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Heckerling 2018 - Report No. 1 (Monday 1/22/18)

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Heckerling 2018 - Report No. 1 (Monday 1/22/18)

As we have done in January for the last twenty one years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting daily Reports to this list containing highlights of the proceedings of the 52nd Annual Philip E. Heckerling Institute on Estate Planning that is being held on January 22-26, 2018 at the Orlando World Center Marriott Resort and Convention Center in Florida. A complete listing of the proceedings and the Institute's 2018 brochure are available at www.law.miami.edu/heckering. **Introduction Part 1** issued on 1/11/18 covered the Institute Opening Reception, its Scope, the Faculty, the Advisory Committee, the Sponsors and the Vendors, plus general information at the end about the Institute. **Introduction Part 2** issued on 1/12/18 contained a complete listing of all of the proceedings of this Institute. This Report begins our coverage of the proceedings.

We also will be posting the full text of each of these Reports on the ABA RPTE Section's Heckerling Reports Website, as we have since the 2000 Institute. The Reports from 2000 to 2017 can now be found at URL http://www.americanbar.org/groups/real_property_trust_estate/events_cle/heckerling.htm. In addition, each Report from 2006 to date can also be accessed at any time from the ABA-PTL Discussion List's Web-based Archive that now only goes as far back as January of 2006 and is located at URL http://mail.americanbar.org/archives/aba-plt.html.

**ERRATA: Introduction No. 2** left out a Special Session that was added after the initial brochure for this year's Institute was released. It is **Special Session IV-F** that will be held on Thursday afternoon from 3:50 to 5:20 PM entitled **Why Your Partnership and LLC Agreements Need a Tune-Up 9n 2018: The New Partnership Audit Rules [CHB]**. It is to be presented by Richard B. Robinson of Robinson, Diss and Clowdus, PC in Denver, Colorado. It is described as follows: Every partnership (including large, small, and family partnerships) must amend its agreement beginning with its 2018 tax year. Partnerships with trusts, grantor trusts, limited liability companies, other partnership or disregarded entities as partners, cannot elect out of these new rules, and every partnership must appoint a Partnership Representative for each tax year. The new rules create complexity and decisions that must be discussed with every partnership. This program will provide an overview of the new rules as well as practical advice on how partnership agreements should be amended to address the issues.

**Summary:** This Report #1 begins our coverage of the proceedings of the 52nd Annual Institute and starts with our coverage of the first of three Fundamentals programs, this one being all about the formation of closely-held businesses that was held on Monday morning. Following that is our coverage of the traditional Recent Developments session that was held on Monday afternoon.

Report #2 will begin our coverage of the Tuesday morning general sessions.
Monday, January 22, 2018 9:00-12:15
FUNDAMENTALS PROGRAM #1
Starting Off On the Right Foot While Avoiding Foot Faults - Issues at the Formation of the Closely-Held Business [CHB]
Presenters: Stephanie Loomis-Price + Samuel A. Donaldson + Ivan Taback
Reporter: Craig Dreyer

Clients launching new business ventures need a lot of guidance, whether they know it or not. This program covered most of the important tax and legal issues related to the formation and ongoing maintenance of a new business entity, including understanding the federal tax implications of the various types of business entities, negotiating the documents related to management, coordinating the business capital structure with the estate plan, and optimizing entity maintenance to minimize IRS attacks. Here are some of the more significant highlights from this session.

**21% Corporate Tax Rate**
The panel opened by discussing the new 21% flat rate tax on C corporation income effective for 2018 and later. The panel noted that there is no longer a special 35% tax rate for personal service corporations, as they pay the same 21% flat rate. There is still the same rate structure on dividends. The former concern about double tax has been substantially mitigated by the new corporate 21% rate. The idea for the new 2017 Tax Act was to make the tax rates similar for C corporations and pass through entities. However, a C corporation allows the ability to defer tax, but be cautious about converting to a C corporation since there may be tax consequences in trying to unwind them and the tax law may change. In general, C corporations are difficult to unwind, but easy to get into. However, the C corporation is not as bad as it used to be from a tax perspective.

**New IRC Section 199A Deduction**
The Second Issue the panel discussed was the new Section 199A deduction for qualified business income (“QBI”). The panel then discussed the top 10 things you need to know about the new QBI deduction.

1. **Who qualifies.** A partner in partnership, shareholder in S corporation, and sole proprietor qualify.
2. **Who doesn’t qualify.** C corporations, C-Corporation shareholders, and employees don’t qualify.
3. **Taxable income zones.** Amount of deduction and eligible business is a function of taxable income indexed for inflation. Zone 1- taxable income does not exceed 157,500 single or 315,000 married filing jointly (“MFJ”), you get full QBI deduction from taxable income. Zone 2- taxable income 157,500-207,500 single or 315,000-415,000 MFJ the size of the
QBI deduction could be limited if the compensation paid or the unadjusted basis in depreciable property tests are not met. Zone 3, if taxable income is more than 207,500 or 415,000 MFJ, the QBI deduction may be entirely eliminated if they don’t meet the wage and unadjusted basis in depreciable property tests.

4. **Specified Service Business.** If business is in zone 2, the deduction is phased out, in zone 3 there will be no deduction. If performing services in health, law, accounting, actuarial science, performing arts, consulting, financial services, or brokerage services, these are specified services (engineers and architects are notably absent). Regardless of the title if you are a business where the principal asset is the reputation or skill of one or more of its employees or owners, you are a specified service business. It may be beneficial to spin off separate businesses to enable them to qualify for the QBI deduction, but be careful in planning as the law may be temporary.

5. **U.S. Trade or Business.** The business must be engaged in the conduct of a United States trade or business. Foreign businesses do not qualify, and investment and personal activities do not qualify. Must actively participate. Spinning off property into and LLC may be difficult to take QBI deduction since it must meet the definition for an active trade or business.

6. **Deduction amount.** Zone 1- you can deduct 20% of QBI. Zone 3 – you can deduct either 20% of QBI or, if less, 50% of the wage basis limitation (W2 income or basis in depreciable property). If no wages and no depreciable property, you get no deduction. Zone 2 - your QBI deduction starts at 20% but is phased out. The deduction for each trade or business is calculated separately.

7. **Qualified Business Income.** Net amount of your income, gain, loss, and deduction from an eligible trade or business, except for items of capital gain, loss, and certain dividends from REITS, cooperatives, and publicly traded partnerships. Essentially, this is the net amount of income from ordinary business operations. If net amount of all eligible businesses is a loss, net loss carries over to next taxable year as a loss from a separate qualified trade or business. No limit on carryover. Compensation and guaranteed payments paid to taxpayer are not QBI.

8. **The Wage Basis Limit.** 199A(b)(2) applies to zones 2 or 3.
   a. 50% of W-2 Wages paid by business to employees; or
   b. 25% of W-2 wages plus 2.5% of unadjusted basis immediately after acquisition of all depreciable property used in the business still on hand at year end.

9. **Eligibility for Estates and Trusts.** Estates and trusts with interest in partnership and S corporation are eligible for the deduction. The 2017 Tax Act instructs Treasury to issue regulations explaining how the deduction is to be apportioned between fiduciaries and beneficiaries.

10. **Sunset, Sunrise.** Individual benefits sunset in 2025. This is a benefit to individuals and not c-corporations since they are not eligible for the QBI deduction.

**Conversion from S to C-Corp**

Transition from S corporation to C corporation. It all depends if it will make sense. Generally, it will be a tax-free event, but you may lose the ability to use cash method of accounting. Switching from S corporation to C corporation may also force accrual method of accounting, but you will need Service permission to do this. In doing so, you may also need to make an IRC Section 481 adjustment.
ENTITIES AND ATTRIBUTES

*Sole proprietorship* –

*Tax.* For tax purposes, a sole proprietorship is a tax nothing, and is reported on Schedule C of the Form 1040.

*Business Issues.* The owner has personal liability since there is no liability protection. The panel noted that is imperative that owners of these entities obtain proper insurance coverage.

*Creation.* There is no formal creation mechanism and generally has no state registration requirement. Municipalities often have some registration requirements. Sole proprietor will have to register fictitious name requirement if they want to operate under a name other than their own.

*Succession Planning.* This can be challenging in sole proprietorship. It can be done by sale or gift and business would consist of all business assets including intangible assets. It can also qualify for IRC Section 6166 deferral for estate taxes. Goodwill is a major part of planning, and you may be able to transfer or not transfer goodwill. *Bross Trucking* case discusses how to potentially set up transfer of business between generations to lessen the impact of good will.

*Family Considerations.* Minimal in sole proprietor context. In community property states, there may be more than one owner in a sole proprietorship. These issues also come up unexpectedly as people move.

*Overall.* Easiest business to form, but also has no liability protection for its owners.

*C-Corporations*

*Tax.* Only C-Corporations qualify for Qualified Small Business Stock IRC Section 1202. If stock qualifies and was acquired after Sept 28, 2010, entire amount of gain on sale of stock can be excluded. This is good for angel investors who want to hold stock for 5 years and cash out. 2017 Tax Act does not prevent 1045 like kind exchange for qualified small business stock. In the past, the double tax had us advise to distribute wages rather than dividends since wages were deductible. Now that we have a 21% corporate tax rate, you must run the numbers to see if the 21% and 23.8% rate creates a push. Since compensation has self-employment tax, it may be better to pay dividends under the new law to avoid self-employment taxes. However, paying generous interest is also usually preferable over dividends if the shareholder is also a creditor of the corporation. Similarly, if the shareholder is also landlord, paying generous rent is still a benefit especially if real estate business qualifies under new IRC Section 199A. One must be careful to avoid the accumulated earnings tax - it is a penalty imposed when the Service says a company has too much retained earnings (avoiding a double layer of tax). It is imperative for corporations to document reasons for retaining earnings. The 2017 Tax Act also got rid of corporate AMT. The bottom line is that being a C-corporation under the 2017 Tax Act is more beneficial than it used to be.
**Business Issues.** Liability protection to shareholders of corporation if corporate structure is respected. Shareholder should not be responsible for debts and liabilities of corporation. It is imperative that rules be followed so as to not be treated as an alter ego.

**Family Consideration.** A properly run corporation should have a shareholder agreement and lays out transfer restrictions. Should have succession plan - with a C corporation it generally involves transferring stock to others and its important to plan for this.

**State Law Issues.** Formation is done by authorized person filing Certificate or Articles of Incorporation with state entity. If doing business in another state you must also file application to do business in the other state. Delaware is one of most popular states to form a corporation. Corporation also generally have by-laws and lay out how entity will be managed. It is important to stay up with corporate formalities to avoid liability to the shareholders.

**Litigation Issues.** It is important to follow C-Corporation regulations to protect from liability. It is also an advantage on the family side to have a C corporation since the service doesn’t attack them as often as on the estate side since they are not as common.

**Overall.** The C corporation may be beneficial over S corporation if people want different classes of stock.

**S corporations**

The panel noted that the eligibility requirements for an S corporation all have practical work arounds. The panel then went through the requirements: 1. Only U.S. Corporation can be an S corporation, but if dual registered can be treated as a U.S. S corporation. 2. Can’t have more than 100 shareholders (but you can also count all members of a family as 1 shareholder even after divorce). 3. Can’t have non-resident alien shareholders. 4. S corporation can only have one class of stock (can’t differ on distribution or liquidation rights but can differ on voting rights). 5. Corporations, partnerships and LLC’s and other entities are not permissible owners of S corporation stock.

**Tax Considerations.** You must affirmatively elect S Corporation Status. Income flows through to shareholders in pro rata ownership. Entity character of income, loss, and deduction flows through to shareholders. Liquidation of an S corporation remains a taxable event. One benefit of an S corporation over a C corporation is in the funding and the purchase of shares. When a shareholder borrows money to buy stock in an S corporation it is treated as though they borrowed the money to buy the underlying business assets allowing them to deduct the interest as a business expense instead of as an investment expense. There is a limitation on business interest deduction that kicks in at over 25 million of gross receipts, but for all others business interest can be deducted in full. Traditionally, paying compensation to a shareholder employee was minimized under the old rules, since it was subject to self-employment tax. S corporation also requires the shifting of tax attributes, which in most other contexts the service would disallow.

**Business Issues.** Succession is similar to C corporation planning, but one must be careful not to violate the one class of stock rules. Most planning involves recapitalizing into voting and non-
voting stock for control and discount planning. Be careful when transferring ownership to ensure an employee does not lose tax free benefits by becoming more than a 2% shareholder.

**Family Considerations.** Who can be a shareholder. Holding shares of stock in trusts for family is a common issue. It is important to note that in order to hold S corporation stock, the trust must be a QSST, ESBT, grantor, or Testamentary Trust (for a limited period of time). The election must be made within 2.5 months of the transfer, except for a grantor trust where no election is necessary. The ability to recapitalize stock is very common to transfer non-voting shares for family planning. Must also be careful that buy/sell provisions for an S corporation do not to violate the one class of stock provision.

**State Law Issues.** Similar issues to C corporations, formalities must be followed. By-laws and minutes are important to maintain. You must file with the state regulatory authority. State and local taxation may differ from one state to another. S corporation is just a C corporation that makes an S election.

**Litigation Issues.** IRS does not allow tax affecting for S corporations. The IRS has taken the position they will not take this into consideration. So far there is not a case that allows tax affecting in a valuation case for an S corporation. The *Cecil* case is pending showing tax affecting in the construct. However, with new tax rate it may not matter anymore and be more of a symbolic victory. As with the other entities, the formalities of the entity must be followed to protect form shareholder liability.

**Partnerships**

**General Partnership (“GP”).** GP is an unincorporated business and all partners have management interest and all partners have full liability. Converting to another entity is rather straightforward and painless. Downside to GP is personal liability. General partners are assumed to have equal ownership and decision-making ability if there is no operating agreement.

**Limited Partnerships (“LP”).** LP has general and limited partners. Limited partners have limited liability to capital contributed. General Partners have unlimited liability and are obligated to run company and have all issues with management. In addition to limited partnership filing with state, the required formalities of partnership must be maintained to keep limited liability of limited partners not being involved in management. Nature of obligations and liabilities for general partners to limited partners can create friction on how entity is run. L.P. often used on one off investments or private equity fund as entity of choice (use has generally been mitigated by LLCs).

**Limited Liability Partnership (“LLP”).** LLP is an entity were several partners share management and limited liability. Advantage is all partners are protected by some form of limited liability protection. Must file papers with state. Many states do not allow some professions to form LLC or corporations, which is why you still see many of these. Some states also may not respect LLP formed in another state, so they are not as good for protecting partners in all cases.

**Limited Liability Company (“LLC”).** LLCs became very popular in 1990’s as their use increased. They are treated like a partnership for income tax purposes, but you get limited liability to all the members. To form an LLC, you must file an article of formation in most states. LLC’s can be
member managed or manager managed. Member managed LLC’s have management done by members with limited liability. Manager managed LLC’s have Managers who have essentially full management control. Manager does not even need to be a member in most states. A multi member LLC can elect to be taxed as corporation rather than partnership. LLCs should have operating agreements among the members that lay out rules regarding ownership, contributions, distributions, management, and the effect of withdrawal, retirement, or death of a member. Operating agreements should also govern restrictions on transfer of interests.

*Tax considerations/State Law Issues.* Most tax consideration are state law specific. States may tax differently. Some states limit certain types of partnerships.

*Business Issues/Family Considerations.* LLC’s allow partners to be general or limited without subjecting them to additional liability. This allows other family members to learn how to operate the business before turning it over, unlike other types of partnerships. Flexibility in allocation of income rather than straight allocation based on ownership. On death, S Corp stock gets step up in basis, but partnership gets step up in all the assets if a 754 election is made. There is also IRS scrutiny to LLC’s regarding valuation issues.

*Litigation Issues.* LLC’s formalities must be followed to prevent an argument for piercing the corporate veil as with other entities.

*Overall.* Advantages of LLC is flow through taxation (if not elected otherwise), limited liability which is subject to piercing of the corporate veil, and allocation of economics among partners. In an LLC you can have capital, profit, and preferred interests. In general, there aren’t many downsides to an LLC.

2:10-5:15

**Recent Developments 2017**
Carol A. Harrington + Steve R. Akers + Jeffrey N. Pennell

Materials by: Steve R. Akers, Samuel A. Donaldson, Charles D. "Skip" Fox, IV, Jeffrey N. Pennell, and Howard M. Zaritsky
Edited by: Ronald D. Aucutt

This panel analyzed the most significant developments of 2017, including the planning implications of enacted and anticipated legislation. The Reporter has focused most of his report on the panel's discussion of the Tax Cuts and Jobs Act which was covered in a 45 minute extended session at the end, for which Carlyn McCaffrey joined the panel.

**A. General Discussion of Recent Developments**

*Withdrawal of Proposed Section 2704 Regulations*
These regulations were only proposed and never temporary. The panel doesn’t think they’ll come back in another form.

Consistent basis rules - IRC Form 8971 and Schedule A

The basis consistency rules have been subject to numerous criticisms, including:

1. Need to provide information to beneficiaries 30 days after 706 is filed. The panel noted the requirement is in the statute.
2. The requirement to inform subsequent transferees of carryover basis property of the property’s basis is not well thought out. The statute only imposes a reporting requirement on the executor, not on heirs.
3. Zero basis rule.

Estate of Powell v. Commissioner

Mr. Akers stated this might be the most important case since the Bongard case in 2005. It extended section 2036(a)(2) to decedents with only limited partnership interests and raised the possibility that partnership assets could be included under section 2036 and the partnership interest could be included under section 2033.

Section 2036(a)(2) was applied because the decedent in conjunction with all other partners could have dissolved the partnership. Mr. Akers noted that this could apply to any form of co-ownership and is very troubling from planning standpoint.

The possibility of double inclusion was raised by the majority on its own, although the majority only included seven of the 16 regular Tax Court judges plus Judge Halpern, a senior judge. Seven judges rejected the double inclusion analysis in a concurring opinion and two concurred in the result only. Prof. Pennell said that he raised the double inclusion issue with IRS attorneys 15 years ago and they said that did not raise it because the result was so ugly for taxpayers that they were afraid they would lose the 2036 argument. The workaround suggested was to dispose of the assets transferred to the FLP.

Notice 2017-73, Guidance on Donor Advised Funds

With TCJA increasing interest in donor advised funds, the panel noted that the guidance in Notice 2017-73, released December 4, 2017, may be more important. The Notice states that the IRS is considering proposing rules that if a DAF pays for a dinner, sports, or other ticket, it results in more than an incidental benefit to the donor that is subject to an excise tax. The use of a DAF distribution to satisfy a donor’s pledge does not result in a benefit that is more than incidental if the DAF distribution does not refer to the pledge and other requirements are met.

B. 2017 Tax Cuts and Jobs Act (TCJA)

TCJA is the first major tax reform since 1986 with provisions affecting individual, business, and transfer taxes. The transfer tax changes and the individual changes generally expire in 2026 while most business changes are permanent.
Transfer Tax Provisions

Although the transfer tax changes are not extensive as the individual and business changes, the panel noted that there are two significant questions:

1. The exact amount of the basic exclusion amount. Inflation adjustments are now computed using the chained CPI, which has a lookback provision. A panelist noted that we are hoping to get some official guidance on whether the chained CPI look-back provision will apply in determining the basic exclusion amount.
2. Whether a future law change reducing the basic exclusion amount would result in the clawback of gifts that exceed the basic exclusion amount at the donor’s death.

Prof. Pennell said that in 2012, when the basic exclusion amount was scheduled to drop from $5.25 million to $1 million, most commentators thought that clawback would not apply. He doesn’t think it will apply now. TCJA added section 2001(g)(2), directing Treasury to prescribe regulations to carry out this Section, reflecting differences between the basic exclusion amount at a decedent’s death and the basic exclusion amount at the time of a gift.

Ms. McCaffrey noted that even if there is a clawback, making gifts will remove all income and appreciation on the property from the decedent’s estate.

Ms. McCaffrey noted that nonresident aliens continue to suffer. Their exemption is stuck at $60,000 with no gift tax credit.

Possible Planning Approaches

The panel then discussed the impact of the increased basic exclusion amount on estate planning. Ms. Harrington noted that it’s difficult to balance all of the various considerations in planning for a client. It is important to build flexibility into the plan and delay final decisions as long as possible.

Prof. Pennell reviewed two ways to build flexibility into an estate plan – disclaimers and QTIP elections. He thinks disclaimer planning is risky because of potential problems, including acceptance of property before a disclaimer; an heir not following through with the disclaimer; and an heir becoming disabled and not receiving court approval for the disclaimer. He believes that QTIP elections are better:

1. The decision can be made 15 months after death rather than nine months for disclaimer
2. With the uncertainty over the basic exclusion amount available at death, the ability to make formula election is important
3. Reverse QTIP elections can be made for GST purposes, and
4. Some states allow state QTIPs

He noted that the big disadvantage of relying on QTIP elections is the requirement to distribute all post-mortem income. A Clayton QTIP could be an alternative.

In a friendly family, Prof. Pennell thinks most people will make 100% QTIP election and portability election. The belief is that it is better to cannibalize marital property than non-marital property

Size of estate:
1. Different themes for couples with under $5.5 million; Need to worry about basis adjustment

2. For couples with $5.5 -10 m, need to worry about estate tax and portability

3. Over $11m, look at gift issues and basis adjustment

The panel agreed that this is a window of opportunity to make gifts significantly greater than $5 million. There is no new benefit to make gifts of $5m or less. The biggest impact could be the cushion effect so that there is no taxable gift even if valuation discounts are lost upon audit. Defined value gifts may be very attractive.

**Ways to use the increased basic exclusion amount include:**

1. Forgiveness of outstanding loans
2. Equalizing gifts
3. Save state estate tax
4. Get assets into trust to roll out of split dollar agreements
5. Use non-grantor trust. Get property into non-grantor trusts for children
6. Bigger seed money into trusts or to existing trusts to help make payments on notes

**Income tax planning**

The panel noted several items concerning the income tax changes.

1. With the state and local tax deduction limited and an increased standard deduction, the use of donor advised funds becomes more attractive to fund charitable contributions. A client can fund a DAF in one year with several years of contributions and itemize deductions that year. In subsequent years, the client can claim the standard deduction and make contributions from the DAF.
2. Trust or estate deductions unique to trusts or estates aren’t subject to the suspension. Prof. Pennell says this takes all trust or estate deductions out of miscellaneous deductions except investment advisory fees.
3. The personal exemptions for trusts and estates were not changed.
4. The section 691(c) deduction for income in respect of a decedent was not suspended.

**Business tax changes**

The panel noted several items concerning business tax changes:

1. There were two good ESBT changes. Non-resident aliens can be potential current beneficiaries. Charitable deductions for ESBTs will be determined under the general rules of IRC Section 170 rather than the trust charitable contribution rules of IRC Section 642(c). This allows the deduction to include unrealized appreciation.
2. The simplicity of the 21% rate for C corporations compared to the complexity of new IRC Section 199A may mean clients look to switching to C corporation status, especially if they are not making distributions to owners.
3. Most of the IRC Section 199A limits don’t apply to taxpayers below the $157,500/$315,000 limits. All they have to do is show that they’re engaged in a business.
4. There are many questions about how IRC Section 199A works or is intended to work.
The Reporters:

Our on-site local Reporters who are present in Orlando in 2018 are Joanne Hindel Esq., a Vice President with Fifth Third Bank in Cleveland, Ohio; Kimon Karas Esq., an attorney with McCarthy, Lebit, Crystal and Liffman Co. LPA in Cleveland, Ohio; Craig Dreyer Esq., an attorney with the Dreyer Law Firm in Stuart, Florida; Herb Braverman Esq., an attorney with Braverman & Associates in Orange Village, Ohio; Kristin Dittus Esq., a solo attorney with offices in Denver, Colorado, Michael Sneeringer Esq., an attorney with Porter, Wright, Morris and Arthur, LLP in Naples, Florida, Michelle R. Mieras, a Fiduciary Risk Manager with Bank of the West in Denver, Colorado, Beth Anderson Esq., an attorney with Wyatt, Tarrant & Combs, LLP in Louisville, Kentucky, Bruce A. Tannahill Esq., a Director of Estate and Business Planning in the Mass Mutual Financial Group in Phoenix, Arizona, and Patrick J. Duffey Esq, an attorney with Holland & Knight in Tampa, Florida.

The Report Editors in 2018 are Joseph G. Hodges Jr. Esq., a solo practitioner in Denver, Colorado, who is the Chief Moderator of the ABA-PTL discussion list. He is being ably assisted in those duties this year by Reporter Bruce A Tannahill Esq.