The New Tax Act

Practical Tips for Families & Business Owners

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C Corporation Income Tax Rates Following the 2017 Act

- A flat 21% rate replaces the prior four tier structure which had a maximum 35% rate.
- Personal service corporations are also subject to the flat 21% rate.
- As under prior law, there is no special capital gain treatment.
- The changes are permanent.

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Individual Income Tax Rates Following the 2017 Act

- The maximum rate is reduced from 39.6% to 37%.
- Other maximum individual rates remain the same as under prior law, i.e. (i) 20% on long term capital gains; (ii) 25% on unrecaptured depreciation; (iii) 28% on collectibles; and (iv) Zero percent on sales of certain small business stock.
- The changes expire for tax years beginning after December 31, 2025.

The 3.8% Tax Following the 2017 Act

- As under prior law, the tax is imposed on net investment income, wages and self-employment income of individuals over a particular income level.

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The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- The deduction results in a maximum effective rate for qualified business income of 29.6%, i.e., 37% minus 20% of 37%.

- The deduction applies to taxpayers other than C corporations, including owners of passthrough entities, sole proprietorships, and trusts and estates.

- Qualified business income must be domestic income.

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The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- Certain types of businesses are excluded, i.e., health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage, where the primary asset is the reputation or skills of one or more employees or owners, investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

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The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- Certain types of income is excluded, e.g., (i) reasonable compensation or guaranteed payments; (ii) capital gains and losses; (iii) dividends; (iv) nonbusiness interest; and (v) annuities.

- The deduction is limited to the greater of (i) 50% of W-2 wages or (ii) 25% of W-2 wages and 2.5% of the unadjusted basis of qualified property.

- The deduction is further limited to 20% of taxable income less capital gains.

The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- There are exceptions to the service business and wage and basis limitations in the case of taxpayers beneath certain income levels, i.e., (i) joint returns with taxable income of $315,000 or less; (ii) generally taxable income of $157,500 or less; and (iii) phase outs up to $415,000 or $207,500.

- The 20% deduction expires for tax years beginning after December 31, 2025.

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Some Practical Tips for Business Owners Following the 2017 Act

- Partnerships are still often the preferred entity for taking losses due to liberal basis rules.

- Make sure rental real estate is a business and not merely an investment to qualify for the 20% deduction.

- Partnerships are still often the preferred entity for holding real estate or other tangible assets likely to appreciate substantially in value due to liberal loss rules, tax-free distributions, and 754 elections.

Some Practical Tips for Business Owners Following the 2017 Act

- If the 20% deduction will be available and the entity will likely distribute earnings currently, a pass through entity will likely be preferred over a C corporation. Compare a 39.8% overall tax with a C corporation to the 29.6% (or 33.4%) overall tax with a pass through entity.

- If the 20% deduction will not be available and the entity will likely distribute earnings currently, the rate differential alone will often not afford a basis for choice of entity. Compare a 39.8% overall tax with a C corporation to a 37% (or 40.8%) overall tax with a passthrough entity.

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Some Practical Tips for Business Owners Following the 2017 Act

- In the case of any entity that will accumulate profits for reinvestment in the business, a C corporation is often the superior choice. Compare a current tax of 21% for a C corporation to a 29.6%, 33.4% or 40.8% for passthrough owners depending on whether the 20% deduction and/or the 3.8% tax applies.

- In the case of a C corporation that will accumulate profits, beware of the accumulated earnings tax and the personal holding company tax.

Some Practical Tips for Business Owners Following the 2017 Act

- Passthrough treatment will often be desirable in the case of an entity that views an asset sale as its exit strategy because this may avoid a double tax, afford capital gain treatment, and provide buyer a basis step-up.

- If a sale of equity is the contemplated exit strategy and Code Section 1202 treatment might apply to provide a zero percent tax, a C corporation could be the preferred choice of entity.

Some Practical Tips for Business Owners Following the 2017 Act

- An entity intending to use life insurance to fund a restrictive stock agreement now has the C corporation as a viable choice because of the repeal of the corporate alternative minimum tax as a result of the 2017 Act.

- The 2017 Act created an incentive for certain service providers to operate as independent contractors as opposed to W-2 employees because independent contractors can potentially avail themselves of the 20% deduction whereas employees cannot.

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Some Practical Tips for Business Owners Following the 2017 Act

- S corporations will remain the favorable choice of entity in minimizing the 3.8% tax.

- In some cases an S corporation might be the poorer choice for maximizing the 20% deduction because compensation might not be permitted to be unreasonably low.

- In some cases an S corporation might be the better choice for maximizing the 20% deduction because a partnership or sole proprietorship cannot pay W-2 wages to service providers that are also owners.

Some Practical Tips for Business Owners Following the 2017 Act

- The pre-2017 Act practice of C corporations zeroing out income by making deductible payments to owners will now, in many cases, be no better or maybe worse than paying dividends. Compare an owner tax of 40.7% on deductible payments to an overall tax of 39.8% based on a C corporation paying dividends.

- Be careful about converting to C corporation status because the 21% rate could be increased and there could be adverse tax consequences in going back to pass through status.

Some Practical Tips for Business Owners Following the 2017 Act

- Be careful not to incur a tax in converting a C corporation to a passthrough for the 20% deduction because it will expire after 2025 or could be repealed earlier.

- Always remember, each case is a facts and circumstances analysis.

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Income and Estate Tax Planning Under the New Tax Laws

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Changes in Tax Laws by the 2017 Tax Cuts and Jobs Act

Estate, Gift, and GST Taxes

2018 Estate/Gift and GST tax exemption - $11,180,000/person

- Expires January 1, 2026
- Use it or lose it
- Probably no clawback
- No repeal

2017 Tax Cuts and Jobs Act

- Estate, gift and GST taxes are irrelevant to most estates now

- Business as usual for large estates
    - Discount planning and family limited partnerships still effective if structured appropriately (Powell case)

Highest Tax Brackets

- 37% Single ($500,00+)
- 37% Married Filing Jointly ($600,000+)
- 37% Married Filing Separately ($300,000+)
- 37% Trusts ($12,500+)
- 3.8% Net Investment Income Tax (on interest, dividends, rents, royalties, capital gains, and trade or business income that is a passive activity)

Capital Gains/Qualified Dividends

- Long-Term Capital Gains and Qualified Dividends 20% thresholds:
  - Trusts over $12,700
  - Single over $425,801
  - Married filing jointly over $479,000
  - Married filing separately over $239,500
  - Head of household over $452,400

Income vs. Estate Taxes

- Even before imposition of state income taxes, top rates are effectively 40.8% for ordinary income and 23.8% for long-term capital gains

- Highest income tax rate is more than estate/gift and GST tax rate of 40%

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Income Tax Basis Planning

- Avoid gifts of highly appreciated property to obtain basis adjustment at death
- Transfer assets to spouse who is likely to die first (using irrevocable trusts to avoid IRC § 1014(e))
  - Use of LLCs to facilitate the quick transfer of assets to spouse in poor health
- Sell loss property prior to death to realize loss

Basis Planning

- Update revocable trusts to grant a beneficiary of a credit shelter trust or lifetime trust a "formula" general power of appointment for basis adjustment at death
  - Formula adjusts to ensure no federal or state estate taxes will be owed

Basis Planning

- Unneeded Insurance Trusts, Qualified Personal Residence Trusts, Credit Shelter Trusts, and other Irrevocable Trusts
  - Modify irrevocable trust to grant formula power of appointment to achieve basis adjustment but maintain divorce or creditor protection

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Basis Planning

- Upstream Planning
  - Give a parent or person of older generation a general power of appointment over your appreciated assets so you obtain a basis adjustment at the older person's death
  - Limit the power to creditors consented to by a non-adverse trustee

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