December 2021

Tax Talk

A quarterly publication of Bridges & Dunn-Rankin, LLP

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Dear Clients and Friends,

Years ago, a very wise friend told me "Never call your newsletter a weekly, monthly or quarterly, because then you will feel compelled to issue it on that schedule. Just call it a newsletter, and then you can issue it whenever you want". I failed to follow that advice, and we called our newsletter a "Quarterly", which has proven to be mostly aspirational, as it gets deferred whenever we get too busy with client matters; which has certainly been the case lately.

There has been much talk of possible tax increases since the Democrats gained control of the White House and Congress, but nothing actually enacted thus far. In this issue, we will discuss proposed legislation, along with estate planning, new workarounds to the limitation on deduction for state income tax, new rules scheduled to take effect in 2022 which require the capitalization and amortization of R&D expenses and which may limit the deduction of business interest expense, and the "F-reorg" structure for sale of an S-corp business.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges

Kent Bridges,
Managing Partner

Proposed Tax Legislation

President Biden campaigned on a promise to increase taxes on the wealthy and corporations, and so, with the White House and Congress both under Democratic control, a significant increase in taxes has been anticipated by many. To date, nothing has happened.

Earlier this year, Biden proposed (amongst other things) to increase the top rate on ordinary income of individuals to 39.6%, tax long-term capital gain of higher income individuals as ordinary income (effectively almost doubling the rate on capital gains), end the step-up in tax basis at death, expand the 3.8% Medicare tax to include the income from flow-through entities of active participants, and increase the corporate rate from 21% to 28%. The capital gains rate increase would have been retroactive to April 28, 2021.

In September, the House Democrats released draft legislation which included many of the changes described above. Under this draft legislation, however, the increase in the rate on long-term capital gains would have been to 25%, and the effective date would have been gains realized after September 13, 2021.

In November, the House passed HR 5376, the *Build Back Better Act (BBBA)*. As we go to press with this newsletter, the Senate is still debating this legislation. It is impossible to say if or when this legislation will be enacted and what changes may be made to it, but here is a high-level summary of some of what is in, and, equally important, what is NOT in the proposed legislation.

Increase in individual ordinary rate – The *BBBA* does NOT include (at least not directly) an increase in the individual ordinary rate. It would, however, indirectly increase the ordinary rate on very high-income individuals and trusts via the surtaxes described below and on owners of flow-through entity businesses via an expansion of the 3.8% Medicare tax on net investment income.

Increase in capital gains rate – Similarly the *BBBA* does NOT directly include an increase in the individual rate on long-term capital gain and qualified dividends, but would indirectly increase the rate on such for some taxpayers via the new surtaxes and expansion of the 3.8% Medicare tax on net investment income.

Surcharge on high income – Under *BBBA*, effective for tax years beginning after 2021, a 5% surcharge would be assessed on individual income over $10 million ($5 million for married filing separately and $200,000 for trusts), and an additional 3% surcharge would apply to income over $25 million ($12.5 million for married filing separately and $500,000 for trusts); for a total 8% surcharge.

Expansion of the 3.8% Medicare tax – The *Affordable Care Act* (enacted in 2010) included a 3.8% Medicare tax on "net investment income" of higher income taxpayers. The same 3.8% applies to earned income via either the FICA (for W-2 employees) or self-employment tax. K-1 income from flow-through entities in which the taxpayer materially participates and gains from the sale of such businesses have, to-date, been exempt from the 3.8% tax. The *BBBA* would remove this exemption for tax years beginning after 2021 for singles with income over $400,000, married filing joint with income over $500,000, and married filing separate with income over $250,000. For the owner of a flow-through entity business, this change combined with the proposed surcharges could add 11.8 percentage points to the tax on high income (for a total Federal rate on ordinary income of up to 48.8% and a total Federal rate on long-term capital gain of up to 31.8%).

Increase in the SALT cap – The *Tax Cuts and Jobs Act* enacted in late 2017 placed a $10,000 per year limit on individuals' deduction for state and local taxes on Schedule A as itemized

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Proposed Tax Legislation — continued

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deductions. *BBBA* would increase this limit (retroactive to 2021) to $80,000.

QSBS exclusion limited to 50% - As we have discussed in prior issues of this newsletter, IRC 1202 provides an almost too good to be true exclusion of up to the greater of $10 million or 10x the amount invested for gain from the sale of qualifying C-corp stock held at least 5 years. For sales of qualified small business stock (QSBS) after September 13, 2021, *BBBA* would reduce the exclusion to a maximum of 50% of the gain.

Limitation on the 20% QBI deduction – The September version of *BBBA* included a provision limiting the 20% qualified business income deduction for K-1 income to a maximum of $500,000 for married couples filing jointly, $400,000 for singles and $250,000 for married filing separately. The current version of *BBBA* does NOT include this limitation.

Corporate tax increases – *BBBA* does NOT include a general increase in the 21% corporate tax rate, but does include a very controversial 15% minimum tax on book profit reported by corporations with over $1 billion of net income, a 1% excise tax on stock repurchases, and some changes in the international tax area.

Grantor trusts – Earlier proposals would have essentially eliminated the ability to do tax planning utilizing the grantor trust rules, but this is NOT included in the current version of *BBBA*.

Basis step-up at death – Under current law, most assets you own at death receive an income tax basis step-up to their fair market value on the date of death (allowing heirs to sell the assets free of any income tax). Earlier proposals would have limited this rule or required that tax be paid on unrealized gains at the time of death. *BBBA* does NOT include any such provision.

Reduction in estate tax exemption – For 2021, the exemption from estate and gift tax is $11.7 million (per spouse), and this amount is increased for inflation each year until 2026, at which time it reverts back to $5 million (as indexed for inflation since 2010). Earlier proposals would have accelerated this reversion to the $5 million level, but *BBBA* does NOT include such.

Statutory disallowance of syndicated conservation easement deductions – The September version of *BBBA* would have statutorily disallowed the conservation easement deduction for most contributions made after 12/23/16 where the deduction flowed through from a pass-through entity and the amount of such was 2.5 times or greater the amount paid for the ownership stake. This provision did NOT make it into the most recent version of *BBBA*.

Delay in the R&D capitalization rule – The *Tax Cuts and Jobs Act* legislation enacted in late 2017 included a provision whereby R&D expenses incurred in tax years after 2021 will have to be capitalized and amortized over 5 years (15 years for R&D conducted outside the US). *BBBA* would delay this rule until 2026.

Is Now the Time to Update Your Estate Plan?

Legislation proposed earlier in the year would have accelerated (to 2022) a significant decrease in the estate tax exemption (currently scheduled for 2026) and eliminated the basis step-up at death rule and curtailed the ability to do estate planning with grantor trusts. This sent many high-net-worth individuals scurrying to see their estate planning attorney.

While the legislation passed by the U.S. House in November (and currently being debated by the Senate) did not include these provisions (thus somewhat alleviating the fire drill), now may still be a good time to review and update your estate plan. Here is a general overview of the current estate and gift tax rules.

There is no U.S. Federal "inheritance tax" (i.e. tax on the receipt of inherited wealth), but there is a Federal estate and gift tax (collectively referred to as the "uniform transfer tax") on the privilege of transferring wealth for less than full and adequate consideration to noncharitable recipients. A few states have an estate tax, an inheritance tax, or both. As a practical matter, the estate and gift tax operate much like an inheritance tax, in that they serve to limit the amount of wealth that can be inherited. Also, while the estate and gift tax are assessed on the transferor, the recipient may be liable for tax under transferee liability rules if they receive property via gift or inheritance from someone who has an unpaid tax obligation.

Under present law, for 2021 the lifetime exemption equivalent from Federal estate and gift tax is $11.7 million (per spouse), so the estate and gift tax is a fairly high class problem. In addition to this lifetime amount, there is an annual exclusion of $15,000 per donee ($16,000 effective for 2022) that does not count against your lifetime exemption. So, for example, a husband and wife could give up to $60,000 per year to their son and daughter-in-law without reducing their lifetime exemption.

The estate tax rate starts at 18%, and quickly rises to 40%.

Over the years, depending on which political party is in power, there has been talk of either repealing the estate tax (Republicans) or expanding it (Democrats) by reducing the exemption amount and increasing the rate. Under present law, the exemption amount will increase for inflation each year through 2025, and then in 2026 revert back to $5 million (as indexed for inflation since 2010).

A person's taxable estate generally includes all assets they own directly or indirectly (including through a revocable trust) at the time of their death, including the face value of any life insurance in which they have any incidents of ownership and certain assets transferred within three years of death. In computing the estate tax, you add to this amount any gifts made during life in excess of the annual exclusion, and then (in effect) reduce it by the exemption equivalent amount.

Any amounts left to charity are not subject to the estate tax.

Those who anticipate they may have an estate (after charitable bequests) in excess of the exemption equivalent amount and want to minimize the estate tax can do so by making lifetime transfers to take advantage of potential discounts to valuation (e.g. for nonmarketable minority ownership), remove future appreciation from their estate, and take advantage of the presently high exemption equivalent which may be reduced in the future. A combination of a family partnership and trusts can be a very effective way of making these transfers in a tax efficient manner, while also enjoying creditor protection benefits.

SALT Deduction Cap Workaround for Flow Through Entities

The *Tax Cuts and Jobs Act* enacted in late 2017 placed a $10,000 per year limit on individuals' deduction for state and local taxes (SALT) on Schedule A as itemized deductions. Many states with an individual income tax immediately began looking for workaround solutions to enable their residents to continue to receive a Federal income tax benefit for the state income tax paid.

To date, at least 20 states (including Georgia) have enacted or introduced legislation permitting S-corps and partnerships to elect (except in Connecticut where it is mandatory) an entity level tax in lieu of the income being taxed at the level of the individual owners. In Notice 2020-75, the IRS indicated that such a tax would be deductible by the entity as a business expense; effectively permitting a workaround to the $10,000 SALT deduction limitation at the individual level.

The rules vary from state to state, but are generally somewhat similar to those enacted by Georgia. Effective for 2022, Georgia permits an eligible pass-through entity (an S-corp or a partnership 100% owned and controlled by persons who would be eligible to be S-corp shareholders) to elect (on timely filed return) an entity level tax in lieu of income flowing through to the owners. This is an annual election and, if made, the owners exclude from their Georgia taxable income the income which was subject to the entity level tax. If an entity intends to make the election, it should make quarterly estimated tax payments. Estimated payments made by the owners cannot be transferred to the entity. However, the entity can avoid incurring a penalty for underpayment of estimated tax by showing that the owners instead made personal estimated payments.


Jacquelyn B. Gibson, CPA

Under the rules of some states, rather than excluding from owner taxable income the income which was subject to entity level tax, the owner claims a credit on his or her personal tax return for their share of the tax paid at the entity level.

While it might seem a no-brainer to make the entity level tax election and gain the benefit of Federal deduction, it is actually a complicated decision. You have to consider whether the individual owner(s) have tax attributes or credits at their personal level that will go unutilized if you make the election, and how the state(s) of residence of the owner(s) will treat the K-1 income. This gets particularly complicated if you have a flow-through entity which is operating in multiple states and has owners who are resident in multiple different states.

Proposed legislation would increase the SALT deduction limit to $80,000, and some in Congress would like to repeal the limitation altogether. If this happens, then these entity level tax SALT workarounds may become unnecessary (although they could still be beneficial if the entity has owners for whom the benefit of a deduction for state income tax is limited by the alternative minimum tax). Finally, we note that even in the absence of Congressional action, the $10,000 cap on deduction of SALT is scheduled to expire at the end of 2025.

New Rule Requiring Capitalization and Amortization of R&D

Historically, “research and experimentation" expenditures have enjoyed very favorable tax treatment. You can elect to deduct such expenses immediately (or capitalize and amortize if more beneficial), the expenses are not subject to the general rules requiring capitalization of start-up expenses, and you can also receive Federal and state tax credits for the expenses.

In an effort to pay for the tax cuts included in the *Tax Cuts and Jobs Act* legislation enacted in late 2017, Congress included a provision that could be a ticking time bomb for early-stage technology companies. This provision, scheduled to take effect for 2022, requires that R&D expenses be capitalized and amortized over 5 years (15 years for research conducted outside the U.S.) rather than deducted immediately. This could result in a situation whereby taxable income (and the tax thereon) greatly exceeds net cash flow.

The *Build Back Better Act* passed by the U.S. House in November (and currently being debated by the Senate) includes a provision deferring the capitalization rule until 2026. Hopefully, this capitalization rule will never take effect. If it does take effect, companies may need to reconsider what they classify as R&D expenses versus normal ongoing operating expenses and whether the resulting R&D tax credit(s), if any, are sufficient to offset the tax on the additional income from capitalization.

Business Interest Expense Limitation Tightens in 2022

The *Tax Cuts and Jobs Act* enacted in late 2017 included a provision which generally limits the deduction for business interest expense to 30% of "adjusted taxable income" (ATI). For 2018 – 2021, ATI is basically EBITDA. But starting in 2022 ATI becomes EBIT. Companies with average annual revenue (computed over 3 years) of $25 million or less and also certain industries (most notably real estate if a proper election is made, but also floor plan financing of auto dealers and regulated utilities) are exempted from this rule. Real estate companies will have to accept slightly longer depreciation lives if they elect out of the interest expense limitation.

F-reorg Structure for Sale of S-corp Business

Buyers of businesses generally desire a deal structure that will be treated as an asset acquisition for income tax purposes. This is because they want to be able to depreciate or amortize the purchase price over a period of years (typically 15 years or less), rather than just have the purchase price sit on the balance sheet with no related income tax deductions.

If the seller is a C-corp, then generally this desire on the part of the buyer cannot be accommodated, as such would result in two levels of tax to be incurred by the seller (once at the entity level and then again at the shareholder level). In this case, the seller may suffer a price reduction or find that a deal simply cannot be

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F-reorg Structure for Sale of S-corp Business — continued

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done.

With an LLC taxed as a partnership, the buyer can get a basis step-up in the assets via a "Section 754 election" if buying less than 100% of the LLC units, or will automatically achieve asset acquisition treatment if purchasing 100% of the LLC units (Rev. Rul. 99-6).

If the business is conducted by an S-corp, there is no "Section 754 election" step-up available and no automatic deemed asset acquisition treatment for purchase of 100% of the stock, but asset acquisition treatment can be achieved either via a direct acquisition of assets, a "Section 338(h)(10) election", or an "F-reorg" structure.

In recent years, most of the S-corp acquisitions we have seen have utilized the "F-reorg" structure. The name comes from Internal Revenue Code Section 368(a)(1)(F), which provides that "a mere change in identity, form, or place of organization of one corporation, however effected" qualifies for tax-free treatment. In Revenue Ruling 2008-18, the IRS provided that where the shareholder of an S-corp forms a new holding company, contributes to it the stock of an S-corp, and has the new parent company make a Qualified Subchapter S Subsidiary (QSub) election for the old S-corp, then the new holding company will be automatically treated as an S-corp, and the QSub will retain its EIN.

In a typical F-reorg structure acquisition, the shareholders of the target S-corp form a new holding company, contribute to it the stock of the target company, file a QSub election (Form 8869) for the target company, convert the target company to a state law LLC, and then have the new holding company sell the target company units to the buyer. While legally a stock sale, this is treated for income tax purposes as an asset sale. This gives the buyer the desired income tax treatment, but should, in most cases, avoid the need to assign contracts.

The F-reorg structure is more flexible than a 338(h)(10) election in that it does not require purchase of least 80% of the stock (a requirement for making the (h)(10) election), it works well where there will be rollover equity retained by the seller, and it enables the buyer to minimize the risks associated with possible invalid S election on the part of seller.

From the seller's perspective, the income tax result of an F-reorg structure is generally largely the same as that of a straight sale of S-corp stock; with some nuanced differences. The deemed asset sale treatment can result in some ordinary income for the seller (e.g. cash basis receivables and depreciation recapture), and higher state income tax may be incurred if the entity conducts business in states with a higher tax rate than that of the seller's state of residence. Sometimes buyers will agree to gross the seller up for some or all of this incremental tax cost; which typically is small compared to the tax advantage the structure provides for the buyer.

It should be noted that if there is rollover equity involved, then the new S-corp holding company formed by sellers should be kept alive and holding the rollover equity in order to avoid triggering taxable gain from the distribution of such to the S-corp shareholders.

Quick Notes

- For 2022, the Social Security wage base increases to $147,000, the maximum wage base for computing retirement plan contributions increases to $305,000, the maximum benefit amount for a defined benefit plan increases to $245,000, the maximum amount which may be contributed to a defined contribution plan increases to $61,000, and the maximum permissible elective 401(k) deferral increases to $20,500 ($27,000 for those age 50 and older). The maximum permissible contribution to an IRA remains at $6,000 ($7,000 for those age 50 and older). Also, for 2022, the maximum amount which can be contributed to an HSA plan increases to $3,650 for individual coverage and $7,300 for family coverage. Those over age 55 can contribute an additional $1,000.
- The annual gift tax exclusion increases to $16,000 for 2022, and the lifetime estate and gift tax exclusion amount will increase to $12,060,000 (per spouse).
- Under temporary Covid-relief rules, for 2021 and 2022 businesses can claim a 100% deduction (rather than the usual 50%) for business-related restaurant meals.
- If you have opted into the IRS Identity Protection PIN program at any time in the past, the IRS should mail to you in December or January a new IP PIN for your 2021 income tax return. There is a separate IP PIN for each spouse who made the election. You must provide this number(s) to your tax return preparer. Otherwise, your returns will not go through electronically.

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