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Planning under the new tax law: relax

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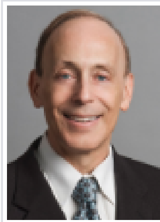

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Thousands of articles have been written suggesting how to restructure your life under the Tax Cuts and Jobs Act President Donald Trump signed on Dec. 22. Tax professionals are sending newsletters and emails inviting clients to review their business and estate plans in light of the new law.

Relax. It is too soon to make thoughtful decisions. We will have better ideas and more refined analyses in 30, and even 60, days. There is no rush. The first deadline is March 15, the last day by which you must revoke an "S" election to have it effective for Jan. 1, 2018.

There are obvious winners under the new tax law. Many are due to the non-deductibility of state and local taxes (SALT). California has, in the maximum income tax bracket, a state tax of 13.3 percent. Previously, after the deduction against federal tax, that was roughly 8 percent. Now it is a full 13.3 percent, an increase of over 5 percentage points and the new tax is 66 percent higher than the old rate.

Cash value life insurance is a winner. Even though the premiums are not deductible, the ability to borrow the cash value and not pay income tax on the loan is an even greater benefit now than before. Of course the premiums must be paid to avoid classification as a MEC (modified endowment contract), but that is easy to do. For those who have the ability to pay $1 million per year (and often less) for five years, PPLI (private placement life insurance) will be attractive: PPLI now has access to over 200 IDFs (insurance dedicated funds) offered by investment banks and hedge funds.

Another big winner due to the elimination of the SALT deduction is the use of a NNG (Nevada non-grantor trust). Under the laws of other states these are called WNGs and DNGs (for Wyoming and Delaware). The California Franchise Tax Board does not like the use of a nonresident, irrevocable, non-grantor trust to avoid California income tax. However, if thoughtfully prepared and properly used, this structure should work. What is a good situation? You plan to sell the stock of your California corporation in three to five years. What is a bad situation? You are negotiating with a buyer and the deal will close in the next six months.

Yet another big winner due to the elimination of the SALT deduction is the creation of Nevada corporations to engage in part of the business previously done by a California corporation. Joe owns Joe, Inc., an S corporation, which sells $10 million of widgets from a Valencia office park, netting $2 million per year. Fifty percent of the sales are to Californians and 50 percent are to people outside California. The business occupies 5,000 square feet, but must expand. Joe locates a 5,000 square foot building in Reno, Nevada, for $500,000. He moves the non-California operations to Reno. The California tax savings completely pay for the building in five years. Compare the taxpayer victory in Daniel V Inc. v. California Franchise Tax Board, BC457301 (Feb. 6, 2013).

An important facet of the new tax law is the 20 percent deduction of "qualified business income" available to pass-through businesses. New Internal Revenue Code Section 199A. We have a lot of thinking to do about how best to use this deduction. However, one point is clear: If the business, owned by a married couple, has $315,000 or less of taxable income, it will be entitled to the full 20 percent deduction. So, if Mom and Dad, ages 60 and 65, have a business with $715,000 of what would otherwise be taxable income, the business will adopt a defined benefit pension plan which will require a $400,000 deductible contribution to reduce the taxable income to $315,000. So, pension plans will be a big winner under the new tax law.

Many corporations will revoke their "S" election and become C corporations, and many unincorporated businesses will become C corporations. However, that decision will require a careful, long-term analysis. Since we have until March 15, 2018, to make a decision retroactive to January 1 (for existing corporations), there is no need to rush. Which business is a good candidate? First, one which must accumulate a lot of capital, e.g., to increase its inventory, to handle for increased accounts receivable. Second, the business is unlikely to be sold in the next decade or two. Third, the owner does not need to withdraw the earnings that are being accumulated. If either of the last two points is untrue, the same problem with C corporations that is true under old law will be true under new law. That problem is the so-called "double tax": a tax at both the corporate and shareholder level.

Virtually all buyers of closely held businesses buy assets, not stock. Why? Fear of liabilities that run with the stock. Assume the C corporation's assets have a zero basis to the corporation and the shareholder has a zero basis in his stock. Under old law the corporation would have a tax of $420,000 on the $1 million asset sale and the remaining $580,000 would have been taxed at roughly $200,000 (state and federal) to the shareholder. The shareholder would have netted approximately $380,000, for a combined effective tax rate of 62 percent. Under the new tax law the corporate tax would be $300,000, leaving $700,000 to be taxed to the shareholder, whose tax would be about $230,000, leaving about $470,000, for a combined 53 percent effective rate, a significant improvement over old law, but still much more than a single level of tax of tax (33.3 percent).

There will be winning strategies under the new tax law. However, there is no need to rush in during the first week of January. Patience is a virtue.