



TAX REFORM

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C Corporations - The Hottest Tax Shelter

- What a deal:
 - Rate drop from 35% to 21%
 - Consistently lower rates than any other entity form
 - not quite—but starting to compare to 12.5% rate in Ireland
 - Compared to full-rate pass-through taxpayers (at 41%), this cuts their tax rate almost in HALF

- BUT the pitfalls are NOT minor
 - Huge political risk
 - Do you trust Congress?
 - But have we hit “reset” so that it’s hard to see 35% corp rates again? Yes.....maybe

- How do you get money out when you're ready?
 - Salary/bonus? Roughly a 40% net-net tax cost (salary/bonus moves all that income to individual, taxed at individual rate of 40% (37% + 3% FICA))
 - Put family members on the board and pay the board
 - Dividend? Net-net 40% tax rate (corp. 21%, plus shareholder 24% [20% dividend + 4% NII])
 - Loans? Problematic for accumulated earnings tax

- Accumulated Earnings Tax (“AET”)
 - Designed to prevent using C corporations from accumulating earnings with no real business purpose – 20% AET (over and above corp tax) on accumulated earnings
 - Lawyering is critical:
 - Some dividend history is helpful (pigs get fat)
 - Documented business plans (e.g., to acquire a new business) can get you out of trouble here
 - Acceptable business rationale
 - Planned expansion – specific, definite, feasible
 - Payment of shareholder’s estate tax (now a much shrunken justification with the \$11 million unified credit!)

— AET Example:

- \$300 million accumulated by a C corporation with \$300 million of state tax liabilities from failure to file in the other 49 states.
- No AET problem, but plenty of others!

- Personal Holding Company (“PHC”)
 - Old, old, old provisions applying to closely held C corporations
 - Regular corporate tax PLUS 20% of undistributed earnings
 - Designed to prevent using C corporations as “holding tank” for passive investments
 - Special extra tax of 20% if C corp’s dividends, interest, rents and royalties are 60% or more of C corp’s income
 - Texas caveat: oil and gas royalties, overrides and production payments MAY be included here

- Comparison to a pass-through
 - Compare this to the basic tax rate if it were a pass-through:
 - 37% individual rate + 3% or 4% FICA/NII = 41%
 - OR (at best)
 - 29.6% QBI-reduced individual rate + 3% or 4% FICA/NII = 33.6%
 - Compare this to the adjusted rate if you assume a high state tax on pass-through income: 41% individual rate plus extra rate cost of state tax deductibility
 - Conclusion:
 - if you don't qualify for QBI, C corporation rate is no worse on your "take home" pay, and a lot better on the amount re-invested
 - Even if you DO qualify for QBI reduced rate, 34% vs 40% isn't shocking

- For a multi-state enterprise where state tax (assume at 5% gross rate) is now non-deductible, add on several points for the effective tax rate
 - Pass-through
 - If state tax (5% rate) were deductible, the overall tax rate becomes 41% federal + (5% X 65%) = 44.25%
 - Compare that to the new world of non-deductibility: 41% federal + 5% state = 46%
 - OR (at best)
 - Again assuming deductibility of state tax AND QBI-reduced rate: 33.6% + (5% X 65%) = 36.85%
 - Compare that to the new world of non-deductibility: 33.6% federal + 5% state = 38.6%

— C corporation

- Basic federal rate of 21% + deductible state tax paid at corporate level (5% state tax rate X 79%) = 25%
- Pull out ONLY enough to live on, because the reinvested rate is almost free—21% (or 25% if state tax)

- Add in the 1202 features of C corp (qualified small business stock—QSBS)
 - Potentially avoid tax on sale of C corp stock
 - Capped at the greater of \$10 million of gain or 10X basis
 - At its most extreme, potentially then this saves \$50 million basis X 10 = \$500 million (at 24% rates, this saves \$120 million)
 - Requirements:
 - Hold 5 years
 - Less than \$50 million invested in the C corp
 - Any active trade or business except: Services, financial services, brokerage, banking, insurance, leasing, investing, farming, oil/gas, hotel, restaurant

— 1202 Example:

- C corp in a qualifying business with a \$5 million start-up contribution
- Income tax paid at 21% on earnings inside the corporation (but vastly reduced by start-up purchase of 100% bonus deductible equipment), assume \$10 million of taxable income over the 6-year period (costing \$2.1 million in tax)

- Sale of stock in year 6 for \$35 million – meaning 100% exclusion (10 X \$5 million = \$50 million cap on gain exclusion)
 - \$0 cap gain due upon sale BUT
 - Presumably the buyer “haircut” the purchase price by 15% or so to recognize buyer’s loss of basis step-up (and immediate write-off of tangible assets)
 - Thus the net-net to 1202 investors is \$35 million - \$2.1 million tax on operating income = \$32.9 million

- Compare that to a pass-through \$5 million investment with 37% tax rates on operating income, and 24% tax rate upon disposition.
- At a 15% “haircut”, that means the assets are worth around \$41 million, so assume:
 - \$41 million sales price; minus
 - operating tax of 37% of \$10 million; minus
 - tax on sale of (\$41 million sales price – basis of \$5 million invested + \$10 million basis increase = \$26 million X 24% = \$6 million cap gains)
 - EQUALS: \$31.3 million



Partnerships and S Corporations - The Better Tax Shelter

- Top individual rate has dropped from 39.6% to 37%
 - Still have to add the 3.8% net investment income tax and state income taxes
- The big benefit under the new tax law is a deduction equal to 20% of “qualified business income” (“QBI”)
 - So if you get the full 20% deduction, it takes the top income tax rate from 37% to 29.6%
 - That’s a big “if”

- What qualifies as a pass-through?
 - S corporations
 - Partnerships
 - Disregarded entities and sole proprietorships

- Formula for the deduction:
 - The sum of :
 - The LESSER of:
 - 20% of the taxpayer's "qualified business income" and
 - The GREATER of:
 - 50% of the W-2 wages with respect to the business, or
 - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property.
 - And
 - 20% of qualified REIT dividends (i.e., ordinary, not capital gain) plus
 - 20% of qualified publicly traded partnership (MLP) income

- Significance of how ordinary REIT dividends work in the formula for the pass-through deduction
 - Not subject to the limitations based on wages or assets
 - This is a powerful incentive to use REITs

- What's QBI?
 - ordinary income (less ordinary deductions) you earn from a sole proprietorship, S corporation, or partnership
 - QBI does not include:
 - wages earned as an employee
 - capital gain or loss (long term or short term)
 - Dividends (other than qualified REIT dividends)
 - interest
 - QBI includes rental income from real estate – as long as it's a “trade or business”

- QBI also excludes income from a “specified service trade or business” unless you’re under an income threshold (\$315,000 for married filing jointly; phase-out between \$315,000 and \$415,000; no benefit over \$415,000)
 - any trade or business involving the performance of services in the fields of **health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services**, or any trade or business where the principal asset of such trade or business is the **reputation or skill** of one or more of its employees; AND
 - the business of investing and investing management, trading, or dealing in securities, partnership interests, or commodities

- Assuming you have QBI, the deduction is limited to:
 - The LESSER of:
 - 20% of the taxpayer's "qualified business income" and
 - The GREATER of:
 - 50% of the W-2 wages with respect to the business, or
 - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property.

- First factor:
 - W-2 wages are:
 - wages paid to an employee, including any elective deferrals into a Section 401(k)-type vehicle or other deferred compensation.
 - W-2 wages do not include payments to an independent contractor or management fees.
 - So for these purposes, it's advantageous to classify service providers as employees, not independent contractors.

- Second factor: 2.5% of the "unadjusted basis" of "qualified property"
 - Qualified property is
 - any ***tangible*** property, subject to depreciation (meaning land, inventory and depletable assets don't count; not good for upstream oil & gas), that is held by the business at the end of the year and is used at any time during the year -- in the production of QBI
 - but only during the first 10 years after the property is placed in service or, if longer, the depreciation life of the property (e.g., buildings)
 - Unadjusted basis means you don't subtract depreciation or immediate expensing

- Putting this all together: The policy shorthand for what it's helpful to have
 - Wages you pay to employees
 - Tangible assets you've invested in

- **An example:**

A is a 30% owner of ABC, LLC. The LLC produced total ordinary income of \$3,000,000. The LLC paid total W-2 wages of \$1,000,000, and the total adjusted basis of property held by ABC, LLC is \$100,000. A is allocated 30% of all items of the partnership.

A is entitled to a deduction equal to the LESSER OF:

	Total	A's Allocable Share (30%)	20% Deduction
QBI	\$3,000,000	\$900,000	\$180,000

And the GREATER OF:

	Total	A's Allocable Share (30%)	50% Limitation
W-2 Wages	\$1,000,000	\$300,000	\$150,000

or the TOTAL OF:

Total	A's Allocable Share (30%)	25% Limitation	2.5% Limitation	Total
W-2 Wages	\$1,000,000	\$300,000	\$75,000	\$75,000
Unadjusted basis of property	\$100,000	\$30,000	\$750	<u>\$750</u>
Total				\$75,750

Thus, A is entitled to a deduction of \$150,000, the lesser of:

- \$180,000, or
- the greater of:
 - \$150,000 or
 - \$75,750.

- Ideas to consider:
 - Convert independent contractors to W-2 employees
 - Break pieces out from a specified services business
 - Combine components to get W-2 payroll and tangible assets matched up with income

- Other pros and cons on pass-throughs
 - It's always easier to move from a pass-through to a C corp than to move the other direction
 - Pass-throughs are better in a sale scenario, especially with immediate expensing of acquired depreciable assets
 - But state income taxes for pass-throughs are subject to the \$10,000 annual limit at the individual level, which can be a big factor



Additional Changes Worth Knowing

Interest Deductibility Limits

The deductibility of business interest (interest on debt that is associated with a trade or business – not investment interest) is now capped at 30% of adjusted taxable income

What is adjusted taxable income?

- Now through December 31, 2021 adjusted taxable income is essentially EBITDA – taxable income computed without regard to:
 - Non-trade or business income
 - Business interest expense/income
 - Net operating losses
 - The QBI deduction
 - Depreciation, amortization, and depletion
- Changes as of January 1, 2022 to exclude depreciation, amortization, and depletion from the determination above – essentially EBIT

Example

For 2018, Corporation A has \$1,000,000 of adjusted taxable income and \$250,000 of business interest expense

Corporation A can deduct \$250,000 of business interest expense, because it is less than \$300,000, 30% of its adjusted taxable income ($30\% \times \$1,000,000 = \$300,000$)

Interest Deduction Limits

Unused business interest may be carried forward to future tax years, but remains subject to the limits in future years

Example

For 2018, Corporation A has \$100,000 of adjusted taxable income and \$250,000 of business interest expense

Corporation A can deduct \$30,000 of business interest expense, because 30% of its adjusted taxable income is only \$30,000. The \$220,000 of disallowed interest can be carried forward indefinitely

For 2019, the same corporation has \$2,000,000 of adjusted taxable income and, again, \$250,000 of business interest expense

Corporation A can deduct all of the \$250,000 of 2019 business interest expense and the remainder of the \$220,000 2018 carried forward business interest, because such aggregated amount is less than \$600,000, 30% of its 2019 adjusted taxable income ($30\% \times \$2,000,000 = \$600,000$)

Partnership Limitation

For partnerships the determination and limitation applies at the partnership level, not the partner level

Partnership Example

Taxpayer owns an interest in 2 partnerships, each with \$250,000 of 2018 business interest expense.

Partnership X has \$2,000,000 of adjusted taxable income, Partnership Y has (\$10,000) adjusted taxable income.

Taxpayer may deduct only his share of the \$250,000 of adjusted taxable income from Partnership X, even though between the two partnerships there is a net \$1,990,000 of adjusted taxable income. The deduction is determined at the entity level, regardless of a partner's other trade or business activities

Exclusions from the Interest Limitation Rule

- Small businesses are exempt - taxpayers that are not tax shelters (as defined in the Code) that meet the gross receipts test (average annual gross receipts of \$25 million or less)
- Certain other businesses won't have such interest treated as "business interest," the biggest being real property trade or business
 - Includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business
 - Must make an irrevocable election
 - Separate election for each real estate entity (vary for different entities?)
 - Subject to longer depreciation periods following such election: residential goes from 27.5 years to 30 years; nonresidential, from 39 years to 40 years

Planning Opportunities:

- To the extent possible, limit big year to year income fluctuations – can only carry the deduction forward, not backward
- Incur debt at the holding entity level rather than at special purpose entities to ensure the largest pool for determining adjusted taxable income
- Incur large capital expenses prior to 2022 when adjusted taxable income is determined after reduction for depreciation, amortization and depletion

Carried Interest Rules

Carried Interest Rules

Certain recipients of partnership interests will be required to maintain ownership of their interest for 3 years (not the normal 1 year) to achieve long-term capital gains with respect to items that would otherwise be long-term capital gains

Carried Interest Rules

- Applies to both
 - a sale of an interest in a partnership or
 - the partnership's sale of its assets
- The making of an 83(b) election will not impact the above

Carried Interest Rules

The new rule covers applicable partnership interests received in connection with services provided in an “applicable trade or business,” which requires both of the following to qualify:

- Raising or returning capital; and
- Either investing in or developing specified assets: securities; commodities; real estate held for rental or investment; etc...

- Because of a technical drafting issue involving a reference to Section 1222 (the main capital gain section) but not section 1231, which governs gains from real property used in a trade or business, it does not appear that sales of real property held by the partnership for less than 3 years trigger the new rule.
- This drafting glitch does not affect sales of a partnership interest that's a carried interest in a real estate partnership, so sales of the partnership interest in less than 3 years is covered.
- Technical correction coming?

- Who does this impact? – Real estate, hedge funds, and private equity shops
- Who is not impacted? – Profits interest recipients in other operating businesses

- Section 1031 like-kind exchanges now limited to real property
 - Cost segregation studies will be important
- 100% expensing for qualified improvement property
 - Qualified improvement property is intended to mean any improvements to the interior of non-residential real property that do not enlarge the building or improve its internal structural framework (other than elevators or escalators).
 - There's a drafting error that appears to make this not effective for property placed in service in late 2017. Technical correction to come?
- Technical terminations of partnerships (transfers of more than 50% in a 12-month period) eliminated



Questions & Answers

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