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Using Tax Reform to Your Advantage

– Far from Being Made Simpler, But Plenty of Benefits –

Much has been written on the changes in tax law occurring under the Tax Cuts and Jobs Act of 2017 ("TCJ Act"), but little exists on planning under the law because not much guidance has been provided through IRS regulations or notices. New concepts and planning opportunities exist throughout these new laws. Nevertheless, planning to realize the greatest benefits for individuals and families can be broken down into a few key areas. This summary, though far from a comprehensive covering all aspects of tax reform, is intended to highlight the opportunities created and to recommend a process by which individuals and their families can gain the greatest advantage.

Estate Tax

As mentioned elsewhere in this Client Update, the estate, gift, and generation skipping tax exemptions have increased to $11.2 million per person in 2018, effectively eliminating wealth transfer taxes on a $22.4 million estate of a married couple. This doubling of the exemptions, however, isn't so dramatic when one realizes the DOW and S&P 500 have doubled since 2012, the year ending with the last fiscal cliff. These exemptions have just kept-up with market valuations. Like under the W. Bush 2001 tax reform, the increase is indexed for inflation and is temporary, as a result of the legislative reconciliation process that forces a 10 year budget window. The increased exemption will sunset and will present us with a "fiscal cliff" in 2025, after which the exemptions return to pre-2018 levels. This assumes there is not a dramatic change in our government, such as could occur with the Democrat platform that seeks to decrease the exemptions to $3.5 million and eliminate many of the estate planning strategies that exist today. The soonest this could occur is in 2021. Therefore, using the exemptions and locking them in prior to change by a new Administration or before 2026 will be the focus of most estate planning. For clients with larger estates, using the exemptions and leveraging them to accomplish more robust wealth transfers will be the focus, by using traditional tools such as family limited partnerships, intrafamily sales, qualified personal residence trusts ("QPRTs"), grantor retained annuity trusts ("GRATs"), and others. At a base level, most planning will focus on transferring wealth to trusts in such a way that exemptions are locked-in, while access remains available.

Existing estate plans should be reviewed for the effect of the increase in the exemptions. For example, many estate plans use the exemption of a deceased spouse to create an exempt trust, commonly referred to as a family or credit shelter trust. Some plans transfer this share to children or others. With the rise in the exemption, this type of formula or plan could inadvertently transfer needed resources away from a surviving spouse or otherwise impose unintended restrictions.

Process: Estate plans should be reviewed for the impact of the TCJ Act and what opportunities to utilize the increased exemptions exist in a client's particular circumstances. Three tax exemptions have been increased to the $11.2 million level- estate, gift, and generation skipping. While alive, only two really matter- the gift and generation skipping exemptions. What is not used during life will automatically be applied at death, unless altered before then by legislation. These exemptions should be preserved before they potentially expire, and preservation can best be achieved through a number of opportunities that commonly exist. Thus, the process is a simple review of existing estate plans and related legal documents, projection of one's estate tax exposure, and implementation of the opportunities presented.

Income Tax

Individual rates remain subject to seven progressive rates starting with 10% and topping out at 37% on amounts over $500,000 ($600,000 for married joint filers). An approximate rate reduction of 3% occurred across most thresholds, while thresholds for increased rates also have risen effectively reducing the rate of tax at the margin for most individuals. However, the 3.8% net investment income surtax that applies to capital gains, portfolio investments, and passive types of income remains. The personal exemption and many itemized deductions have been eliminated or are phased-out. The most significant phased-out exemptions are the interest deduction on mortgages in excess of $750,000 and state level income and property taxes exceeding $10,000. The deductibility of interest on home equity loans is no longer available, even if used for home improvements. Personal investment expenses are also eliminated. But, the medical expense deduction has been liberalized and is now deductible to the extent medical expenses exceed 7.5% of AGI for 2018 and 2019, after which it reverts to 10% as exists under prior law. The thresholds for application of the alternative minimum tax and the phaseout of those exempt levels has also been increased. The net result is that most taxpayers, except those with large interest and state tax expenses, will see a tax reduction in 2018 through 2025. Taxpayers resident in New York, California, Connecticut and other high tax states may see higher taxes, and those that do may become motivated to seek a change of tax residence and domicile. The lost state income tax deduction will not affect taxpayers otherwise subject to the alternative minimum tax.

One of the unique aspects of the TCJ Act, which has largely been ignored, is the significant reduction in the marriage penalty. The marriage penalty refers to the fact that the joint brackets are not double the single brackets. Under prior law, a married couple with taxable income of $100,000 would face higher rates than two single taxpayers making $50,000 each. Under the TCJ Act, a married couple does not experience a marriage penalty if their joint taxable income is less than $600,000. All joint brackets, except the 37% bracket, are double the single brackets. This benefit dissipates with those having taxable income above $600,000 and is exacerbated by the loss of itemized deductions, particularly of those living in high tax states where an actual tax increase could be experienced. Again, taxpayers resident in New York, California, Connecticut, and other high tax states will be encouraged to seek a change of tax residence and domicile.

Process: In essence, a review of income sources and sources of expenses should be undertaken. As will be seen further below, incurring expenses in different entity structures or realizing income from reconstructed activities may present income reduction and shifting opportunities. It may also encourage the reorganization of holding company type structures, to separate real estate activities from portfolio investments. For those not tax resident in Florida, the feasibility of a change in tax residence is not a difficult process. Individuals who previously filed separately because of the marriage penalty should explore filing jointly. Regulations have not been issued by the IRS on most of these changes of law, but opportunities abound. For example, what now may be nondeductible itemized deductions may be susceptible to qualification for deduction in trusts or business entities.

Businesses and Real Estate

A principal goal of the TCJ Act was reduction of the corporate tax rate from 35%, which was one of the highest levels in the World. With some compromise, the TCJ Act passed a 21% corporate tax rate. This makes U.S. corporations a tax shelter, with the highest rate 26% lower than the highest individual tax rate (37%) and lower than the rates in many other countries. However, for U.S. corporations with U.S. shareholders, a generally unavoidable double tax is incurred on distributions of profits from corporations- once at the corporate level and then at the shareholder level. As a result, most family owned businesses in the U.S. are pass-through entities (S corporations, partnerships, or LLCs) designed to eliminate the double tax consequences of operating business as a regular, often called "C", corporation. The tax on passthrough profits is born by the owners or shareholders. So as not to eliminate small businesses from the intended encouraging effects of tax reform, the TCJ Act enacted a new statute aimed at providing business owners with a tax benefit through a deduction. Under new Code Section 199A, individuals, trusts, and estates are entitled to deduct 20% of their distributable share of business income from passthrough entities. In essence, this means the highest marginal tax rate on passthrough profits is 29.6%. However, this 20% deduction is subject to limitations, which are discussed further below.

In addition to 199A, the TCJ Act increases the threshold of full deductibility and expands the line of "qualified property" subject to the rule. This new rule applies to purchases occurring after September 27, 2017. Cost recovery through depreciation has also been enhanced by shortening depreciation periods and expanding the types of real property and components of real property. In general, the TCJ Act provides a number of features that encourage investment in real property, whether directly or through various types of entity structures.

New Code Section 199A provides a deduction associated with income, and cannot therefore create a loss on its own. Historic limitations on the ability to deduct losses from business operations remain, and basis, at-risk, and passive loss limitations remain. The TCJ Act does, however, provide a change to net operating loss ("NOLs") rules. After 2017 and before 2023, NOLs may only offset 90% as opposed to 100% of taxable income. Furthermore, an individual, trust, or estate may only use up to $250,000 ($500,000 for married couples filing jointly) of the NOL in the year incurred, with the excess is carried forward. In future years the NOL is limited to 90% of taxable income through 2022, and to 80% thereafter.

Much planning will likely focus on 199A and securing the 20% deduction. This is because there are tiers of limitations and phase outs if ones taxable income is over $157,500 (or $315,000 if married filing joint). If these thresholds are exceeded, the "deductible amount" is limited to the greater of 50% of W-2 wages or 25% of W-2 wages, plus 2.5% of the original cost of qualified property. The amount of the deductible amount that a given taxpayer may use is further limited to (1) the lesser of (a) the taxpayer's qualified business income or (b) 20% of the taxpayer's taxable income less net capital gain, plus (2) the lesser of (a) 20% of qualified income from various types of real estate investments (including REIT dividends) or (b) the taxpayers taxable income reduced by net capital gains for the year.

Process: Evaluating the ability of an individual to benefit from the TCJ Act's business provisions will involve a study of the various current and potential sources of income and where expenses should be incurred. Long term business expansions and growing businesses, where earnings will be retained, may best be organized or reorganized as regular "C" corporation's to gain the advantage of the 21% corporate tax rate. Where cash flow to shareholders is a priority, sheltering the corresponding income flowing from passthroughs will be a priority. Shelter occurs with deductions, and historically deductions involve expenses, whether from actual expenditures or paper cost recovery from depreciation and amortization. Code Section 199A introduces a new and creative type of deduction that is generated from income and not an expense. Generating this type of income essentially means business and real estate income that is qualified is partially tax free, in a sense like a partially tax exempt municipal bond. Planning will involve attempting to have otherwise nondeductible itemized deductions expensed in business entities and reorganizing holding companies and others to take advantage of the deduction associated with qualified income. Furthermore, REITs and other forms of real estate investments should see an increase in demand. In this regard, since the enactment of these provisions, many REITs have seen a significant rise in their market values.

Note: The above is a summary and not reflective of all provisions of the TCJ Act. It is meant to provide our typical client with a general understanding of the TCJ Act in advance of our new Client Update, which is anticipated in mid-January 2018. Please contact us with any questions or comments.

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