or your immediate family) use the vacation home for 14 days or less, or under 10% of the days you rent out the property, whichever is greater, the IRS will classify the home as a rental property. In this instance, while the personal portion of mortgage interest isn't deductible, you may report (subject to limitation) as an itemized deduction the personal portion of property taxes. You must report the rental income and may deduct all allocable rental expenses, including depreciation, subject to the passive activity loss rules.

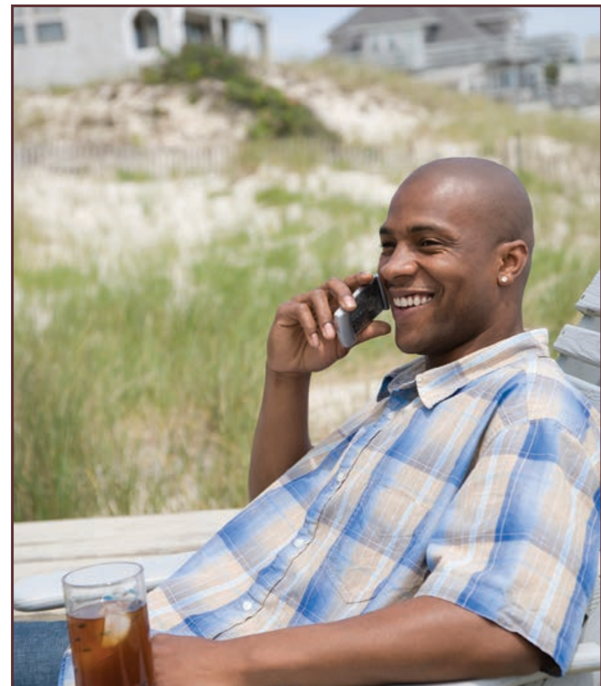
Planning for the future

As with any asset, it's critical to account for your vacation home in your estate plan. What will happen if an owner dies, divorces or decides to sell his or her interest in the home? It depends on who owns the home and how the legal title is held. If the home is owned by a married couple or an individual, the disposition of the home upon death or divorce will be dictated by the relevant estate plan or divorce settlement.

If family members own the home as tenants-in-common, they're generally free to sell their interests to whomever they choose, to bequeath their interests to their heirs or to force a sale of the entire property under certain circumstances. If they hold the property as joint tenants with rights of survivorship, an owner's interest automatically passes to the surviving owners at death. If the home is held in an FLP or FLLC, family members have a great deal of flexibility to determine what happens to an owner's interest in the event of death, divorce or sale.

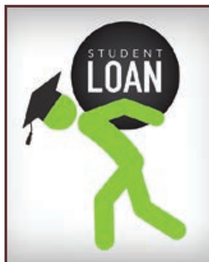
Keep it in the family

If your vacation home has been in your family for generations, you'll want to do everything possible to hold on to it for future generations. Contact your advisor to learn more about the tax and estate planning aspects of owning a vacation home. ■



Employers can use 401(k) plans to help employees pay student loans

In a recent private letter ruling, the IRS approved an employer's student loan repayment program, under which it made contributions to employees' 401(k) plan accounts that were contingent on repayments of student loans. Essentially, the employer agreed to make a matching contribution equal to 5% of an employee's compensation if an employee either 1) made an elective contribution to the 401(k) plan equal to at least 2% of compensation, or 2) made a student loan repayment equal to at least 2% of compensation.



The program is an attractive benefit, because it allows employees to pay off their student loans without sacrificing matching 401(k) plan contributions. In addition, because the employer's contributions are free of payroll taxes and aren't subject to federal income tax withholding, the program offers significant tax advantages over other student loan assistance programs.

Employers considering such a program should contact their advisor to discuss the various administrative and planning issues it would entail, including the potential impact on nondiscrimination testing. ■

Get ready for Tax Reform 2.0

Republican leaders in Congress have introduced several bills to expand the tax reforms made by last year's Tax Cuts and Jobs Act (TCJA). Among other things, the bills would 1) make the TCJA's individual income tax rate cuts, 20% "pass-through" deduction, and $10,000 limit on deductions of state and local taxes permanent (they're currently set to expire at the end of 2025), 2) expand access to new and existing tax-advantaged savings vehicles, 3) expand the benefits of Section 529 college savings plans, and 4) provide new and expanded tax breaks for start-up businesses. ■

Substantiation of charitable contributions

Recently, the IRS finalized regulations on the substantiation and reporting rules for deductible charitable contributions. A few highlights:

- For cash contributions in any amount — whether made by cash, check or other means — the donor must maintain a record in the form of 1) a bank record or 2) a written communication from the donee. The record must show the name of the donee organization, the date of the contribution and the amount of the contribution.

- For donations of property, 1) contributions under $250 require a receipt from the donee *or* reliable records, 2) contributions of $250 to $500 require a contemporaneous written acknowledgment, 3) contributions over $500 but not more than $5,000 require a contemporaneous written acknowledgment plus a completed and filed Form 8283, and 4) contributions over $5,000 require a qualified appraisal plus a completed and filed Form 8283 (together with a copy of the qualified appraisal for contributions over $500,000).

- Qualified appraisers must now demonstrate verifiable education and experience in valuing the type of property subject to the appraisal. ■

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