Entertaining Uncertainty: Tax Planning During COVID-19 and Under a Biden Regime

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Agenda

- Democratic and GOP Tax Proposals
- Navigating Music Monetization
- Production Timing Issues
- Estate Planning
- Additional Topic Materials

Disclaimer:

- *This presentation is intended as a summary of the issues presented and is not intended to provide legal advice. It is provided for the general information of the attendees. Legal counsel and advice should be sought for any specific questions and before taking any action in reliance on the information presented.*

Democratic Tax Proposals

Biden: Individual Tax Proposals

- Reverse TCJA tax cuts for wealthy taxpayers
  - Will not raise taxes on individuals making less than $400,000
  - Restore the 39.6% top individual rate
  - Phase out business income deduction (Sec. 199A) for filers with incomes above $400,000
- Itemized deductions
  - Cap benefit of itemized deductions for taxpayers at 28% of value
  - Restore Pease limitation on itemized deductions for incomes above $400,000
  - Repeal SALT cap
- Eliminate capital gains "loopholes"
  - Individuals with incomes above $1 million will pay a 39.6% rate on LTCG
  - Eliminate step-up in basis for inherited assets
  - Eliminate "carried interest"
- Estate tax reforms
  - Roll back the unified estate tax exemption increase in TCJA (to what level?)
  - Rate increases to "historical norms" (unspecified)
  - Reforms to trusts – various Democrats have advocated for changes in recent years
    - Minimum term requirements and transfer taxes for Grantor Retained Annuity Trusts (GRATs), valuation discount limitations

Biden: Individual Tax Proposals (cont.)

- Create 12.4% payroll tax on wages above $400,000 (w/no tax between $137,700 and $400,000)
  - Split between employee and employer
  - Cannot be done through reconciliation
- Reform opportunity zone program
  - Have Treasury review OZ benefits – requiring clear economic, social, and environmental benefits
  - Require reports detailing poverty status, job creation, and housing affordability in OZ communities
- Equalize tax treatment of retirement contributions (26% refundable credit to replace deduction)
- Create renewable energy tax credits for individuals
- Prioritize tax benefits for low-income taxpayers
  - Expand EITC (to cover childless individuals over age 65) and credits for children and elder care
- Expand credits for children and elder care
  - Make child care tax credit fully refundable and cover up to $8,000 for one child and $16,000 for multiple children (currently allowed to claim max of $3,000 in expenses for one child)
  - Create a $5,000 "informal caregivers" credit (Credit for Caring Act)

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Democratic Proposals on Taxation of Capital Gains

Democrats are looking at major changes to the way capital gains taxation works. The effects of their tax proposals would depend on each taxpayer's circumstances and on market performance.

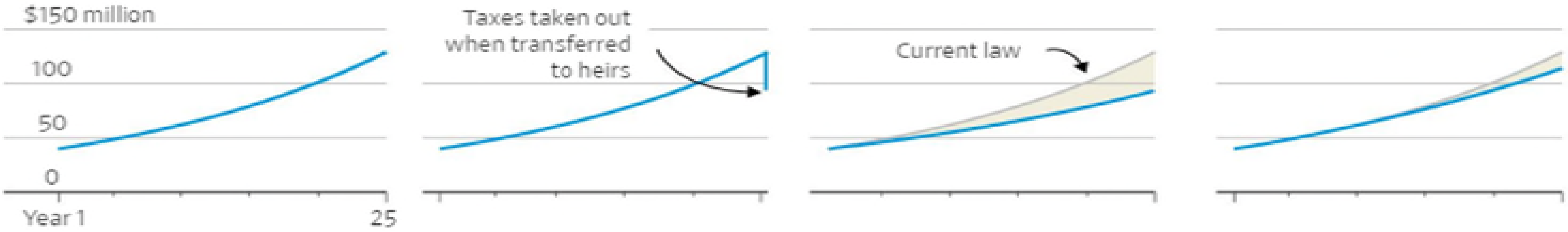
CURRENT LAW
Assets can appreciate without capital gains taxes and heirs pay taxes only on gains in value after the original owner's death.

BIDEN PLAN
Death would be considered a realization event, triggering capital gains taxes on appreciated assets, paid at ordinary income tax rates.

WYDEN PLAN
Each year, investors would pay income taxes on the gain in their assets. This is called a mark-to-market system.

WARREN PLAN
Net worth above $50 million subject to a 2% annual tax, plus a 1% tax on net worth above $1 billion.

Example one: Asset value begins at $40 million, 5% growth until person dies in year 25



Total taxes taken under law/plans:

Current law	Biden plan	Wyden plan	Warren plan
$0	**$35.6 million**	**$21.4 million**	**$11.9 million**

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Biden: Capital Gains and Estate Tax Reforms

- Individuals with incomes over $1 million will pay 39.6% on LTCG
- Eliminate the step-up in basis for inherited assets
  - Carryover basis or death as a realization event?
  - No specifics, but an Obama proposal would have treated death as a realization event
- Example:
  - Basis of original asset is $1 million. Value increases to $5 million.
    - Present law: Upon the owner's death, beneficiary receives asset with a tax basis of $5 million (no CG tax).
    - Obama proposal: Beneficiary would pay 43.4% (39.6% increased CG rate + 3.8% net investment tax) on $4 million in gains = <u>$1,736,000 in tax</u>.
    - Carryover basis: No tax due, but beneficiary inherits asset with a $1 million basis.

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Biden: Capital Gains and Estate Tax Reforms (cont.)

- Capital gains interaction with estate tax — double taxation?
  - 2015 Obama proposal exempted $100,000 of capital gains ($200,000 for joint filers) from the estate tax
- Biden has suggested repealing estate tax exemption increase in TCJA
  - Reduced exemption amount from $11.58 million to as low as $3.5 million
- Example: Asset with original cost of $10 million now worth $15 million
  - Present law
    - Beneficiary pays no CG tax; inherits asset with a new tax basis of $15 million
    - Estate subject to 40% estate tax on $3,420,000 (amount above $11.58 million exemption) = $1,368,000 in estate tax
    - Total taxes: <u>$1,368,000</u>
  - Biden plan
    - Beneficiary would pay 43.4% CG tax on $4.9 million gain ($5 million minus $100,000 exemption) = $2,126,600 in CG tax
    - Estate subject to 40% estate tax on $11,500,000 (amount in excess of $3.5 million exemption with entire CG apparently included) = $4,600,000 in estate taxes

    Total taxes: <u>$6,726,600</u>

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Mark-to-Market Tax (Wyden Proposal)

- Require annual tax (at ordinary income rates) on unrealized gains of tradeable property
  - Determined on last day of taxable year
    - Use largest of: (i) unadjusted basis; (ii) value determined at date of last transaction establishing value; and (iii) value of interest from most recent applicable financial statement.
  - Non-tradable assets (closely held businesses, collectables, real estate) would fall under lookback provision
    - Tax assessed when asset is sold with lookback charge applied (interest accrued over holding period)
    - Transfers of property would be a realization event.
- Allow deduction for losses (but "subject to certain limitations to prevent abuse")
- Applies to individuals, estates, or trusts that meet asset or income requirements for preceding three years
  - $1 million income threshold or $10 million asset threshold indexed for inflation (single and joint filers)
- Special exemptions
  - Retirement accounts ($3 million exemption for total combined value)
  - Personal residences ($2 million exemption for all homes combined)
  - Family farms ($5 million exemption)
  - Household goods not considered applicable assets (subject to certain limitations)
- Rules for treatment of debt, whether losses reduce ordinary income, and transition rules still being considered

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Effective dates: History of retroactive taxes

- Retroactive taxes face Fifth Amendment constitutional questions
  - Due process clause: "nor be deprived of life, liberty, or property, without due process of law"
  - Takings clause: "nor shall private property be taken for public use, without just compensation"
- Courts have repeatedly allowed retroactive tax legislation
  - Takings clause dismissed because courts see distinction between the government's taxing power and its power to take private property upon payment of just compensation
    - 9th Circuit: *Quarty v. United States* (1999)
      - Rule that taxes do not affect takings is "well established."
  - Most promising challenges have come from due process claims
- Any retroactive tax legislation in a Biden administration is likely constitutional, as long as there is a "rational legislative purpose" and it is limited to a "prompt and modest period of retroactivity" (discussed in the next slide)

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U.S. v. Carlton (1994)

- Amendment to limit estate tax deduction under IRC 2057 (contribution to an employee stock ownership plan) passed in December 1987 – amendment retroactively included in tax reform that was passed in October 1986
  - Estate purchased and then sold MCI stock to MCI ESOP and claimed a deduction based on 50% of the sales proceeds
  - Supreme Court: Taxpayer not eligible for the deduction
- Unanimous decision: Court held that retroactive amendment did not violate due process clause
  - **Congressional action was not "illegitimate or arbitrary"**
    - "Retroactive application of statute supported by legitimate legislative purpose furthered by rational means"
    - Limited unanticipated revenue losses: deduction originally estimated to cost $300 million, and without limitation could have been as much as $7 billion
  - **"Prompt and modest period of retroactivity"**
    - Amendment proposed by February 1987 and enacted within 14 months of effective date
  - **"Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code"**
    - No proper notice required
    - "…a taxpayer should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation."

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Biden: Business Tax Proposals

- "I'd make the changes on the corporate taxes on day one." (September 9 cable network interview)
  - Increase corporate tax rate to 28%
  - 15% corporate AMT on book income with net income above $100 million (greater of)
- International tax proposals
  - Double GILTI rate from 10.5% to 21% (and from 13.125% to 26.25% in 2026)
    - Apply on jurisdictional instead of aggregate basis
    - More stringent rules for calculating tax
  - "Offshoring tax penalty"
    - 10% surtax on U.S. companies' overseas profits and services for sales to the United States (30.8% rate)
  - "Made in America" Tax Credit
    - 10% advanceable credit to companies that create jobs and accelerate economic recovery
  - Supports more stringent inversion legislation (Stop Corporate Inversions Act) and regulations
  - Delay deductions and expensing write-offs for moving jobs or production overseas
- Reform tax "loopholes" in real estate industry
  - Section 1031 exchanges
  - Depreciation rules
- Repeal CARES Act temporary NOL carryback provisions (and the temporary loss benefits for pass-through owners)
- Financial fee on liabilities of firms with more than $50 billion in assets (similar to Obama-era proposal)

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Biden: Business Tax Proposals (cont.)

- Create tax credits for small businesses that sponsor retirement plans
- Establish a Manufacturing Communities Tax Credit
  - Incentives for investment in communities that experienced a major job loss event (closure of major employer or government facility)
  - Obama administration proposal
- Expand the New Markets Tax Credit
  - Provides incentives for investment in low-income communities
  - Increases annual allocation to $5 billion and makes the credit permanent
- Climate-related proposals
  - Global recession shifted Biden's focus away from carbon pricing schemes (with greater focus on incentives)
    - Carbon tax push could still come from Congress: Democrats have proposed legislation delaying implementation of carbon tax until 2023
    - Recent wildfires and hurricanes could increase urgency
  - Expand and make permanent the Renewable Energy Investment Tax Credit (ITC)
    - Provides credits for certain renewable energy investment (solar, wind, geothermal)
  - Encourage carbon-free manufacturing, increase incentives for carbon capture credits, and EV manufacturing
  - Make existing green energy credits permanent and more accessible to low-income taxpayers
  - Remove tax subsidies for fossil fuels and "take action" against polluters

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GOP Tax Proposals

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GOP: Individual Tax Proposals

- Reduce tax rates in bottom three brackets (22% bracket and lower to 15% for individuals making less than $100,000 per year)
- Make individual tax reforms permanent
  - 23 individual TCJA provisions set to expire after 2025
    - Reduction in individual rates, increased child tax credit, increased standard deduction, AMT exemption, 199A deduction, estate taxes
- A reduction in the capital gains tax rate to 15% (or index to inflation)
- Increase tax credits for childcare and provide access to quality preschool
- Make opportunity zone program permanent
  - Push program deadlines to allow more time for investments
  - Relax certain limitations

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GOP: Business Tax Proposals

- Lower corporate tax rate to 20% (possibly lower)
- Expand and/or make permanent full expensing ("bonus depreciation")
  - 100% bonus depreciation set to begin phase-out in 2022
  - Expand full depreciation to buildings (current law gives a 39-year depreciation period to nonresidential structures)
- Immediate amortization of R&D expenses
  - Amortization period expands to five years in 2022 under TCJA
- Made in America tax credits
  - Medical and pharmaceutical onshoring incentives
  - Tax deferral on repatriation of intellectual property
- Tax policies to respond to COVID-19 pandemic and stimulate economy
  - Enhanced Employee Retention Tax Credit
  - Refundable work safety tax credits
  - Full deduction for business meals
  - Payroll tax relief – terminate the payroll tax?
- International taxes
  - Tax credits for bringing jobs back from China
  - Trump said he will put tariffs on companies that leave the U.S.

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Navigating Music Monetization

Monetizing Music Catalogues During COVID

- COVID-19 Impact on the Music Industry
- Character of Music Rights and Related Tax Issues
- Secured Lending
- Catalogue Sales
- Partial Liquidity of Capital Gains with Right to Regain Control

Pandemic Impact on Music Industry

- Global music industry is worth over $50 billion, made up of two major income streams:
  - Live music (revenue from sales of tickets and live performances).
  - Recorded music (revenue from streaming, digital downloads, physical sales, and synchronization revenues, such as licensing of music for movies, games, TV, and advertising).
    - Recorded music today is close to the industry's pre-piracy peak, with streaming making up almost half of recorded music revenue.

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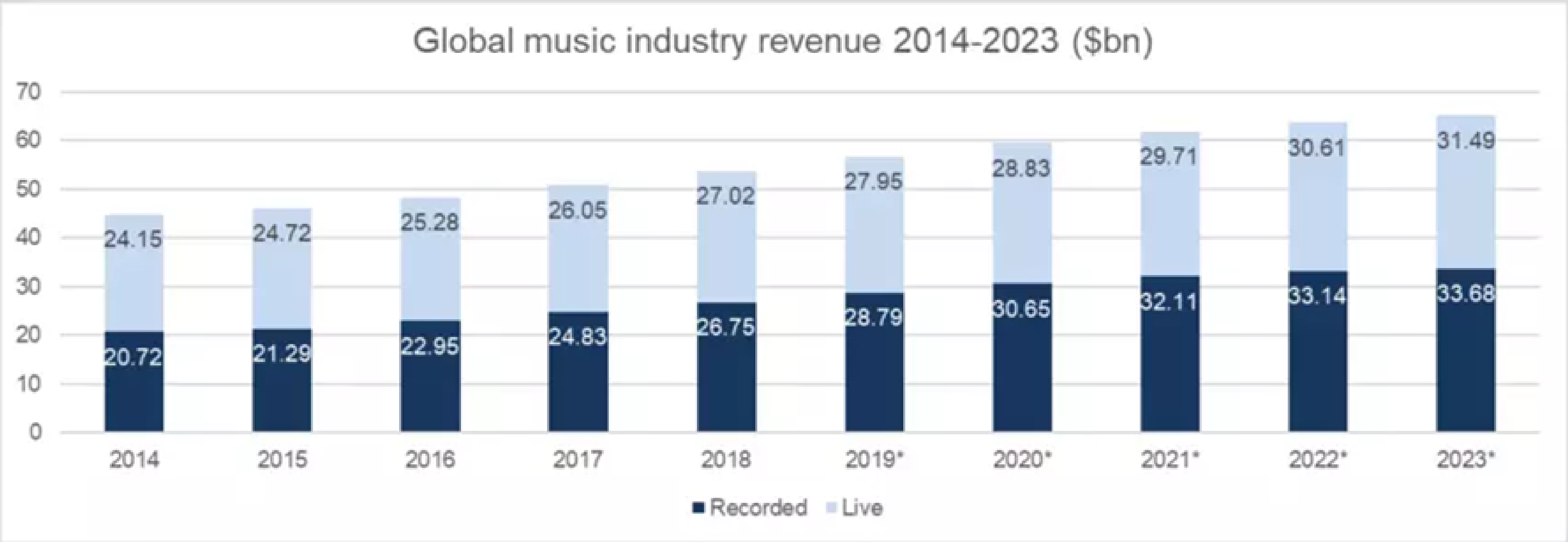
Pandemic Impact on Music Industry



Source: PwC, World Economic Forum

Pandemic Impact on Music Industry – Live Music

- Live music represents 50% of global music industry revenue.
- Touring industry shut down as a result of pandemic.
  - Many artists have turned to streaming for live music events.
  - A National Independent Venue Association survey suggested that the pandemic could force 90% of independent music venues in the U.S. to close forever.
  - For many, opening under social distancing rules with substantially reduced venue capacities is not economically viable.
- If properties remain closed until the end of the year, an estimated $9B would be lost in ticket sales alone (excluding food and drink revenue).

Pandemic Impact on Music Industry – Recorded Music

- Pandemic has devastated touring, but also has cut into growth of digital streaming.
- Certain streaming platforms began 2020 up 20.4% over 2019, but then ratcheted back to an increase of only 13.8% between March and July because of less time spent in the car and at the gym; but audio consumption was up nearly 10 points over 2019 mid-year.
  - Streaming sales have grown from 9% to 47% of total industry revenues in just six years.
- Physical music sales, which represent one-fourth of recorded music revenues, started up 4.6% in 2020, but were down 20.3% for the first half of 2020.
- Digital sales have fallen 11%.
- Music consumption has shifted to home devices (TVs and smart devices).

Source: “Nearly All Independent Venues May Fail to Survive Lockdown” *Ultimate Classic Rock*, June 10, 2020.

Secured Lending

- One way music artists can monetize their catalogues to mitigate the impact of COVID-19 on their cash flow is to borrow money secured by their underlying revenue streams.
- The loan will be repaid with ordinary income (from service income or royalties).
- Secured lending results in accelerated cash flow that can help navigate decreased revenue streams, but could result in financial stress, given that artists must return 2x revenue to repay debt (assuming 50% effective tax rate).
  - E.g., borrow $1 million, but have to earn $2 million to repay the $1 million with after-tax proceeds.

Full Music Catalogue Sale

- Pre-COVID-19, music catalogues may sell for 20-30x multiples.
- Amounts received by music artists who own copyrights in musical works may be royalties or compensation, depending whether they own and license the copyright or create it for an employer.
- Copyright ownership for income tax purposes.
- Sale vs. license of a copyright for income tax purposes.
- Self-created copyrights are ordinary assets, except that taxpayers may elect to treat gain from the sale of self-created musical works as capital gain (applies for tax years beginning after May 17, 2006).

Full Music Catalogue Sale

- Generally, if "royalty" payment to the artist is for services, then the sale of the contractual right may generate ordinary income, which could implicate IRC 409A under certain circumstances.
- Must have copyright ownership to achieve capital gain treatment.
  - Master recordings
  - Publishing rights
  - Writer's share

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Full Music Catalogue Sale

- The devil is in the details!
  - Independent record label is granted a profits interest in a JV with a major record label and subsequently redeemed.
  - Copyrights sold for income tax purposes years ago and there's a current sale of the income stream associated with such copyrights.
  - Can a copyright termination right be transferred? Does such transfer, alone, constitute the sale of a copyright interest for income tax purposes?

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Music Catalogue Partial Sale

- Downside of full catalogue sale is loss of control over catalogue.
- Structuring opportunities may be available to achieve long-term capital gain with the ability to reclaim ownership of the music catalogue in the future.
- Currently, the market may bear a partial sale of the catalogue; accordingly, this type of transaction generally is for a music artist who is looking to monetize at capital gain rates, but has the ability to reclaim control over the catalogue in the future.
- If looking to maximize the purchase price, consider full catalogue sale.

Copyright Termination Rights

- Copyrights created by an *individual* after January 1, 1978 are eligible for a valuable right referred to as a "copyright termination right," which effectively allows the creator to reclaim their copyright interest (from a prior license or sale to a third party) without consideration during a 5-year window 35 years from the copyright creation date. A longer analysis applies to works that were created prior to January 1, 1978.
- This generally is a non-waivable right, by contract or otherwise.
- The creator's statutory heirs will inherit this right unless the creator expressly bequeathed the copyright to a beneficiary under his/her will.
- A copyright created on a work-for-hire basis by a corporation does not have a copyright termination right.

Copyright Termination Rights

- "Work for Hire"
  - Work prepared by an employee within the scope of his or her employment, or
  - Work specially ordered or commissioned for use as a contribution to a collective work, as part of a motion picture or other audiovisual work, as a translation, as a supplementary work, as a compilation, as an instructional text, as a test, as answer materials for a test, as an atlas, *if the parties expressly agree at the outset and in a written instrument* signed by them that the work shall be considered a work made for hire.
- What is the taxation upon exercise of Copyright Termination Rights?
- Can a music artist sell his/her copyright termination rights? If so, what is the character of the income?

Nevada Incomplete Gift Non-Grantor (NING) Trusts

- Upon transfer of intangible assets to a NING (funding the trust), no gift tax should be due, and the NING assets should get a step-up in basis at the time of the grantor's death (under current law).
- The NING pays its own taxes, and, as a Nevada trust, it is not subject to California income tax on non-California source income, including sale gain.
- Accumulation of income and appreciation of trust assets can grow free from California income tax, resulting in greater after-tax earnings for reinvestment.
- Trust assets are creditor protected.

Film & TV Production Timing Differences

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Production Timing Issues During COVID

- Production Services Entities
- Capitalization and Cost Recovery
- Timing Issues Solutions
- Problems in Light of COVID-19 and Potential Solutions

The COVID-19 Impact on the Film/TV Industry

- Global box office revenues totaled $42 billion last year (an all-time high), contributing to one-third of the estimated $136 billion in value of worldwide movie production and distribution.
- Hollywood supports more than 2 million jobs and 400,000 American businesses.
- British film & TV are worth around £60 million each day to the UK economy.
- China's trade in creative goods between 2002 and 2015 has had an annual average annual growth rate of 14%.
- Movie audiences grew by over 860% from 2009 to 2019 in China (compared to North America, where ticket sales have barely changed since 1995).

Work-for-Hire Production Companies

- WFH production companies do not own the underlying copyright to the film or TV production.
- Timing issues may be navigated by receiving cash from the studio as and when needed for production to align income and expenses within the same taxable year.
- Alternatively, if certain requirements are satisfied, then the production cash received may be excluded from gross income.
- Accrual method taxpayers may be eligible to elect to defer advanced payments for production services for up to one year.

Production Companies That Own Copyrights

- Required to capitalize production costs.
- Depending on how financing is structured, could result in timing issues with income and deduction recognition.
- Qualified U.S. productions may qualify for IRC 181, which may put production companies on same footing as WFH production companies; however, renewal of IRC 181 is uncertain.
- Qualified U.S. productions may qualify for “bonus depreciation,” but requirement to take bonus depreciation when placed in service can still result in timing issues.
- All other productions generally will be recovered using the income forecast method.
- Capital contribution; deferral method election; loan.
- Production delays could further impact timing issues and solutions.

Estate Planning Opportunities

It's All About the Numbers

- Gift and Estate Tax Exemption $11.58M
- Generation-Skipping Transfer (GST) Tax Exemption $11.58M
- Annual Exclusion $15,000
- Low Interest Rates

It's All About the Numbers

Calendar Year	Gift and Estate Tax Exemption	GST Tax Exemption	Highest Estate, Gift, and GST Tax Rate
2026	$5 million*	$5 million*	40%
2020	$11.58 million	$11.58 million	40%
2019	$11.4 million	$11.4 million	40%
2018	$11.18 million	$11.18 million	40%
2017	$5.49 million	$5.49 million	40%

*Indexed for inflation

*Election Impact: **Trump's** proposal retains the $11.58 million exemption and 40% highest tax rate across the board, without reduction in 2026; **Biden's** proposal could reduce the exemption to as low as $1 million for Gift Tax and $3.5 million for Estate Tax and increases rates to historic rates of 45% or more, as early as January 1, 2021*

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It’s All About the Numbers

Rates	October	November
7520 Rates	0.4%	0.4%
Short-Term AFR	0.14%	0.13%
Mid-Term AFR	0.38%	0.39%
Long-Term AFR	1.12%	1.17%

Wealth Transfer Techniques to Consider by Year End

- Grantor Retained Annuity Trust (GRAT)
- Charitable Lead Trusts
- Sale to Gift Trust
- Intra-Family Loans
- Outright Gifts

Taxable Bucket

(You)

Nontaxable at Death

(Children, Family, Friends, & Charity)

Example: GRAT

Assumptions

- $10M Contribution
- 6% Growth
- Increasing Annuity Payments
- .4% 7520 Rate
- 10-Year Term

Year	Beginning Principal	6.00% Growth	Required Payments	Remainder
1	$10,000,000.00	$600,000.00	$396,005.10	$10,203,994.90
2	$10,203,994.90	$612,239.69	$475,206.12	$10,341,028.47
3	$10,341,028.47	$620,461.71	$570,247.34	$10,391,242.84
4	$10,391,242.84	$623,474.57	$684,296.81	$10,330,420.60
5	$10,330,420.60	$619,825.24	$821,156.17	$10,129,089.67
6	$10,129,089.67	$607,745.38	$985,387.40	$9,751,447.65
7	$9,751,447.65	$585,086.86	$1,182,464.88	$9,154,069.63
8	$9,154,069.63	$549,244.18	$1,418,957.86	$8,284,355.95
9	$8,284,355.95	$497,061.36	$1,702,749.43	$7,078,667.88
10	$7,078,667.88	$424,720.07	$2,043,299.32	$5,460,088.63
Summary	$10,000,000.00	$5,739,859.06	$10,279,770.43	$5,460,088.63

Amount Returned to You $10,279,770 **Amount to Beneficiary** $5,460,088

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Positive and Negative Considerations with GRATs

- Positives
  - Control and Use of Assets – Donor can be trustee of the GRAT and principal of asset back for use during life
  - Flexibility – Can always swap assets for higher appreciating assets during GRAT term
  - Tax-free Growth – Property in trust appreciates tax-free (because Grantor reports the trust income on his/her return)
  - Valuation Protection – Expressing annuity as a percentage of initial fair market value allows for automatic adjustment of the required annuity if valuation is contested in audit (no protection if annuity payment made in kind)
  - Series of Rolling GRATs are effective to increase appreciation passing to children
- Negatives
  - Limited GST Planning – GST exemption cannot be allocated to a GRAT until the end of the annuity period
  - Mortality Risk – Grantor must outlive the GRAT term or assets includible in estate
  - Not Ideal for Illiquid Assets – Annuity payments made within 105 days of annuity date; best if income producing property, not hard assets
  - Carryover Basis – Property that passes to remainder beneficiaries maintains the tax basis, no step-up

Example: Charitable Lead Annuity Trust

Assumptions

- $10M Contribution
- 6% Growth
- Increasing Annuity Payments
- .4% 7520 Rate
- 10-Year Term

Year	Beginning Principal	6.00% Growth	Payment	Remainder
1	$10,000,000.00	$600,000.00	$396,005.00	$10,203,995.00
2	$10,203,995.00	$612,239.70	$475,206.00	$10,341,028.70
3	$10,341,028.70	$620,461.72	$570,247.00	$10,391,243.42
4	$10,391,243.42	$623,474.61	$684,296.00	$10,330,422.03
5	$10,330,422.03	$619,825.32	$821,155.00	$10,129,092.35
6	$10,129,092.35	$607,745.54	$985,386.00	$9,751,451.89
7	$9,751,451.89	$585,087.11	$1,182,463.00	$9,154,076.00
8	$9,154,076.00	$549,244.56	$1,418,956.00	$8,284,364.56
9	$8,284,364.56	$497,061.87	$1,702,747.00	$7,078,679.43
10	$7,078,679.43	$424,720.77	$2,043,296.00	$5,460,104.20
Summary:	$10,000,000.00	$5,739,861.20	$10,279,757.00	$5,460,104.20

- **Amount to Charity** $10,279,757
- **Amount to Non-Charitable Beneficiary** $5,460,104

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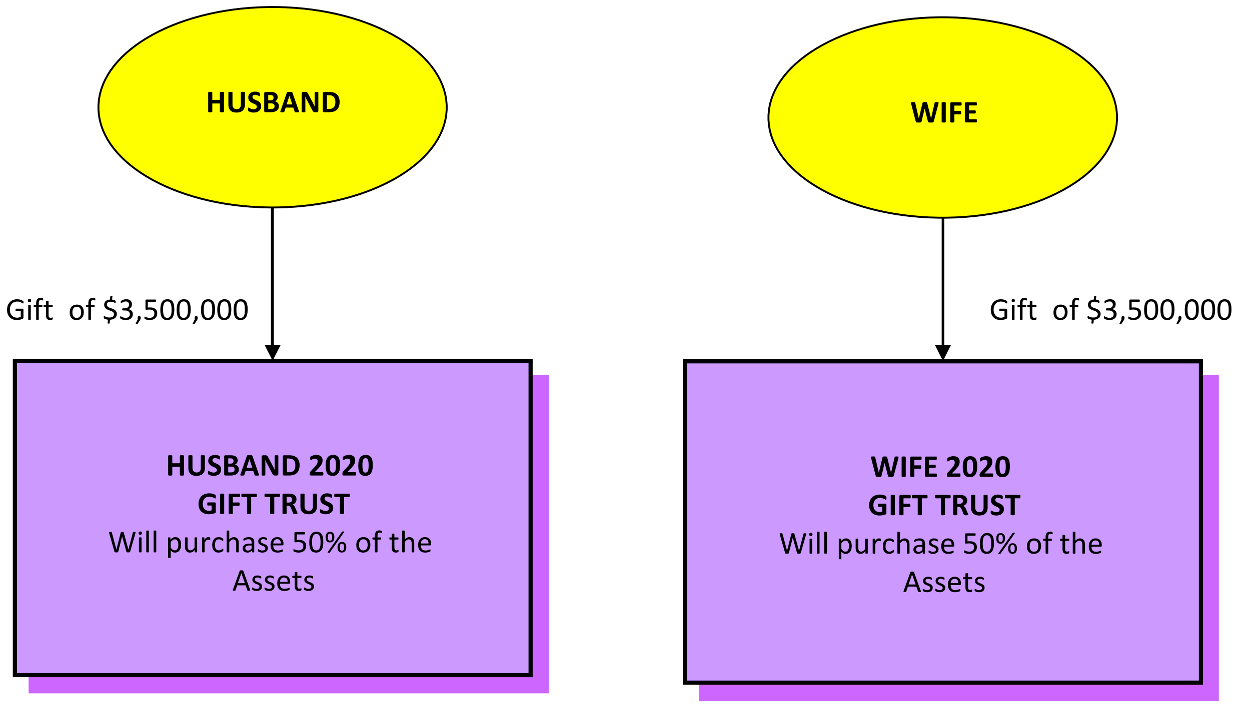
Example: Sale to Gift Trust

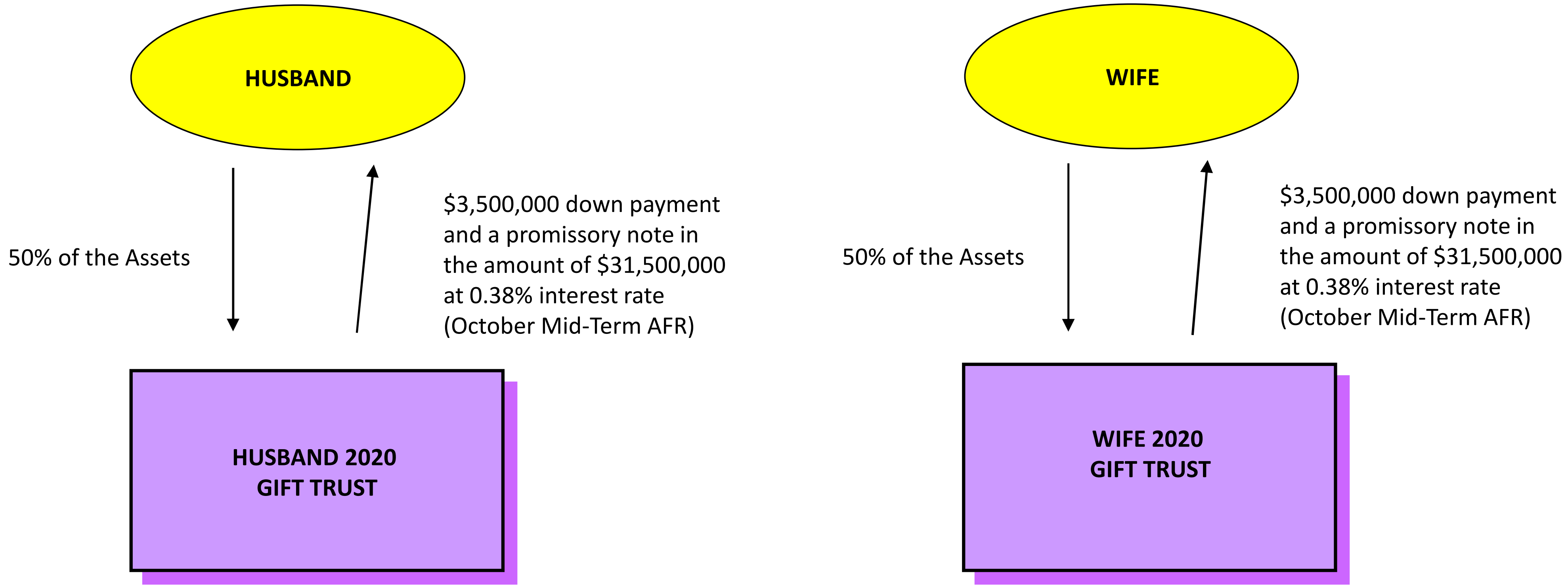
Assumptions

- Sale of Assets (i.e., LLC interests or Real Property)
- $50M Assets
- Value of Assets for Gift Tax Purposes $35,000,000
- October Mid-Term AFR .38%

Husband and Wife
Sale to Gift Trust Diagram
Step 1: Gift Seed Money to Trusts



Sale to Gift Trust Diagram
Step 2: Sell Assets to Gift Trusts



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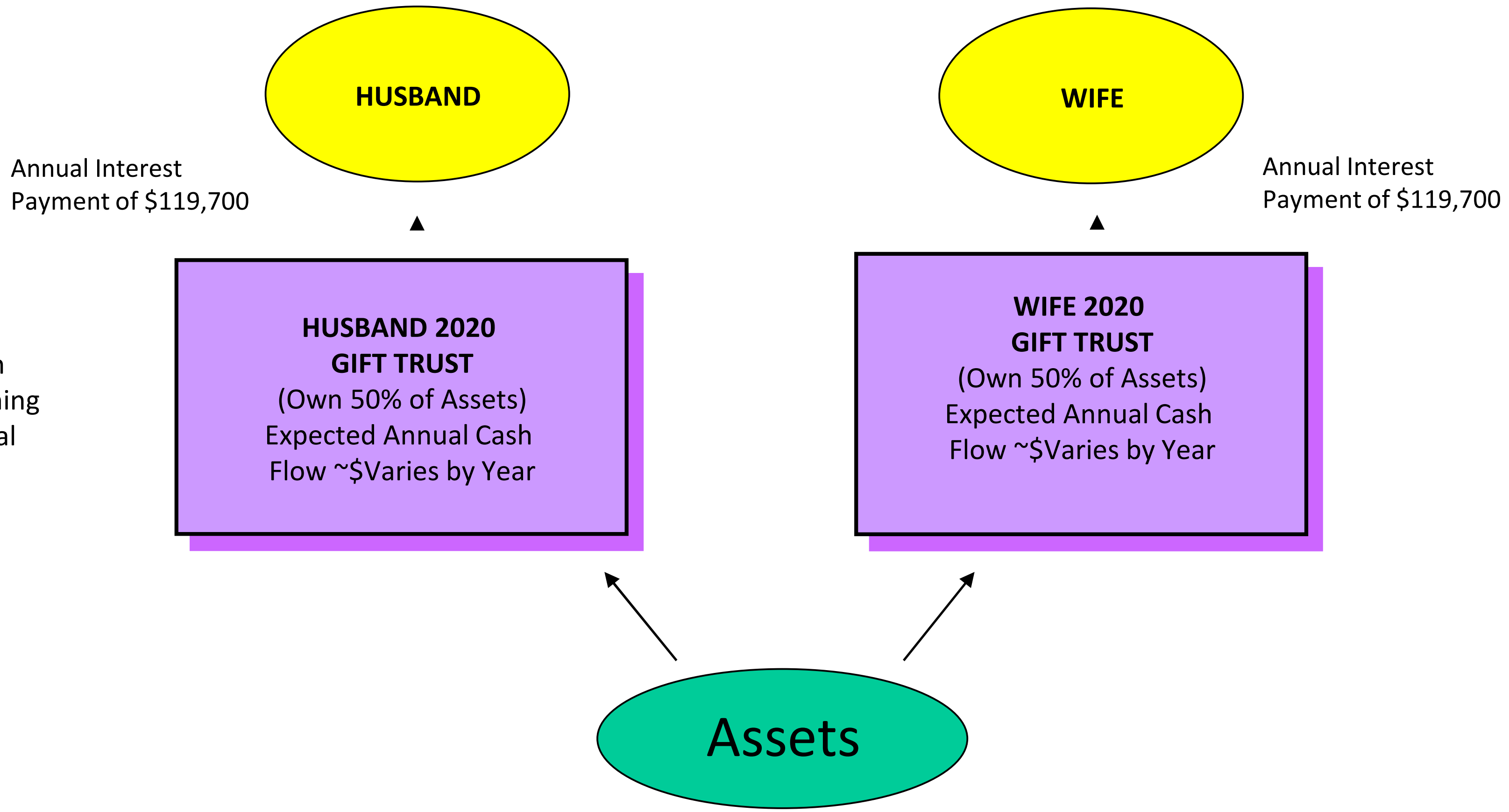
Sale to Gift Trust Diagram
Step 3: Cash Flow Post Sale



*Trustee has discretion with respect to the timing and amount of principal payments on the note.

Tax Consequences

Income Tax Consequences

- Sale of asset to Gift Trust does not trigger Income Tax because Grantor is treated as owner of Trust for Income Tax purposes.
- No change in Basis of assets after sale.
- Interest paid on the Note paid to Grantor; not Income to Grantor or deductible by Trust.
- Grantor reports all Income from Trust assets and pays Income Taxes.

Gift Tax Consequences

- Seed gift is taxable gift.
- Sale of assets to Trust should not trigger Gift Tax if made for full and adequate consideration.
  - FMV of asset equals purchase price (risk that IRS contests valuation).
  - Interest equal to AFR.
- Payment of Income Taxes by Grantor is a de facto, but tax-free, gift to the Trust beneficiaries.

Estate Tax Consequences

- Trust assets not included in Grantor's estate.
- Amounts received in payment of note (principal and interest) and/or value of unpaid note will be included in Grantor's estate.
- Net benefit = excluding appreciation or accumulated income out of the Grantor's estate.

Final Thoughts and Questions

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Additional Topic Materials

Production Timing Differences: Section 181 / Bonus Depreciation

- Section 181 is extended through 2020.
  - Immediate deduction is available for production costs <u>when incurred</u> if eligible for election, subject to cap of $15 million (or $20 million).
  - Retroactive application to 2018.
- Under the 2017 Tax Act, qualified film, television, and live theatrical productions are now eligible for immediate expensing of all production costs through new "bonus depreciation" rules in the tax year when the project is "<u>placed in service</u>" (the 100% deduction is phased out during the period from 2023 through 2026).

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Production Timing Differences: Section 181 / Bonus Depreciation

- Same definitions as Section 181, but no $15 million/$20 million limit
- Qualified film or TV production
  - Any motion picture film or video tape (subject to exceptions) where 75% of the total compensation of the production is for services performed in the U.S. by actors, production personnel, directors, and producers (excluding participations and residuals) ("**Qualified Compensation**")
- Qualified live theatrical production
  - Any live stage production of a play (with or without music) which is derived from a written book or script and is produced or presented by a taxable entity in any venue which has an audience capacity of not more than 3,000 or a series of venues the majority of which have an audience capacity of not more than 3,000 if 75% of the total compensation of the production is Qualified Compensation
  - Special rules for touring companies

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Production Timing Differences: Section 181 / Bonus Depreciation

- "Placed in service"
    - Qualified film / TV production – at the time of initial release or broadcast
    - Qualified live theatrical production – at the time of initial live staged performance
- Effective Date
    - Applies to qualified property (i) acquired after September 27, 2017, and (ii) placed in service after such date

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Production Timing Differences: Section 181 / Bonus Depreciation

- Overlap of Section 181 and Bonus Depreciation
  - Any amount in excess of the 15/20m cap under Section 181 may be picked up by bonus depreciation under Section 168(k)
    - E.g., $50 million total production expenses
      - $15 million expensed under Section 181 "as and when incurred"
      - $35 million expensed under bonus depreciation "when placed in service"
  - The 181 regulations support this approach
    - "Amounts not allowable as a deduction under section 181 . . . May be deducted under <u>any other applicable provision of the Code</u>." Treas. Reg. § 1.181-1(c)(2)

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Production Timing Differences: Advance Payment Deferral / Loss Limitations

- Accrual method taxpayers may elect to defer advance payments of royalties and service income until the next tax year (Rev. Proc. 2004-34 generally codified in new Section 451(c))
- IRS Notice 2018-35 (continue to rely on Rev. Proc. 2004-34)
- Net operating loss (NOL) rules will change beginning January 1, 2021 (deferred by CARES Act)
  - Currently allowed a 5-year carryback for NOLs arising between 2018 and 2020; HEROES Act limits carrybacks to no earlier than 2018.
  - Will lose ability to carry back NOLs beginning January 1, 2021
  - Indefinite carryforward
  - NOL will be limited to offsetting 80% of taxable income
  - Could mitigate the impact of bonus depreciation rules if taxpayer has insufficient income in year project is placed in service
- Loss limitations beginning January 1, 2021 (deferred by CARES Act)
  - Use of flow-through losses limited to $250k (for individuals) and $500k (for married filing jointly)
  - Any disallowed loss is carried forward indefinitely as an NOL
  - Passive loss rules apply first
  - CARES Act clarification: capital losses, NOLs, QBI deduction, and employee service deduction not "business losses"

Special Elections for NOLs

- Special elections available under Rev. Proc. 2020-24:
  - Waive carryback for NOLs arising after December 31, 2017, and before January 1, 2021
  - Exclude 965 repatriation year from carryback period
  - Waive, reduce, or revoke any carryback period for taxable years that began before January 1, 2018, and ended after December 31, 2017

The CARES Act

Paycheck Protection Program (PPP)

- Loans to qualifying small and midsize businesses
  - In order to qualify, must have:
    - 500 or fewer employees (or within size standard of specific industry)
    - Certify that uncertainty of current economic conditions makes the loan necessary to support the applicant's ongoing operations
- Forgiveness of principal and interest amount for any loan proceeds used during specified period of time ("covered period") to pay for:
  - Payroll, capped at annualized $100,000 per employee
    - At least 60% of total loan proceeds (previously was 75%)
  - Rent
  - Mortgage interest
  - Utilities
- Covered period lasts until the earlier of: (i) 24 weeks from the date of origination of the loan or (ii) December 31, 2020
  - Under prior law covered period lasted only eight weeks
  - Borrowers who received PPP loan before June 4 can elect to use eight-week covered period

Paycheck Protection Program / Tax Treatment

- Forgiven amount excluded from gross income for tax purposes
  - Normally would give rise to COD income, but exempt to the extent requirements are satisfied
  - However, generally should still affect partners in partnership and S corporation shareholders same as COD because tax-exempt income also increases basis
- Expenses paid with proceeds from forgiven loans not eligible for tax deduction per Notice 2020-32
  - Bipartisan support for legislative override; HEROES Act has a provision allowing the deduction
    - Does not make economic sense because gives taxpayers a windfall

Paycheck Protection Program / Outstanding Issues

- Compensation to owners as a payroll cost
  - Includes amount paid to general partners and "owner-employees"
    - No definition for "owner-employee"; likely applies to shareholders of S corporations but not clear
  - Capped at lower of (i) eight weeks' worth of 2019 compensation or (ii) $15,385
    - New rule introduced in forgiveness application—not in the statute
    - Will likely change to reflect new 24-week covered period; joint statement by Treasury and SBA confirms new loan forgiveness application is coming
- Payroll cliff
  - Wording of new 60% payroll cost threshold implies that if not met then <u>none</u> of the loan will be forgiven
    - Recent joint statement by Treasury and SBA confirms this is not the intended interpretation and additional guidance will correct this issue
- Many more issues because rules constantly changing

Payroll Tax Relief

- **Employee Retention Credit**: 50% refundable credit on up to $10,000 of qualified wages paid per employee for employers that: (i) fully or partially suspend operations due to coronavirus-related government order or (ii) experience significant decline in gross receipts.
    - Significant decline = 50% or more decrease in gross receipts compared to last year
    - Qualified wages =
        - >100 employees = only wages paid to employees not providing services due to reasons above
        - <100 employees = wages paid to all employees
    - Employers that receive PPP loan ineligible for credit (may change in HEROES Act)
    - Maximum credit = $5,000 per employee (50% x $10,000)
- Deferral of employer-side 6.2% Social Security payroll taxes incurred through December 31, 2020
    - Pay 50% by December 31, 2021 and other 50% by December 31, 2022
    - Deferral previously disallowed for borrowers who received PPP loan forgiveness, but changed in recent legislation

HEROES Act – Proposed Overhaul of Employee Retention Credit

- Increased amount of credit
  - Maximum credit of $36,000
    - 80% of qualified wages capped at $45,000 per employee ($15,000 per quarter beginning Q2)
- Changes to "qualified wages"
  - Higher employee threshold
    - Applies to wages paid to all employees unless employer has more than 1,500 full-time employees and gross receipts of more than $41.5 million in calendar year 2019
  - Health plan expenses included as wages
- Changes to "significant decline" in gross receipts
  - Significant decline in gross receipts for any calendar quarter where employer's gross receipts are less than 90% (instead of 50%) of gross receipts for the same calendar quarter of 2019 and ending at the end of the first subsequent quarter in which gross receipts are more than 90% (instead of 80%) for the same calendar quarter of 2019
- PPP borrowers eligible to receive credit

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Other Changes in the CARES Act

- Business interest deduction allowance under 163(j) up from 30% to 50% of AGI for 2019 and 2020
- Excess business loss limitation suspended through 2020
    - HEROES Act as drafted brings back the excess business loss limitation and makes it permanent (originally drafted to sunset in 2026 when introduced in 2017 as part of the TCJA)

Other HEROES Act Proposed Tax Changes

- No limitation for SALT deductions in 2020 and 2021
- Fixed expense tax credit for eligible employers against employment taxes
  - 50% refundable payroll tax credit for qualified fixed costs (rent, mortgage, utilities) available to employers with no more than 1,500 full-time equivalent employees or no more than $41.5 million in gross receipts in 2019.

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