Essential tax and wealth planning guide

2021 EDITION

Deloitte. Private

GET STARTED

01 Welcome

DEAR READER,

Despite the lack of clarity at this moment on what changes tax reform may bring, it is time to bring your overall tax goals into focus again and examine whether there are any steps that you should consider to advance your goals. Earlier this year, we discussed how political and economic considerations could affect tax legislation as it moves through the legislative process and issued a perspective on how to plan in a potentially increasing income tax rate environment.

Deloitte's *2021 Essential tax and wealth planning guide* continues our examination of the interplay between the entity and the owner of family enterprises. Whether you own an operating business or a family office or are an individual with an investable pool of capital, we hope to provide new lenses through which you can look to determine your next steps for the last quarter of this year and next year, such as:

- **Tax policy:** Learn more about potential legislative changes, when they might take effect, and how the political landscape may shift as the legislation takes shape.
- **Family enterprises:** Examine how to integrate the various perspectives, goals, and dynamics of the family enterprise, which could encompass a high-net-worth family, their operating business, or even a family office.
- **Philanthropy:** Consider how to navigate the donation of a closely held business to a family foundation and other charitable planning considerations.
- **Passthrough entity taxes:** This bonus feature provides a high-level overview of newly enacted or proposed state entity-level taxes and potential issues to consider for both the entity and the owner of a partnership or S corporation.

As we look out on the horizon, the tax landscape for 2022 continues to take shape. Tax planning is not just a year-end discussion, but more of an evolution over time that often requires reexamination to bring it into focus and align it with your goals. We hope that the insights provided in this year's *Guide* will help you with that process.

To find a member of the Deloitte Private Wealth practice who specializes in your area of interest, please contact us at ustaxprivatewealth@deloitte.com.

Regards,

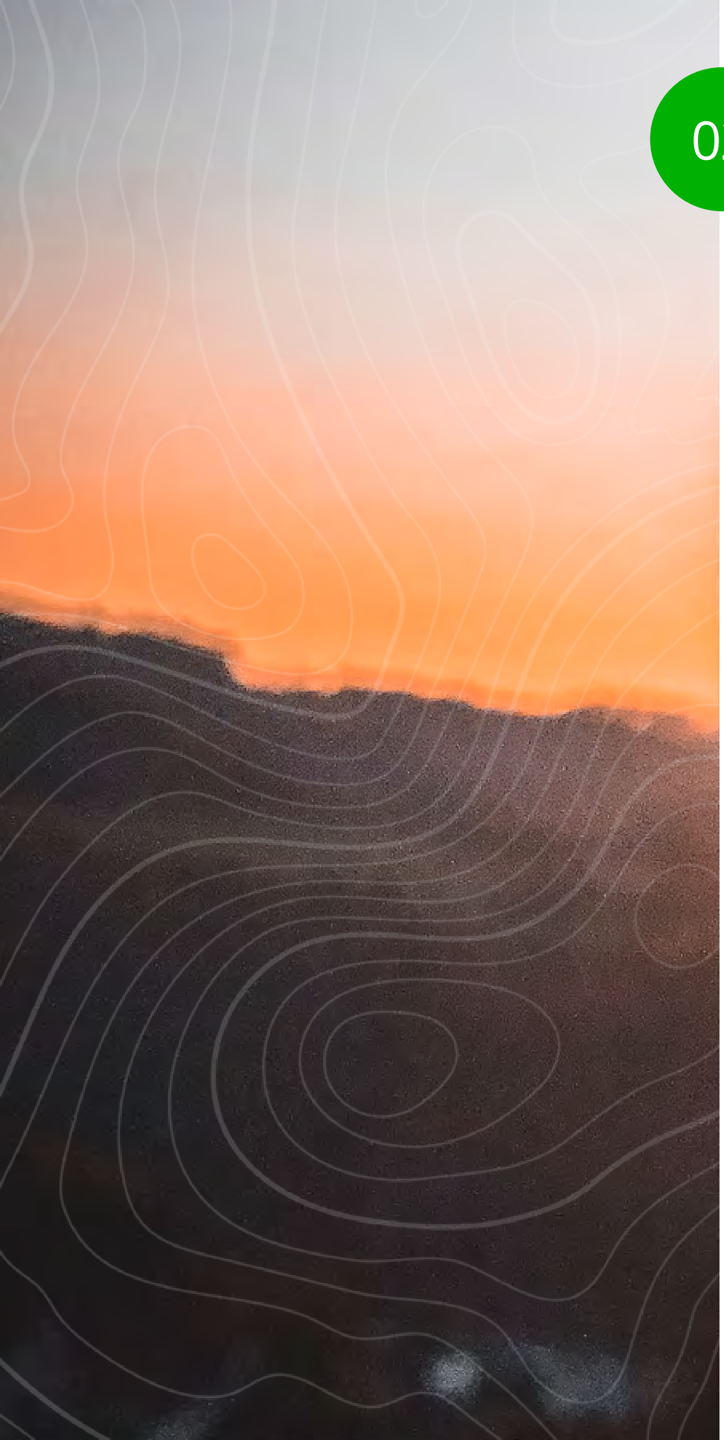
Wendy Diamond

Wendy Diamond
US Family Enterprise Leader
Deloitte Tax LLP

What's inside

01
02
03
04
05

02 Tax policy



02

TAX POLICY

“Build Back Better” and the potential for tax increases

Democratic leaders in the House and Senate have been working largely behind the scenes to agree on the parameters for the Build Back Better Act—the massive tax-and-spending legislation they aim to move through Congress under fast-track budget reconciliation protections—and to determine how they may need to adjust their policy priorities to reflect the likelihood that the final product will be smaller than many had hoped to approve.

President Biden based the economic planks of his 2020 election campaign on the premise that the benefits of 2017’s Tax Cuts and Jobs Act were skewed to large corporations and wealthy individuals and that the federal income tax system needs to be modified to ensure that these taxpayers are contributing “their fair share.”

The House Ways and Means Committee laid out its approach to realigning the tax code in a revenue title for the Build Back Better Act, which it approved in September. The Senate Finance Committee is said to be considering its own tax package but has not released a comprehensive proposal, so it is unclear just how closely that panel’s vision will align with the Ways and Means package.

02

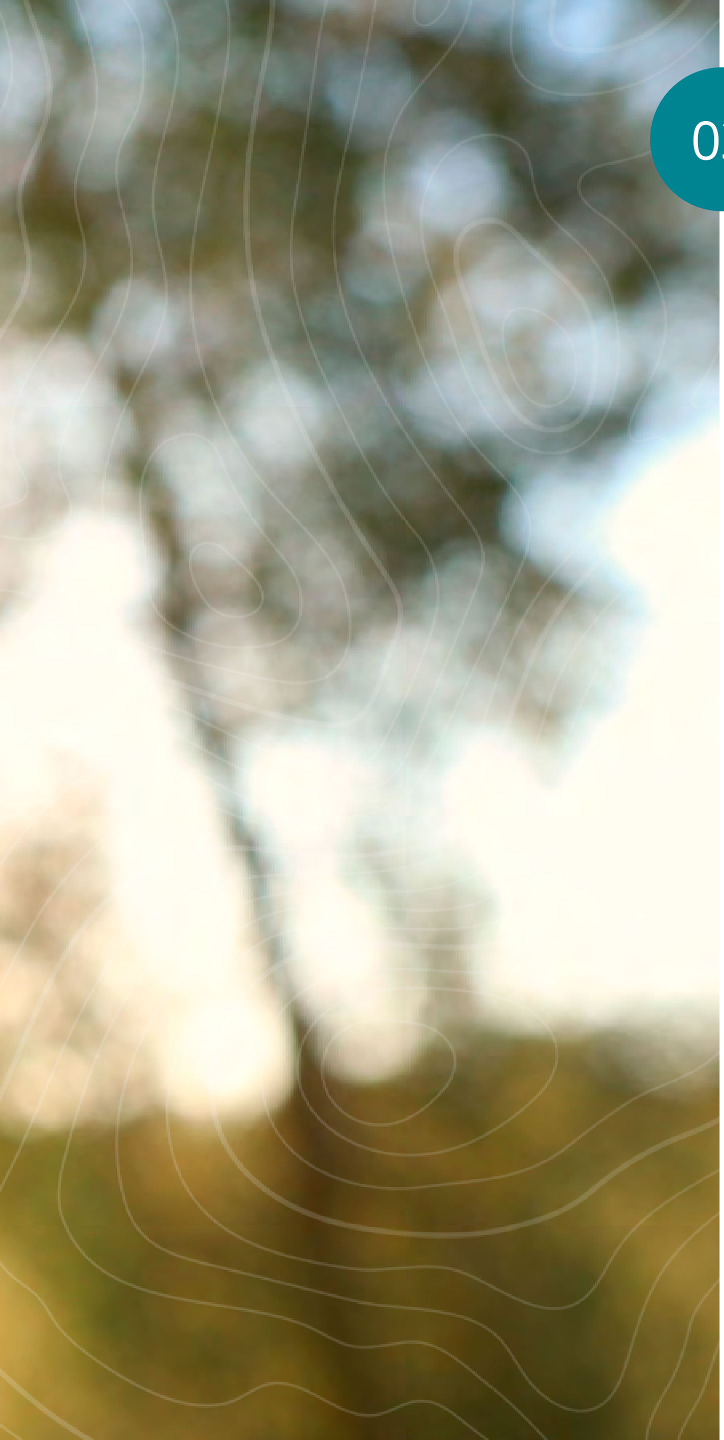
TAX POLICY

"Build Back Better" and the potential for tax increases

As Democratic leaders negotiate an agreement on a package that can clear both chambers, they will need to resolve specific policy differences and address disputes over just how much the package should cost. Progressive Democrats have called for upward of $3.5 trillion in spending while more moderate Democrats prefer something closer to $1.5 trillion, but given the tight Democratic majorities in both chambers, there is an expectation that a final number will be on the lower end of that range. If that is the case, any cuts on the spending side would reduce the need for revenue and could prompt negotiators to scale back the size and scope of proposed tax hikes.

For continuing coverage of the Build Back Better Act, see *Tax News & Views* from Deloitte Tax LLP.

03 Family enterprises

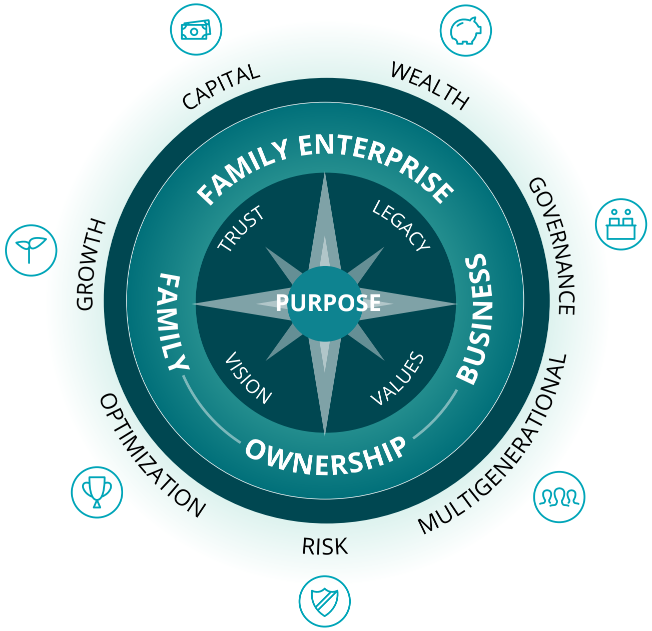


03

FAMILY ENTERPRISES

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Family businesses have always been important to the economy. Within the United States, family businesses comprise 50% to 60% of GDP annually. They serve as a cornerstone of the US economy and major source of economic and societal impact around the world. This year, the pandemic has created a pivotal moment where family business leaders are looking toward the future. Should they continue to grow the business, focus on maximizing legacy, or consider liquidity options? By approaching these challenges with a new lens—viewing the totality of the family enterprise as opposed to the singular perspective of individual family members, the family business, or the family office alone—we will explore how family enterprises can bring their efforts into focus to approach the unique issues they face as a thriving enterprise.



The family enterprise: Who are you, and what do you need to focus on this upcoming year?

The definition and life cycle of a family enterprise

Within Deloitte Private, we have defined "family enterprise" to be a complex family organization encompassing the interests of a high-net-worth (HNW) family, their operating business, and the family office. The family enterprise generally includes two or more of the following components:

HNW family or individuals:

Generally those families who have amassed $100 million or more in personal wealth. That value will often also include the value of the family business.

Family business:

Defined as a business entity with annual revenue of $100 million or more, managed by a single HNW family where 50% or more of the business is privately owned, or 30% or more ownership if it is publicly listed. The family will have active involvement and decision-making powers in the affairs of the business.

Family office:

The family's private wealth management arm. The advisory firm or entity serving the single HNW family, established by the family themselves to provide the solution to manage their personal finances and investments.

03

FAMILY ENTERPRISES

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Family enterprises are not simply created overnight. It is an evolutionary process that takes time to grow and develop, and it requires nurturing and attention. While not all family enterprises are built the same way, the family enterprise comes into focus following a business life cycle journey.

STARTUP PHASE

Most family enterprises **start** life as an owner-managed business. The founder typically has voting control, makes all key decisions, and is largely focused on establishing the main operating business. The family may have investments in equities such as stocks and shares, own a private home and car, and be involved in some form of charity work, such as volunteering or charitable donations.

GROWTH PHASE

Businesses that move beyond the startup phase and into the **growth stage** will start to grow exponentially, both in size and revenue. Profits from the business may be distributed among family members, reinvested back into the business, or used to fund new ventures, thus expanding the family's portfolio of business assets. The family may also diversify their private investments into real estate, such as commercial property to support business operations, and private equity. Their interests in lifestyle assets may have expanded from additional properties and new cars to art and jewelry. They may also start to become more strategic around their philanthropic activity through a range of giving efforts aligned with the family's agreed-upon values and purpose.

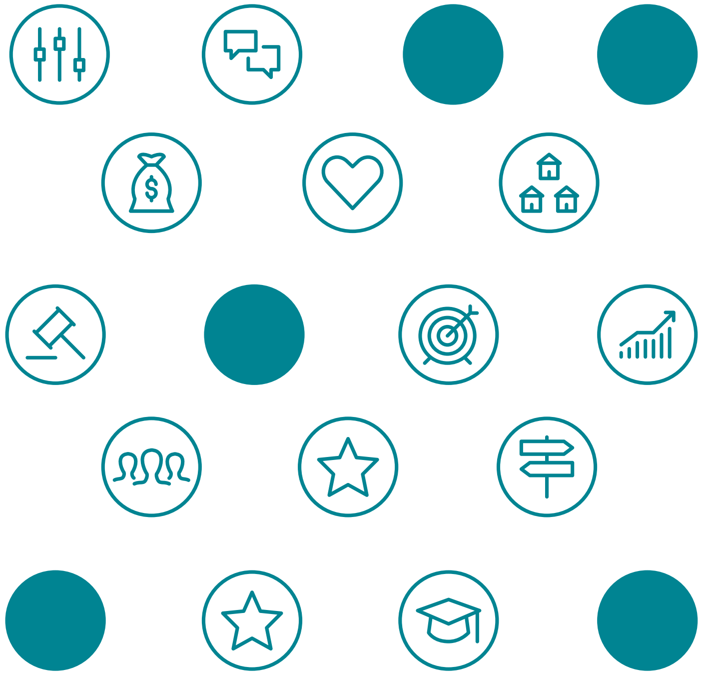
MATURE PHASE

As the business **matures**, assets become highly diversified across operating businesses, private investments, lifestyle assets, and philanthropic activity. To the extent there is increased liquidity accreting outside the business, the family may consider more formal structures to manage their assets, such as a family office or a private foundation. A family office is a private wealth management firm established to manage all aspects of the family's financial affairs. A private family foundation may be created to achieve the family's philanthropic ambitions.

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

01
02
03
04
05

With the right approach, a family enterprise can elevate itself, leading to a future where it drives growth, capital, and wealth. Having a long-term perspective encompassing the next generation(s), rather than just the next quarter, requires the family enterprise to maintain a 360-degree view of both the challenges put in its path and the stakeholders that rely upon and support it. Acknowledging this intersection of stakeholders, challenges, and opportunities sets the family enterprise up to be a good steward to a thriving and sustainable legacy, leading to multigenerational success.



Common challenges for family enterprises

The long-term success of the family enterprise depends on the functioning and mutual support of each group of stakeholders: the business owners, the family members, and the business itself. There can be diverse interests and concerns at any time and in any family business, regardless of organization size or type of business. As challenges present themselves, it's important for the family enterprise to understand each stakeholder's perspectives and motivations; furthermore, having an established structure for the family to make decisions regarding the family enterprise can help them navigate challenges.

The family enterprise encounters a myriad of unique challenges. These challenges are found in non-family-owned businesses as well, but at the intersection of family and business these risks need to be viewed from the lens of the family enterprise. Failing to address them allows them to reverberate beyond family and ultimately affect all enterprise stakeholders.

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Control

Senior family members may try to preserve the status quo and resist change. They may be especially resistant to ideas and change proposed by the younger generation. Behavior patterns can then become ingrained, sometimes hindering progress and growth of the business. Family businesses are often influenced by traditions established by senior generations. While this can be a positive in many situations, it could in some situations restrict an enterprise's ability to pivot and move quickly when change or opportunity arises.

Communications

Members of family businesses often think that they are communicating in a comprehensive and transparent manner when they are not. A lack of open communications can lead to role confusion, emotions, political divisions, or other relationship problems.

Compensation

Dividends, salaries, benefits, and other compensation for family members are often not clearly defined and justified and may not reflect the market rate. Contracts covering their terms of employment and benefits packages are often replaced with a promise that they will own the business someday.

Emotions

Family problems and emotions play a significant role in family businesses. Parent-child conflict and sibling rivalry are particularly common and can seriously disrupt the operation of a business.

Estate planning

Effective management of a family business should provide for business continuity, liquidity, and family needs in the eventuality of the departure, for whatever reason, of a key figure. In the absence of adequate planning, inheritance (estate) tax and other tax liabilities on the transfer of interests in a family business can cause costly problems and put significant financial pressure on the business.

Governance

There can also be an absence of clear policies, standards, and procedures in relation to family members, which can lead to distrust and disengagement.

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Growth

Family businesses commonly have a problem with the idea of raising money from outside sources, both in relation to short-term funding and longer-term capital. This attitude often stems from a fear of loss of control and an aversion to outsiders acquiring influence over how the business is run. However, this can lead to underfunding significant ventures or struggling through cash-flow shortfalls, thus potentially stunting the growth of the business.

Strategy

Often, family businesses will lack documented plans or long-term planning in the form of a written strategy. Rather, decisions are made day to day in response to issues as they arise. This also applies to the exit strategy, where there might not be any clear plans on how to sell, transfer, close, or otherwise walk away from the business.

Succession planning

Many family business leaders avoid the topic of succession. A reluctance to give up control (or choose between sons, daughters, or an outsider) often means that they do not have a formal plan for handing control and decision-making to the next generation, which can be disastrous for the business.

Talent

Family businesses may lack the systems and procedures to appropriately attract and retain the right talent. This can lead to a tendency to hire family members who either lack the qualifications, skills, and abilities for the role or whose ambitions lie beyond the family business. This perceived "special treatment" of family members, a practice known as nepotism, can lead to resentment and high turnover among nonfamily employees.

Training

Family principals often dictate that family members should be trained according to what is best for them as individuals rather than improving their ability to contribute to organizational objectives. Training may lack specifics around the goals, expectations, and obligations of a position.

Vision and values

The cross-section of employees, managers, and investors, as well as family members who are related to one another in a family business, can lead to conflicting goals, attitudes, opinions, and problems. Many family businesses struggle to strike a good balance between the best interests of the business and the well-being of the family.

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Building resilience by anticipating challenges

Now that we've defined family enterprises, acknowledged the stakeholders involved, and identified the risks and challenges they commonly face, what do we do about it? What are those key areas to focus on in the short and long term to continue success and grow the business(es) and wealth?

- Family governance and leadership
- Preparedness: Death of a business owner and legacy assessments
- Business succession planning
- Family office transformation
- Philanthropic planning

FAMILY ENTERPRISES

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

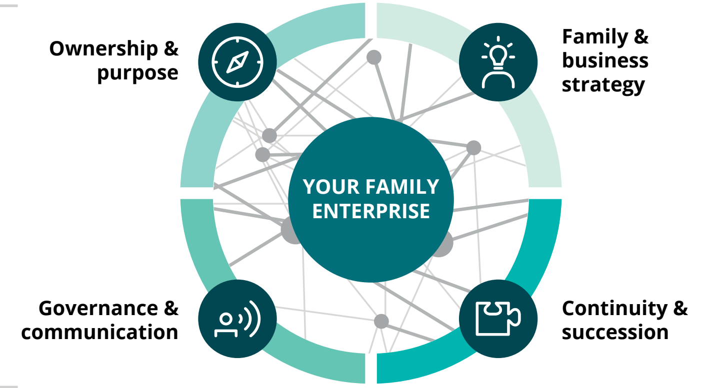
Family governance and leadership

For a family enterprise, aligning the family and business strategy is one of the keys to success. Assessing the family's alignment across the four pillars of family enterprises allows the family enterprise to define and align family and business goals and produce the road map for success as the family seeks to achieve (or keep) family harmony.

Consider these key questions:

- Is your family strategy aligned to your business strategy?
- Does your family employment policy support the development and future success of family members in the business?
- Is your family communication structure between active and passive owners effective?
- Does your family governance structure address the interests of all owners of the business?
- Do you have a robust plan to ensure the continuity of the family legacy and preservation of family ownership?

Through a phased approach, families can dive deeper into assessing their alignment across the four pillars of family enterprises. Those pillars include:



Stakeholders can work together to develop a shared vision and identify and prioritize those strategic initiatives that are necessary for the family enterprise to thrive. The goal is to design an executable action plan that considers the time, cost, resources, and expected value of the initiative to the family and business. By coming together to create a more formalized governance structure, as well as a family and business strategy, the family will be aligned and more prepared to address new challenges and opportunities in the future.

The Family Governance and Leadership Lab

Provide the family business with **a structured process** to uncover key issues and areas of opportunity and deliver **an actionable road map** that aligns family and business ownership purpose, strategy, governance, and continuity planning.

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Preparedness: Death of a business owner and legacy assessments

Death and taxes are inevitable, so neither should be a surprise. The passing of a business owner is a defining moment for both the family and the business. Proper planning, by performing a legacy assessment, can position and prepare the family enterprise for the inevitable.

A legacy assessment focuses beyond the computation and payment of the estate tax burden. Families need to look more broadly at the complicated issues surrounding legacy in order to anticipate and evaluate the implications of a principal's death for the family enterprise, the family office, existing investment structures, charitable vehicles, trustees, and the family's governance structure. The assessment should touch upon the relevant items relating to the estate of the family business owner, such as:

A 90-day drill

A process that identifies necessary financial, accounting, legal, regulatory, and administrative action items to address in the period immediately following the death of the principal.

Financial implications of the principal's death

A process to quantify the projected expenses, liabilities, and potential taxes, then identify sources of liquidity to pay those expenses.

Asset disposition

An analysis of issues related to the disposition of specific assets, such as large concentrated equity positions, unique real estate holdings, and other hard to value and illiquid assets.

Family office transition and transformation

Development of a transition plan for the family office that addresses the inevitable changes resulting from the death of the principal.

A preparedness assessment allows the principal, the family enterprise, the family office, and the family overall to address these issues proactively and thoughtfully while also developing organized plans that will be executed upon the business owner's death. It will help the family enterprise quantify short- and long-term liquidity needs, address questions where the principal desires input in decision-making, and highlight areas where family members need additional training and development to be prepared to assume new responsibilities. Having the foresight to conduct these exercises can create significant value for the family by reducing confusion and providing stability during a difficult time.

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Business succession planning

The operational demands of running a family business or other closely held enterprise can be all-consuming, but it is vital that business leaders take the time to assess their organization's business succession planning. The penalty for failing to get ahead of leadership or ownership changes can be significant when the coming years may bring substantial transfers of wealth, as businesses change hands and/or adopt new ownership structures. The long-term survival of a business and the preservation of the wealth generated will likely depend on getting ahead of those changes through strategic succession planning.

For family-owned businesses, a solid succession plan can drive the growth of the business, reduce taxes, and set the stage for retirement. Family-run businesses may benefit further by focusing on preserving harmony within the family. Business owners need to consider a broad range of topics in order to facilitate an orderly transition of management and ownership, which may include:

- How a strategic, long-term approach to business succession planning can help meet personal and business goals and how to get started
- How the choice of entity structure, valuation methods, and financing options can affect succession planning (and outcomes) for private businesses
- How the management of talent assessment, development, and compensation planning can help solidify the next generation of company leadership
- How planning ahead for estate and gift taxes, life insurance, and investments can help address family and business liquidity needs and meet retirement goals
- How to balance business needs and family concerns in order to create a long-term governance plan that can help the business and family prosper together
- How adopting leading practices and strategies can help confirm one's legacy isn't left to chance

Taken together, these issues demonstrate that succession planning is an important and evolving process. This is not a subject to be put off until later; to be done successfully, it needs to be an integral part of a family enterprise's evolving business strategy and operations.

> The ultimate goal of business succession planning is to understand the value of the business, to preserve that value and its future growth potential, and to pass it forward intact.

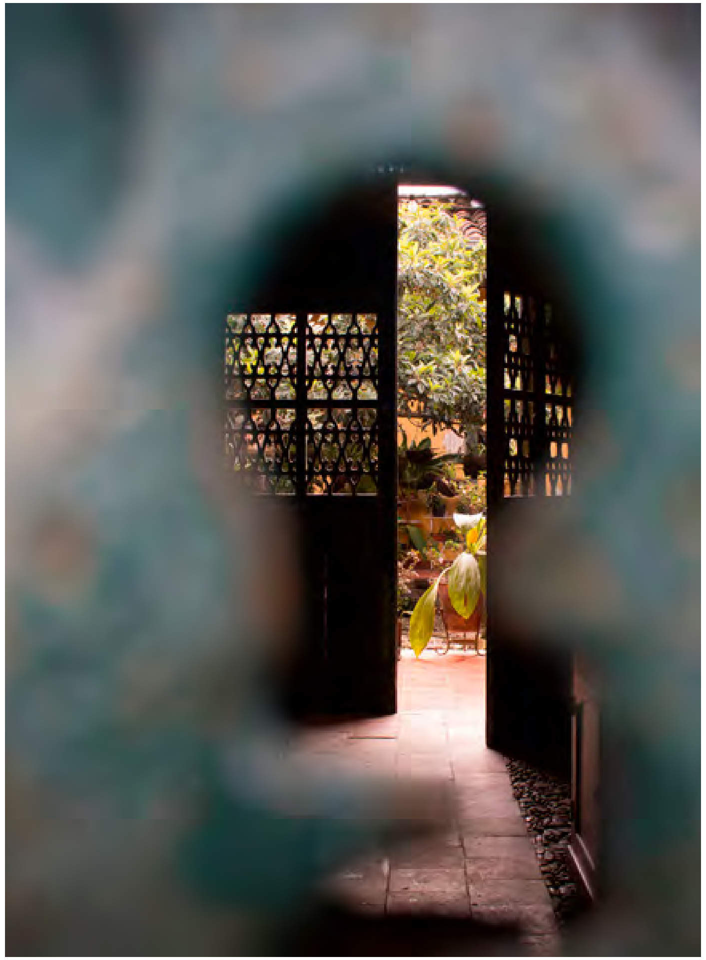
The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Family office transformation

Every family office has its own DNA that has been forged over time. Each office is unique as to its formation, the services it provides, and its approach to serving the family. Exciting opportunities, as well as new challenges, can arise as a family enterprise acclimates to the increased complexities related to its wealth. As the family desires more liquidity to be distributed from the operating company to diversify investments, there are greater demands placed on the family office, if one exists. A family office that may have organically grown within the family enterprise before becoming its own family office should continue to evaluate, from time to time, how it modernizes its existing structure (or perhaps even formalizes the informal) as it oversees the financial affairs of the family.

To reiterate, a family office is:

- A private organization established by a family to oversee, directly or indirectly, the financial affairs of the family
- Often the result, like wealth accumulation in general, of owning a successful family business
- An organization that offers many of the same services as top-tier private banks and investment firms but is devoted to the needs of a single family
- A highly tailored organization, often reflecting the characteristics and aspirations of the family it serves



The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Traditional paths of the family office

One of several scenarios often results in the formation of a family office

Scenario 1: Separation

The family business has grown significantly. Profits from the business have been diversified into new investments. The management and administration of those investments has become highly demanding for family business personnel. To mitigate conflicts of interests and other risks, the family's nonbusiness operations embedded within the company are separated into a newly established family office.

Scenario 2: Liquidity event

The family business is monetized through, for example, a sale of all or part of the family ownership. A family office is established following the liquidity event to provide a formal structure to promote family governance and decision-making around the resulting wealth.

Scenario 3: Fund redemption

A hedge fund or private equity fund manager redeems out third-party investors of the fund. Subsequently, the fund manager evolves into a family office, now serving the principal and family members.

In such an ever-volatile environment, establishing and operating a family office (or expanding and modernizing the services of an existing one) requires careful analysis and planning to properly manage, protect, and grow the family's wealth. The approach taken to modernize operations needs to be customized and scaled to match the family's needs. The goal is to identify an operating model that makes the best use of family office resources and helps the family office better align with the family's goals and expectations and transform where necessary.

The family enterprise: Who are you, and what do you need to focus on this upcoming year?

Philanthropic planning

Philanthropy often unifies a family behind a purpose, encouraging effective governance and collaboration while giving the family an opportunity to create a meaningful impact on social and environmental issues in their communities and around the world. It also engages younger generations in the family vision and succession plans, even if they do not choose to work in the family's operating business, if one still exists. Similar to investing, philanthropy is often a cornerstone activity for the family enterprise.

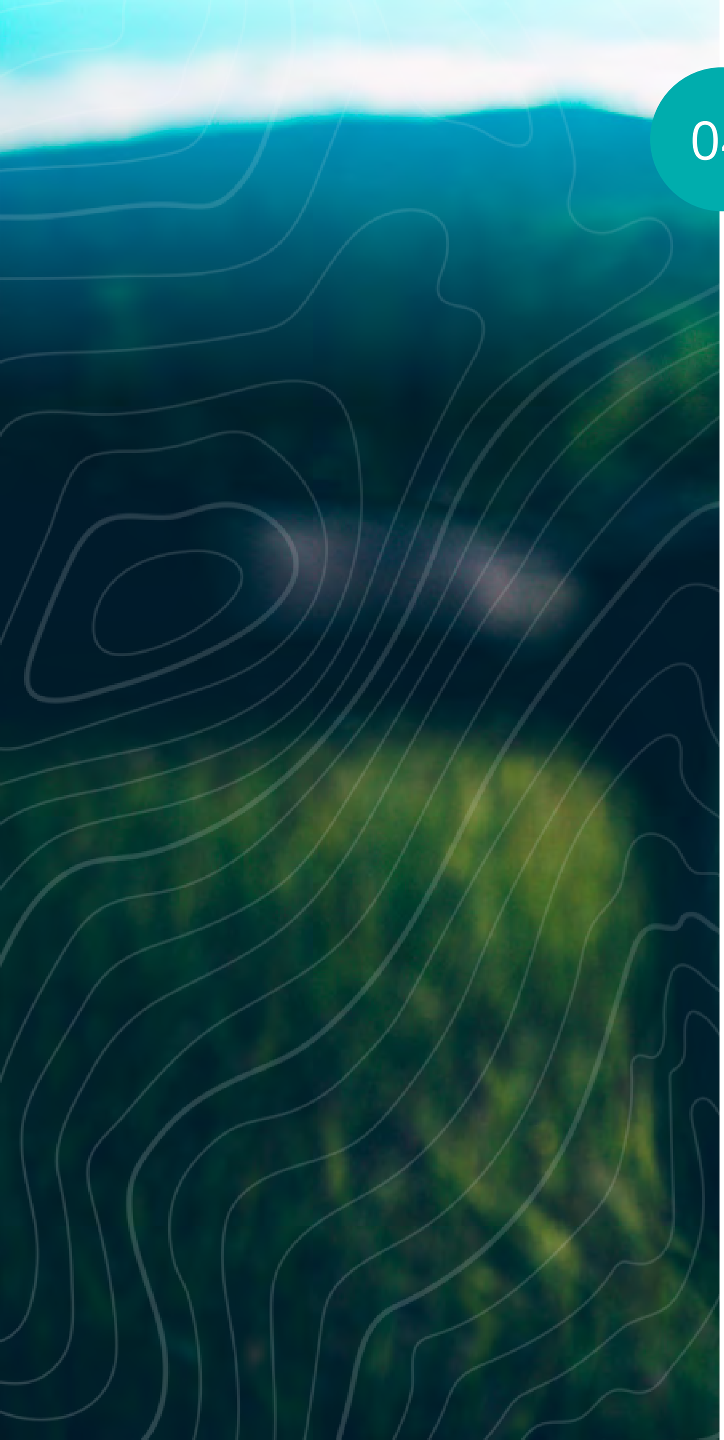
Families today have more options to create social and environmental impact than ever before. They can donate through a dizzying array of vehicles, ranging from private foundations and donor-advised funds to board service. The abundance of charitable options is further complicated by ever-changing tax laws that can affect the ways individuals may interact with tax-exempt organizations. There are also emerging methods for families to effect change through their investment portfolios by using a socially responsible investment filter or making direct investments in social enterprises that produce both financial and social returns.

We invite you to engage in the next chapter of this guide, "*Matching your charitable vision to the right planned giving strategy*," to further explore how family enterprises can endow their family foundations with their most coveted asset: their family business.

The private foundation

For the family that desires to create a legacy and have greater control over its charitable giving, a private foundation may be an appropriate charitable giving vehicle. **Click the icon to learn more** about the decisions that need to be made before committing to the formation of a private foundation.

04 Philanthropy



Matching your charitable vision to the right planned giving strategy

The family business enterprise and the family foundation

Many donors view the family business with its steady income streams as an ideal way to fund their family foundations, either as a lifetime gift or through their estate plan. However, due to excise tax considerations, this has been an area fraught with subtleties and nuances that make a seemingly easy choice into one that requires careful planning.

A donor with a closely held business enterprise that wishes to give that enterprise to their private foundation while retaining control of it is limited in that plan due to excess business holding rules. A private foundation is considered to have excess business holdings when the combined holdings of the private foundation and certain persons (known as disqualified persons in the tax rules) are more than 20% (or 35%, in specified circumstances) of the voting stock, profits, or capital interests in the donor's business.[1] Most closely held business enterprises will trigger this rule, as the family often owns more than 20% (or 35%). If a foundation is subject to this rule, then it must dispose of any holding that would be considered an excess business holding or be subject to an excise tax of up to 200% of the value of the excess business holdings.

Based on feedback from taxpayers and the larger tax professional community, Congress enacted relief specific to these donors in the Bipartisan Budget Act of 2018 (the BBA).[2] The BBA addition

1 An exception allows for ownership over these permitted thresholds if acquired by a means other than purchase (i.e., through gift or bequest) if the foundation disposes of the holding within five years of acquisition.
2 Pub. L. 115-123 (enacted February 9, 2018, but made retroactive to December 31, 2017).

Matching your charitable vision to the right planned giving strategy

provided a structure to allow 100% of the voting stock in a business enterprise to be held by a private foundation.

Qualification of a business enterprise

In order to qualify for the ability of the private foundation to avail itself of this new rule, there are three conditions which must be satisfied:[3]

While private foundations can be useful philanthropic vehicles, they are not the only choice for charitably minded persons, especially when a family does not want to give up voting control of the enterprise or when it would run afoul of the other requirements noted here. There are other rules and nuances to consider, as well as many planning alternatives, especially when considering income, estate, and gift taxes. Always seek out the advice of a knowledgeable adviser when engaging in transfer tax or philanthropic tax planning.

Components of the section 4943(g) exception to the excess business holding rules

There are three conditions that must be satisfied to allow a 100% holding of a nonfunctionally related business enterprise to meet the exception to the excess business holding rule:

1. **Acquisition and ownership**
   The private foundation must hold 100% of all voting stock at all times during the tax year and the stock must be acquired by a means other than purchase (i.e., a gift or bequest)
2. **Disposition of profits**
   The business enterprise must distribute to the private foundation the operating income net of taxes and a reasonable reserve within 120 days of the close of the business enterprise's year end
3. **Operational independence**

No loans may be outstanding from the business enterprise to:

- A substantial contributor,
- The private foundation, or
- Any family member of a substantial contributor

The private foundation's substantial contributor (including all family members) may not hold any of the following positions (or a similar role) with the business enterprise:

- Director
- Officer
- Trustee
- Manager
- Employee
- Contractor

The private foundation's directors must have a majority that is neither:

- Directors or officers of the business enterprise, nor
- Family members of a substantial contributor (but a substantial contributor themselves may be a director to the private foundation)

3 Note that certain organizations otherwise subject to the excess business holding rules which may not avail themselves of this exception include donor-advised funds, certain supporting organizations, and certain charitable and split-interest trusts.

Matching your charitable vision to the right planned giving strategy

Alternate charitable giving considerations

What if your philanthropic goals do not involve the family business? Often, a tax deduction for charitable contributions is not the driving factor for a philanthropist, but it does enable the charitably inclined to give more. Even philanthropists focused on the intrinsic value of a donation to charity may seek to benefit the greater good in a more tax-efficient manner.

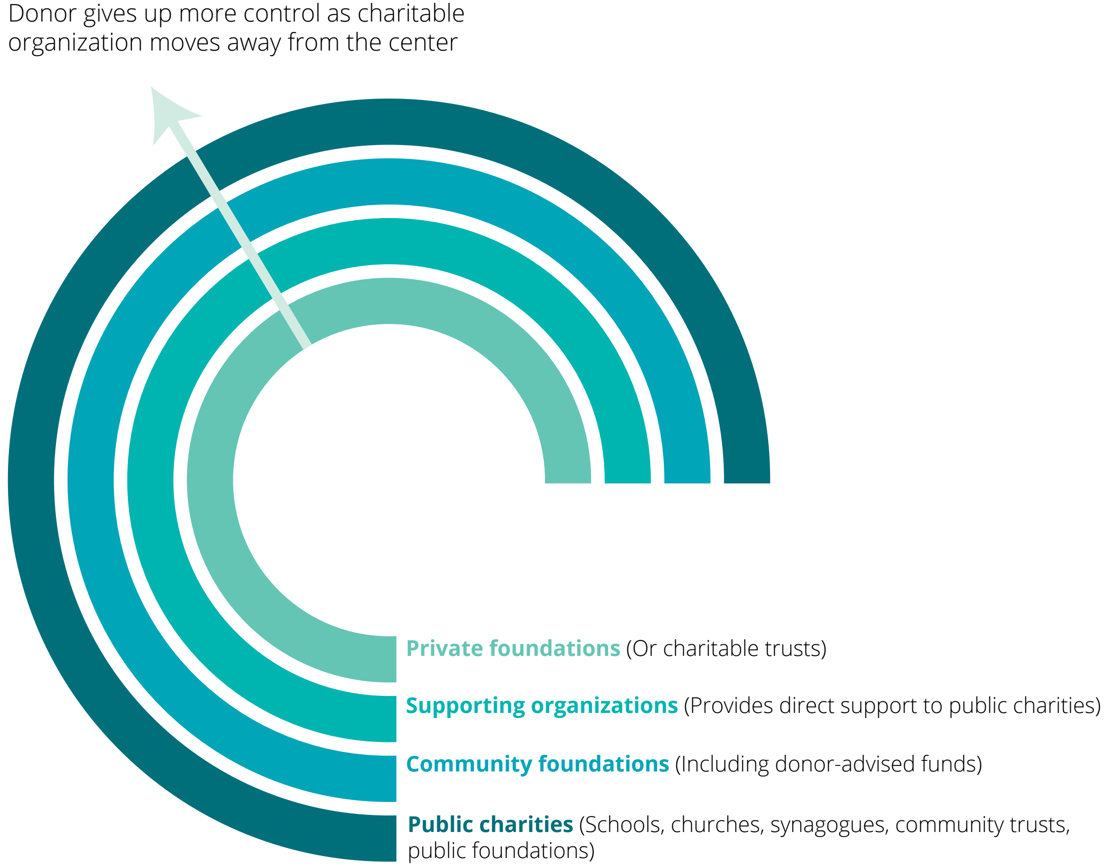
Each time you review your charitable giving plan, consider the following questions:

- With how much wealth am I willing to part?
- What type of assets do I have at my disposal?
- How much control do I want?
- What is the desired income stream for me, my family, and my charity?
- What percentage of my income do I want to spend on philanthropy?
- Do I anticipate an income event that will enhance or limit the benefit I receive from a charitable donation?
- When does the charity need the funds to meet both my goals and its own?
- What is my desired timing for receiving an income tax deduction for the charitable gift?

PHILANTHROPY

Matching your charitable vision to the right planned giving strategy

For those pursuing tax efficiency, there are many areas that require thoughtful consideration: the type of asset to donate, the timing of the gift, the vehicle to use to fund the gift, and the type of organization to receive it. If you wish to engage in more complicated planning, it may be possible to maintain partial control over an asset being contributed to a charity or, in limited situations, to maintain a cash-flow stream from the asset. If control is your primary concern, then using a vehicle such as a donor-advised fund or a private foundation may be appropriate. However, if a cash-flow stream is desired, then a split-interest charitable trust may be more advisable.



Matching your charitable vision to the right planned giving strategy

The following chart summarizes the factors you should consider when evaluating where to contribute assets.

Planned giving options	Private foundation	Donor-advised fund	Public charity
Deductible contributions?	Yes	Yes	Yes
Contribution limit (generally, exceptions apply)?	30% of adjusted gross income (AGI) for cash contributions; 20% of AGI for noncash	50% of AGI for cash contributions;[4] 30% of AGI for noncash	50% of AGI for cash contributions;[5] 30% of AGI for noncash
Donor controls grantmaking?	Yes	No, but donor can advise	No
Donor controls investment decisions?	Yes	No. Donor may choose investment plan, but sponsoring organization has control	No
Donor manages operations and administers organization?	Yes	No. Donor pays a fee to sponsoring organization to provide administrative services	No
Annual distribution requirements	Yes (5% of fair market value of non-charitable use assets)	No	No
Organization subject to income or excise tax?	Yes (1.39% excise tax on net investment income and an income tax on unrelated business income)	No, unless there is unrelated business income	No, unless there is unrelated business income
Organization subject to excise tax for prohibited actions?	Yes. Potential excise tax due for engaging in acts of "self-dealing," having "excess business holdings," and making "jeopardizing investments" or "taxable expenditures"	Yes. Potential excise tax on excess business holdings, taxable distributions, and excess benefit transactions	Generally, no (potential excise tax on political activities)
Organization required to file an annual tax return?	Yes (Form 990-PF)	No. An annual filing by sponsoring organization, not each separate donor-advised fund	Yes (Form 990)

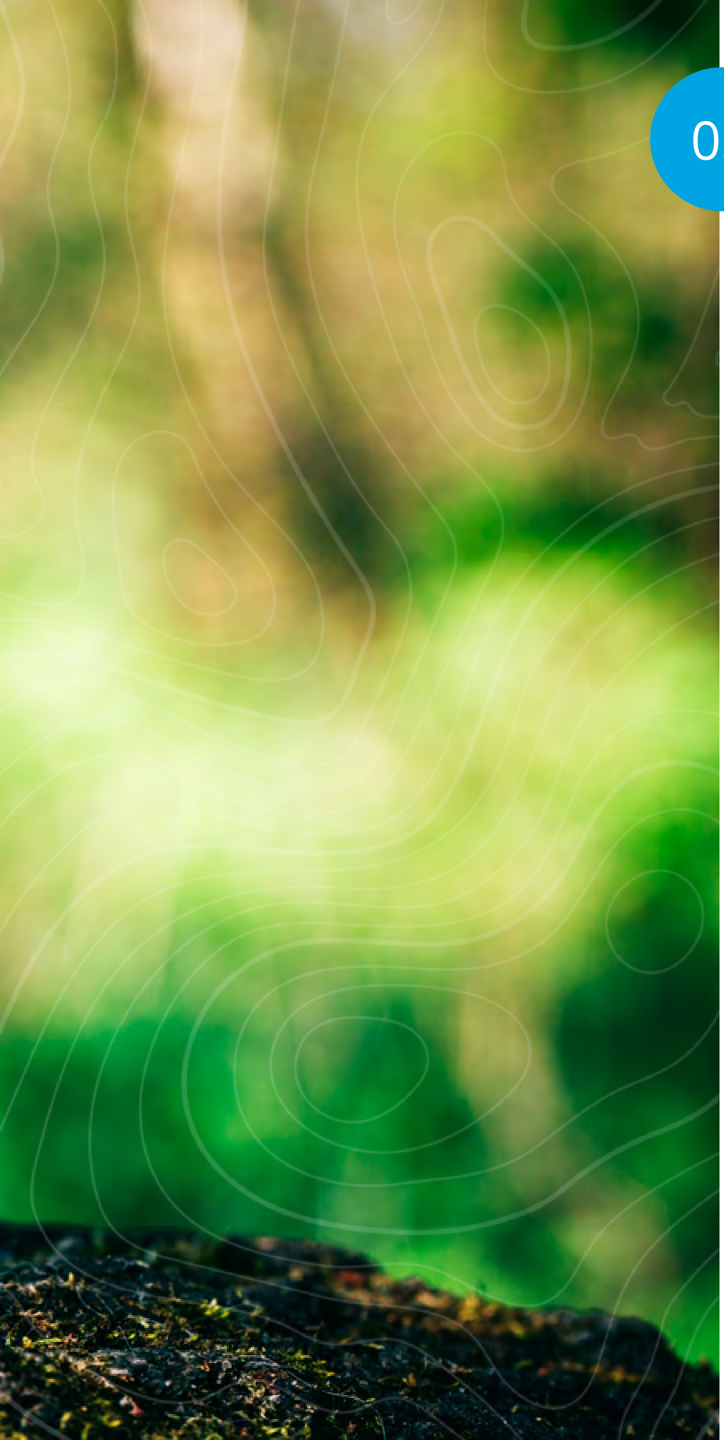
4 In certain circumstances beyond the scope of this article, the 50% AGI limitation could be increased to 60%.
5 In certain circumstances beyond the scope of this article, the 50% AGI limitation could be increased to 60%. In addition, an election to deduct up to 100% of AGI for cash contributions is available for tax years 2020 and 2021.

PHILANTHROPY

Matching your charitable vision to the right planned giving strategy

Charitable contributions are often the largest controllable deduction for an individual. For those seeking tax efficiency, there are many areas that require thoughtful consideration: the type of asset to donate, the timing of the gift, the vehicle to use to fund the gift, and the type of organization to receive it. It is critical to work with an adviser specializing in this area to navigate your way through these decision points effectively for the sake of both your philanthropic goals and your tax planning.

05 Passthrough entity taxes



PASSTHROUGH ENTITY TAXES

Bonus feature: Multistate passthrough entity taxes (PETs)

Prior to the Tax Cuts and Jobs Act (TCJA),[1] the Internal Revenue Code allowed individuals to claim a deduction for state and local taxes (if itemizing). In 2017, the TCJA added section 164(b)(6), limiting the state and local tax (SALT) deduction for individuals to no more than $10,000 annually ($5,000 if married filing separately) for taxable years 2018 through 2025. In response to the TCJA, certain jurisdictions have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations ("passthrough entities") that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In most cases, the jurisdiction's tax law provides a corresponding or offsetting owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. Thus, through the passthrough entity, the owners receive a deduction for federal purposes that would have been limited if the SALT were paid by the owner directly.

1 P.L. 115-97 is known informally as the Tax Cuts and Jobs Act and officially as *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.*

01
02
03
04
05

PASSTHROUGH ENTITY TAXES

Bonus feature: Multistate passthrough entity taxes (PETs)

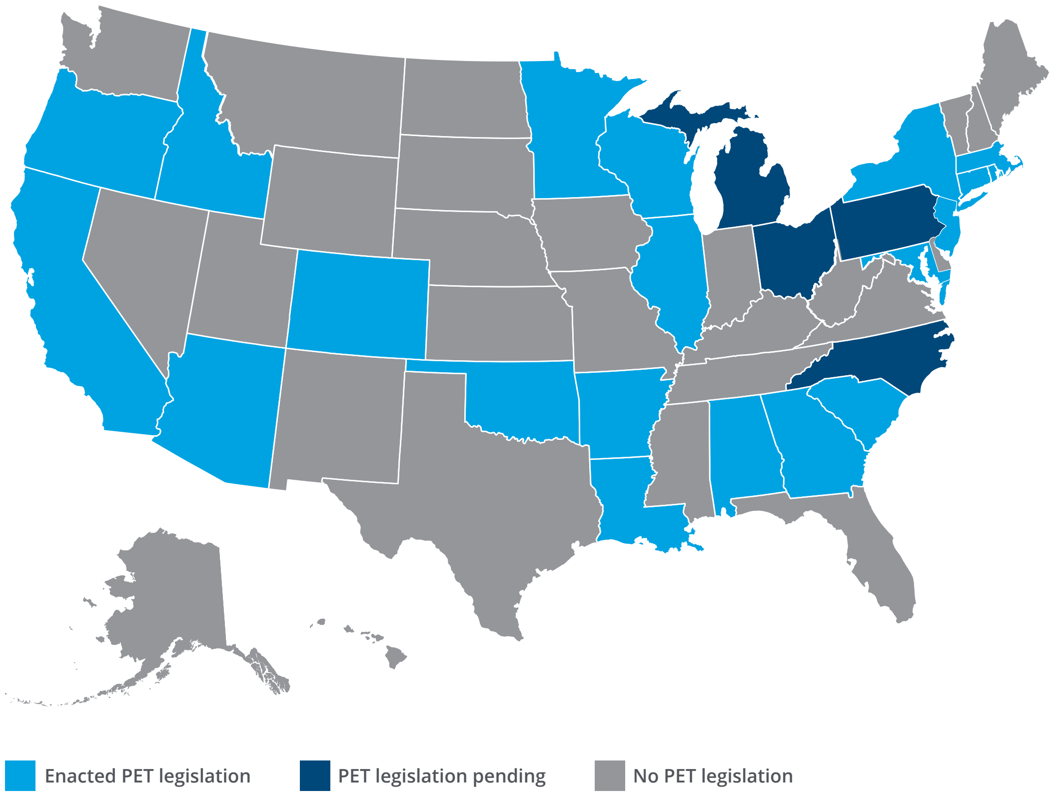
On November 9, 2020, the IRS issued Notice 2020-75,[2] which provides that "specified income tax payments"[3] are deductible by partnerships and S corporations in computing their non-separately stated income or loss and are not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or shareholder in the S corporation.

Based on these considerations, electing into a PET regime may seem like the obvious choice to enable passthrough entity owners to increase their federal tax benefit from state tax payments. However, this analysis can be surprisingly complex. Whether to elect into a state's PET regime is the passthrough entity's decision. As such, it is critical that passthrough entities and their owners work together to evaluate the potential implications of passthrough entities' state PET election(s) on their owners. The following series of questions is a nonexhaustive list of considerations that may assist in the PET election decision-making process.

2 The notice applies to payments made on or after November 9, 2020, but taxpayers can apply to payments in a taxable year of the passthrough entity ending after December 31, 2017, and can rely on the notice prior to the issuance of proposed regulations.

3 Under Notice 2020-75, a specified income tax payment is "any amount paid by a partnership or S corporation to a State, a political subdivision of a State or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or S corporation."

States with enacted and proposed passthrough entity taxes (PETs) – as of October 7, 2021*



*Some jurisdictions such as DC, NH, NYC, TN, and TX impose an income tax directly on passthrough entities.

Bonus feature: Multistate passthrough entity taxes (PETs)

Potential implications for passthrough entity taxpayers:

Does the passthrough entity have owners who are resident in states where the PET is applied to the resident owners' entire income (for example, AZ, CA, CO, NY, WI)?

If so, consider:

- To the extent the PET is voluntary, in which jurisdictions and where in the entity's structure should elections be made?
- Does the operating agreement accommodate special allocations, if any, of PET expense? If not, should amending the agreement be considered? Note: S corporations are not permitted to have disproportionate distributions.
- May an owner-level election may be made, and if so, what owners qualify?
- Is legal-entity structuring necessary for the owners to benefit from the PET regime? In California, for example, the PET election cannot be made for partnerships that have partnerships as partners.
- What timing of payment(s) is necessary to ensure that the PET expense deduction will be realized in the appropriate tax period?
- Are the PETs related to trade or business or investment activity? What are the implications for federal tax reporting?
- On an owner-by-owner basis, what is the state PET expense or owner credit and the corresponding net federal tax benefit? Note: Considerations for individual, trust, and estate taxpayers are discussed separately.
- What are the state tax implications for tax-exempt owners?
- What are the logistics in each applicable state (such as election dates, estimated payment dates, etc.)?
- What are the internal administration considerations (for example, reducing cash distributions to owners benefitting from the PET to reflect the entity-level expense while leaving nonbenefited owners unaffected)?

Bonus feature: Multistate passthrough entity taxes (PETs)

Does the passthrough entity have significant state-source income in states with a PET?

All of the previous considerations apply for resident individual owners. For nonresident owners, state-source income PET considerations also include:

- What is the impact of the PET election on different groups of nonresident owners? Certain groups of nonresident owners may be negatively affected by the PET election.
- Does the owner's resident state allow a credit for taxes paid at the entity level? If not, what is the potential negative impact of a PET election on the group of nonresident owners who reside in that state?
- Are there structuring alternatives to isolate owners that want to elect into a regime into a "feeder" entity if the owners can't directly opt out of a regime?

Bonus feature: Multistate passthrough entity taxes (PETs)

Potential implications for individual, trust, and estate taxpayers:

- **Does the passthrough entity conduct a trade or business or an investment activity?**
  The "non-separately stated" verbiage in Notice 2020-75 has resulted in some uncertainty as to whether PET taxes paid by an investment partnership (or any passthrough entity with respect to investment income) is covered by the Notice because "non-separately stated taxable income or loss" is generally interpreted as a reference to trade or business income. Note that, depending on how the PET paid by the entity is deducted, alternative minimum tax (AMT) implications may need to be considered by the owner.

- **Is there a state tax refund that could be related to PET payments? If so, what are the tax benefit rule implications?**
  Generally, the tax benefit rule, which applies when an amount deducted in one year is later refunded, acts to balance the tax consequences of the deduction received with the tax consequences of the refund. Under the tax benefit rule, if the deduction for state tax paid provided a federal tax benefit, then the state tax refund would be subject to federal income tax to the extent of the benefit received.

  The tax benefit rule can come into play in many situations. One question here is whether the state tax refund is a function of a deduction that relates to PET payments and if there are implications that would cause that refund to be included in taxable income. For example, consider whether the state's PET rate is higher than the tax rate that applies to the individual or fiduciary.

Bonus feature: Multistate passthrough entity taxes (PETs)

- **Is the taxpayer a trust or an estate?**
  If so, the PET analysis involves another level of complexity.
  - Federal tax considerations for non-grantor trusts and estates taxpayers:
    - How is distributable net income (DNI) allocated between the trust or estate and the beneficiary(ies)? The answer to this question will determine who receives the benefit of the specified income tax payments (SITPs).
    - Non-grantor trusts and estates with SITPs related to passthrough income that is not trade or business income have similar AMT considerations as individuals; however, they have the additional complexity of determining who must add back the SITP in computing AMT income. Care should be taken because, in certain circumstances, who benefits from the SITP may be different from who has to add back the SITP in computing AMT income.
  - At the state tax level, similar considerations apply with respect to the allocation of state tax credits between the non-grantor trust or estate and the beneficiary(ies).
    - For example, in New York, the credit stays at the trust level, regardless of the allocation of DNI to the beneficiary. This could result in the trust or estate having an unusable state tax credit and the beneficiary subject to state income tax, but unable to claim the tax credit (which means the beneficiary's direct state tax payments would be subject to the federal SALT deduction cap).
    - Also note that in some states, the credit is refundable, while others allow the credit to be carried forward for a certain period of time before it expires. This creates the potential for double taxation in situations where the credit is stuck at the trust level, but the income is taxed at the beneficiary level.

PASSTHROUGH ENTITY TAXES

Bonus feature: Multistate passthrough entity taxes (PETs)

- In addition, many states require an add-back of state taxes in calculating state taxable income. In some states (e.g., New York), the add-back is tied to the PET credit. In other states, the allocation of the add-back may be different from the allocation of the credit. In some states, for example, the allocation of the add-back may be tied to the allocation of the expense in computing federal income.
- For grantor trusts, PET regimes can affect certain estate planning practices.
  - For example, consider a sale to an intentionally defective irrevocable trust (IDIT). A sale to an IDIT in exchange for a note from the trust is intended to allow the grantor to transfer appreciation on a business after the date of sale undiminished by any income tax obligation. Tax distributions from the business provide the trust with cash flow to make note payments, and there is the additional benefit of reducing the grantor's estate through tax payments on the trust's income. If the business is subject to or elects into a PET regime, the tax paid by the business entity could reduce the amount distributed to the trust, and the resulting impact on the trust's cash flow may jeopardize the trust's ability to pay off the note. In addition, the grantor's direct state tax payments would be subject to the federal SALT deduction cap.

While it is clear that PETs have the potential to benefit some taxpayers, the analysis and logistical requirements are far from simple. Future regulatory and/or legislative changes may also affect these considerations. As currently enacted, the repeal of the SALT deduction cap is slated to occur for tax years after 2025. Taxpayers should engage tax advisers experienced in this area for considerations specific to their facts and circumstances.

Resources

OUR CONTRIBUTORS

Greg Bergmann

Wendy Diamond

Eddie Gershman

John Hynes

Meghan Kerns

Jeffrey Kummer

Chris Meskimen

Andrew Sakalarios

Mike Schlect

Jane Searing

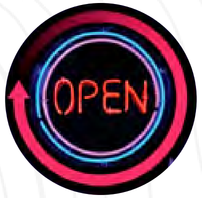
Kristina Rasmussen

Courtney Reitman-Deinlein

Tracy Tinnemeyer

RESOURCES

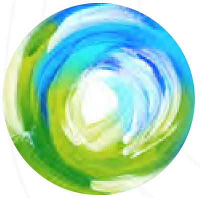
Useful links



Deloitte Private

Family Enterprise Services

Tax News & Views Newsletter



Examining potential increases to capital gains tax rates

Private Wealth Tax Services

Family Governance and Leadership Services

Tax News & Views Podcast: Tax policy and its impact on private business and its owners

Private Foundations

Deloitte.
Private