The Tax Cuts and Jobs Act of 2017 (the 2017 Tax Act) and the recent taxpayer victory in the U.S. Tax Court's *Lender Management, LLC* decision have created important planning opportunities for both our closely held and family-controlled entities in 2018. In particular, we are advising our clients with respect to:

- Navigating the elimination of the various deductions and the expansion of "bonus" depreciation;
- Determining appropriate entity structures (corporate, partnership and pass-through taxation) for new ventures as well as considering whether existing S corporations should convert to a C corporation; and
- Bolstering the "trade or business" positions of our closely held investment management clients and as well as family office structures.

Elimination of Miscellaneous Itemized Deductions

Prior to 2018 (and, barring further legislation, after 2025):

- Individuals and trusts were permitted to deduct non-business investment management expenses only to the extent that those expenses (along with certain other deductions) exceeded 2% of adjusted gross income (AGI); and
- Individuals with AGI in excess of $261,500 ($313,800 for spouses filing jointly) were subject to a phaseout of their itemized deductions to the extent of 3% of the excess.

Under the 2017 Tax Act, miscellaneous itemized deductions, of which investment management expenses are perhaps the most significant, are disallowed entirely from 2018-2025 for individuals and trusts. For alternative minimum tax purposes (AMT), it continues to be the case that no deduction is permitted for non-business investment management expenses.

Notwithstanding the foregoing, a private company engaged in a trade or business may take a full deduction for investment management and related expenses. Accordingly, closely held investment management companies and family office clients engaged in a trade or business have a significant opportunity for tax savings under the current law.

Expansion of "Bonus" Depreciation

Under the 2017 Tax Act, bonus depreciation has been extended and increased.

Prior to 2018, an immediate 50% depreciation deduction was available for qualified property (generally, assets depreciated over 20 years or less, computer software and certain improvements to leased property, all of which were required to be new property) placed into service in 2017. This percentage was to be reduced to 40% in 2018 and 30% in 2019 before being eliminated entirely beginning in 2020.

Under the 2017 Tax Act, a 100% deduction is available for qualified property placed into service from September 28, 2017 through December 31, 2022 (or, for certain property, 2023). The deduction is then reduced by 20% each year until it is eliminated in 2027 (or 2028).

Importantly, the 2017 Tax Act also expanded the definition of "qualified property" to include used property (provided that it is first placed into service by the taxpayer during the requisite timeframe). Accordingly, the incentive for capital investment by operating companies under the 2017 Tax Act is substantial.

C Corporation Tax Rate Cut to 21%

The new flat tax rate of 21% on C corporation income is the centerpiece of the 2017 Tax Act and is sure to generate significant cash flow savings for C corporations both privately held and publicly traded.

- From a planning perspective, this lower tax rate environment may make C corporations an attractive vehicle for closely held businesses, as well as to carry on investment activity, particularly for the accumulation and reinvestment of wealth where a regular payout of dividends is not mandated.
- Many privately owned and family-controlled entities were formed as S corporations or LLCs to take advantage of the lower overall tax rate imposed on the income of such flow-through entities. Given the new 21% C corporation tax rate, it is important that the structure of such closely held and family-controlled entities be reconsidered.

In conjunction with Perkins Coie Tax practice partners, we are analyzing the potential tax-savings of converting existing flow-through entities to C corporations (or initially forming new closely held or family-controlled

entities as such). This analysis is not clear-cut and may yield different results depending on each taxpayer's unique circumstances. In order to realize the benefits of the lower C corporation tax rate, taxpayers may be required to navigate:

- The 20% accumulated earnings tax applicable to a corporation that retains earnings and profits beyond its reasonable business needs;
- The 20% personal holding company tax applicable to certain closely held corporations of which at least 60% of gross income is passive;
- Differences in state income tax on individuals and corporations; and
- Shareholder/employee cash needs.

Longer Holding Period Requirement for Profits Interests

Under the 2017 Tax Act, capital gains attributable to profits interests (i.e. interests in the profits of a partnership received by the manager in exchange for investment management services) in certain investment partnerships are characterized as short-term capital gains unless the partnership held the asset to which the gain relates for more than three years.

- Previously, investment managers holding profits interests were entitled to long-term capital gain treatment if the asset to which the gain related was held by the partnership for more than one year.
- This highly technical tax provision contains a number of exceptions, and questions linger as to how it will be applied and are of particular concern to our clients involved in private equity, venture capital, hedge funds, REITs and other investment entities. See the January 22, 2018 update by Carl T. Crow and Bryan S. Smith for an in-depth analysis.

Tax Court Upholds Trade or Business Activity Under Family Office Structure

In *Lender Management, LLC v. Commissioner*, a December 2017 Tax Court decision held that, for purposes of Section 162 of the Internal Revenue Code, a family owned and operated LLC was carrying on the trade or business of providing investment advisory services rather than serving as a passive investor.

In conjunction with the implementation of family office investment structures and a thorough assessment of existing privately held and family office investment structures common with private equity, hedge fund and venture capital investment structures, the following factors cited in the *Lender Management, LLC* case should be considered to bolster trade or business positions:

- The appropriateness of legal, accounting, investment advisory and other consulting services should be considered and may be engaged by privately held and family office entities;
- Formality should be strictly adhered to and contracts should be in place documenting legal, accounting, investment and consulting service arrangements;
- Regular meetings should be held (at least annually) with executives of the entity and the investors. In family office situations, meetings should occur among personnel and the individuals and trustees whose wealth is being managed;
- Recognizing the developing virtual economy, office space should be rented or owned to establish a physical as well as virtual presence;
- Dedicated employees, including family members, should be employed by the privately held and family office investment structures;
- Compensation for services should be paid, including salary to all employees;
- In instances where an investment partnership structure is utilized, consideration should be given to the appropriateness of the privately held and family office entity receiving a significant stake in the investment partnership, e.g., an annual management fee of 2.5% of the net asset value, plus 25% of the

annual increase in net asset value; and
- Diversity of investors, third parties, individual family members and/or trusts may directly engage the private investment management firm or family office for legal, accounting, investment advisory and other consulting services for investment assets.

Please contact experienced counsel to take maximum advantage of these recent changes that create numerous planning opportunities.

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