WEALTH MANAGEMENT

BUSINESS PLANNING OPPORTUNITIES AFTER TAX REFORM

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The recently enacted tax reform legislation contains a substantial number of business-related changes to the Internal Revenue Code. Here we introduce key provisions of the new law, the potential impact on businesses and opportunities they present to business owners.

This is a condensed version of a detailed article on tax planning that includes helpful charts and graphs. Click here to view the full article.

The new tax laws have answered many of the concerns and wishes of the business community — reducing corporate tax rates, providing business deductions and fine-tuning business-related sections of the tax code. They likely will create opportunities — and some challenges — over the coming months and years that may require businesses to make decisions in a number of different areas.

An important aspect of the new tax law, in our view, is that the majority of the provisions applicable to businesses are meant to be permanent. While a future Congress may decide to repeal or modify the tax laws, the absence of an expiration date may provide business owners with a level of confidence regarding federal taxation rules and allow them to plan accordingly. Below we introduce key issues business owners may want to address, and a number of planning opportunities they may want to discuss with their professional tax and legal advisors.

ENTITY EVALUATION

One of the most frequent questions we have received is, "What is the best entity for my business?" The nontax reasons for choosing an entity structure remain the same. However, changes in the tax code could make this an appropriate time to consider whether a change in entity would be beneficial.

REVISIONS REVISITED

The corporate tax rate applicable to C corporations has been reduced from 35% to 21%, and the corporate alternative minimum tax (AMT) has been repealed. Congress anticipated that a number of S corporations may decide to convert to C corporations and included provisions that provide more favorable tax treatment when a business decides to make this status change.

At the same time, pass-through entities — S corporations, partnerships and sole proprietors — may now take advantage of a new 20% deduction on qualified business income even if the business entity has no wages.

The new tax laws also contain numerous other tweaks to business-related sections of the tax code, many of which likely will benefit businesses in different ways depending on their specific circumstances. Certain qualified professional service corporations — for example, those that provide services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting — will now be subject to a substantially lower 21% tax rate, down from a flat tax rate of 35%.

USING MULTIPLE ENTITIES

Many businesses are structured under multiple entities for various tax- and nontax-related reasons. A real estate developer may segregate projects under multiple limited liability companies (LLCs). A manufacturer may have its buildings and equipment owned by a C corporation while the property on which these buildings are located is owned by a separate S corporation. Changes in the tax law may present additional opportunities to take advantage of multiple-entity structures.

BUY–SELL AGREEMENTS

Business owners may want to review the structures for any proposed buyouts in their buy-sell agreements.

For example, there are a number of tax and nontax reasons a C corporation may prefer a stock redemption buyout agreement over a cross-purchase agreement. However, under the former tax code, a key tax consideration led many owners of C corporations to implement cross-purchase agreements.

A stock redemption buy-sell agreement requires the company to redeem the stock of the deceased owner upon his death. A cross-purchase agreement requires the remaining owners to buy the shares of the deceased owner.

Companies often use life insurance to fund stock repurchases. Prior to the tax law changes, the growth of the cash values of life insurance policies and the death benefit were subject to the corporate AMT. This is no longer the case now that the corporate AMT has been repealed.

ESTATE PLANNING

There is a window of opportunity in which to consider making gifts of family business interests to the next generation free of gift taxes[1]. The estate and gift tax exemption has been doubled from $5 million for an individual and $10 million for a married couple to $10 million for an individual and $20 million for a married couple. With indexing, this means that a married couple may exempt $22.4 million from estate and gift taxes in 2018. In addition, the step-up in basis rules remains in effect and allows the beneficiary of inherited property to adjust the basis of the property to the fair market value at the date of death.

When combined, these tax provisions may result in the avoidance of estate taxes on $22.4 million and little to no capital gains tax when the property is sold by heirs. Prior to modifying estate plans and documents, it is important to recognize that the increase in the estate and gift tax exemption expires at the end of 2025.

The generation-skipping transfer tax exemption has also been increased to $11.2 million for an individual and $22.4 million for a married couple. This may provide an opportunity to make additional contributions to an existing generation-skipping trust, also referred to as a dynasty trust, to benefit grandchildren and future generations.

PROFIT DISTRIBUTIONS

For smaller, closely held businesses that operate as C corporations, it may be appropriate to revisit the method in which profits are distributed from the business. The 14% reduction in the C corporation tax rate and the elimination of the corporate AMT could make it advantageous to change how profit distributions are made.

For example, the question of year-end cash bonuses versus qualified dividends may have a different answer based on the cumulative changes in the tax laws. The tax treatment for qualified distributions has remained unchanged, with the highest rate being 20% (plus 3.8% net investment income tax at higher levels of income). The highest individual tax rate has been reduced by 2.6%, and numerous deductions no longer are available.

1 Under the new law, the Treasury is called upon to prescribe regulations as may be necessary or appropriate to clarify the implications as a result of differences between the basic exclusion amount in effect at the time of the decedent's death and at the time of any gifts made by the decedent.

EXECUTIVE COMPENSATION

The tax law changes are generally favorable for owners of both C corporation and S corporation stock. The new tax treatment of qualified equity grants may provide improved tax treatment for nonqualified stock options and restricted stock units.

This may motivate key employees to request stock ownership as part of their compensation. It is important to take into consideration the nontax implications of granting stock to employees, including minority shareholder oppression laws, increased fiduciary obligations, and other concerns. An alternative would be a phantom stock plan or stock appreciation rights plan. Both provide additional tax-deferred compensation that is tied to the success of the business, similar to direct stock ownership, but without creating additional shareholders.

NONQUALIFIED DEFERRED COMPENSATION

A nonqualified deferred compensation plan allows a key employee to defer compensation, therefore deferring taxation on compensation. Employers typically offer such arrangements to a select group of key employees as part of a comprehensive executive compensation package. One advantage for the employee is the deferral of taxes. The coinciding disadvantage for the employer is the deferral of a deduction for compensation paid. With only a modest reduction in the highest individual tax rates, the decision for the employee to defer compensation has not changed substantially.

However, since corporate income tax rates have dropped, the cost of the deferred deduction has dropped substantially. Now may be a good time to explore whether adding such a plan would be appropriate.

READY TO HELP

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