RAYMOND JAMES

Tax planning: Businesses

Understanding how the tax law affects businesses

Given the complexity of changes to the tax code in the United States, there is much to consider in determining the impact tax legislation will have on businesses, and by extension their owners and executive decision-makers.

OVERVIEW

Passed in late 2017, tax-reform legislation made sweeping changes to the tax code in the United States, including changes to individual and corporate income tax rates. Known as the Tax Cuts and Jobs Act, the legislation first took effect in 2018.

The law includes tax-rate cuts for corporations and pass-through businesses, and eliminates many business deductions. The Alternative Minimum Tax (AMT) for corporations was eliminated. Also, numerous changes affect multinational businesses.

While many of the provisions affecting individuals and pass-through businesses are set to expire on Jan. 1, 2026, those affecting corporations, including dramatic tax-rate cuts, do not have expiration dates. So, as business owners and executives make strategic decisions based on the tax law, it is important to consider any applicable time frames.

PASS-THROUGH BUSINESSES

TAX LAW CHANGES

Pass-through entities – S corporations, partnerships, LLCs and sole proprietorships – still can pass income through to their individual owners. Previously, those individuals paid income tax on business income at individual rates. Under the legislation, individuals, as well as trusts and estates, may generally be able to deduct 20% of pass-through business income. The balance, including wages, will be taxed at individual rates up to a top tax rate of 37%, thus reducing the effective marginal tax rate to no more than 29.6%.

Individuals below certain income thresholds are eligible for the full 20% deduction. However, for certain service businesses above the threshold, the deduction is disallowed. And for non-service businesses exceeding the income threshold, the deduction is subject to specific limitations.

New entrepreneurs: For individuals contemplating starting a business, the lower effective tax rates could improve future financial projections and make entrepreneurship more attractive.

IMPORTANT TOPICS

Rethinking entity types: Before the legislation, pass-through entities were generally viewed as the most tax-efficient structure. However, despite the 20% deduction, pass-through businesses now have a top tax rate of 29.6%, which is no longer lower than C corporations. The difference between the maximum corporate and individual tax rates (21% vs. 37%) versus the maximum effective rate of 29.6% (net of the 20% pass-through deduction) may be significant enough for existing businesses to reevaluate their business structures.

TAX PLANNING

Deduction benefits: Owners of small businesses operating as pass-through entities should consult with their tax advisors to see if they could take advantage of the 20% deduction on qualified business income.

Deduction limits: The limitations on qualifying for the 20% deduction may cause some pass-through businesses, such as specified service trades, to reconsider becoming a C corporation.

C-status appeal: Business owners should discuss with their tax advisors whether it makes sense to convert their entity type from a pass-through to a C corporation. The 20% pass-through deduction is set to expire after 2025. In contrast, the corporate tax-rate reduction in the law is permanent. Also, owners of businesses, such as S corporations, partnerships and even sole proprietorships, may want to consider whether C corporations are now more favorable, in light of the 21% flat rate and the repeal of the corporate Alternative Minimum Tax (AMT).

Breaking apart pass-through entities: Pass-through business owners should discuss with their tax advisors the possibility of dividing into multiple pass-through entities. Factors include more favorable real estate and depreciation rules providing accelerated deductions, as well as transaction costs, tax consequences and the potentially temporary nature of tax law changes.

REITs and MLPs: Real estate investment trusts (REITs) and master limited partnerships (MLPs) qualify for the tax reduction associated with small businesses and pass-through entities. People with pass-through businesses should discuss with their tax advisors whether purchasing and holding interests in MLPs and/or REITs in their businesses could produce tax savings.

Business retirement plans: The reduced net tax rate on pass-through income may affect how business owners view retirement investing. Marginal tax rates for pass-through business income, especially after the 20% deduction, could be lower than rates they will face in retirement when drawing down their tax-deferred retirement plans. One strategy for small business owners to consider is making sure their company 401(k) plans have a Roth option.

NON-PASS-THROUGH BUSINESSES

TAX LAW CHANGES

The maximum income tax rate for C corporations was reduced from a top rate of 35% to a flat rate of 21%. As noted above, pass-through entities are taxed at individual rates up to 37%, but when the potential 20% pass-through deduction is considered, some pass-through businesses will have a top tax rate of 29.6%.

Although the Alternative Minimum Tax (AMT) for individuals was retained and modified, the corporate AMT – applicable only to C corporations – was repealed completely.

TAX PLANNING

Conversion to S corporation: Business owners might consider converting from a C corporation to an S corporation or other pass-through entity to take advantage of the 20% pass-through deduction.

C corporations and SALT deduction limit: The state and local tax (SALT) deduction remains available to C corporations without the limitations imposed on individuals.

Thorough C analysis: Any analysis should take into consideration the double taxation of C corporations when making dividends to shareholders, the potential for trapping appreciated property in a corporation, and the sunset provision of the pass-through rules scheduled for Jan. 1, 2026.

Business retirement plan: The reduced net tax rate on C corporation income may affect how business owners view retirement investing. The 21% flat rate applicable to C corporation income could be lower than rates owners will face in retirement when drawing down their tax-deferred retirement plans. One strategy for small business owners to consider is making sure their company 401(k) plans have a Roth option.

C corporation investment in taxable bonds: Given the reduced tax rates for individuals and corporations under the legislation, higher income individuals with a closely held C corporation should consider the tax-efficient alternative of investing in taxable interest-bearing bonds within the corporation, rather than in an individual account. By the time the interest income is paid out as a taxable dividend, the effective tax rate could be lower than if the bonds were held in an individual portfolio.

PUBLIC COMPANIES

TAX PLANNING

Deduction limits: The legislation modified existing limitations on deductions for excess compensation for certain employees of publicly traded companies and non-public companies with publicly traded debt. Increased limits likely will result in the loss of some of the tax advantages of performance-based compensation, and may even cause some companies to reevaluate their executive compensation programs. Regardless, it's possible many companies will nevertheless retain performance-based compensation programs for other reasons, including the effectiveness of linking executive compensation to company performance.

Executive compensation agreements: Public companies should immediately begin to review their compensation arrangements to determine which will be affected by the legislation, and they should exercise caution before making any modifications to pre-existing executive compensation plans.

Performance-based compensation: Due to repeal of the performance-based compensation exception to the limit on deductibility, companies may award more compensation that is not based on achievement of objective performance goals. Salaries may increase, and other compensation may be tied solely to continued service and/or to more subjective performance goals.

NON-PUBLIC COMPANIES

TAX PLANNING

Publicly traded debt: Corporations that have no publicly traded equity but do have publicly traded debt should review their executive compensation programs in light of the deduction limitations for excessive compensation applicable to public companies.

Performance-based compensation: Due to repeal of the performance-based compensation exception to the deduction limit, non-public companies with publicly traded debt may award more compensation that is not based on achievement of objective performance goals. Salaries may increase, and other compensation may be tied solely to continued service and/or to more subjective performance goals.

Potential opportunity for employees: Qualified equity grant rules allowing private company employees to defer income recognition on certain stock options and restricted stock units could present a tax-planning opportunity. While this provision may see limited application for several reasons, private companies should consult with their tax advisors to see if employees can benefit from the new Section 83(i) deferral election.

TAX-EXEMPT ORGANIZATIONS

TAX LAW CHANGES

A permanent 21% excise tax applies to nonprofit employers for compensation exceeding $1 million paid to their five highest-paid employees. This excise tax is not an income tax, but rather an indirect tax that is paid by the employer, not paid directly by the employee. This tax also applies to some severance and parachute payments.

TAX PLANNING

Excise tax: Organizations with highly paid executives or employees may immediately look to curb individual annual compensation to amounts below the $1 million limit, as well as restructure severance agreements to avoid triggering the 21% excise tax.

Compensation agreements: Organizations should review their executive compensation arrangements in the light of the 21% excise tax and determine whether modifications in executive compensation are needed and possible.

MULTINATIONAL BUSINESSES

TAX PLANNING

Taxation of overseas income: Previously, U.S. companies were subject to tax on all profits, no matter where earned, under what is referred to as a worldwide system of taxation. The legislation switches from a worldwide to a modified territorial system, in which U.S. companies would pay tax only on profits earned in the United States. Representatives of these businesses should consult their tax and legal advisors regarding tax planning.

Repatriation of offshore profits: As a result of converting to a territorial system, the legislation deems all currently deferred offshore corporate profits as repatriated and imposes on them a one-time repatriation tax at rates of 15.5% for profits held in cash or cash equivalents, and 8% for reinvested foreign profits. This tax can be paid in eight annual installments. Representatives of these businesses should consult their tax and legal advisors regarding tax planning.

LIFE INSURANCE

Businesses and their representatives should consult their tax and legal advisors to discuss how the tax legislation will affect life insurance planning.

Funded corporate buy-sell agreements: Due to changes in individual and corporate income tax rates, business owners should consider reviewing insurance-funded buy-sell arrangements, as the assumptions underlying the original plan may have changed. Previously, funded buy-sell agreements where there were numerous C corporation shareholders steered clear of the redemption-style buyout, in part because of the corporate AMT, and instead looked to cross-purchase trusteed agreements. With the corporate AMT gone, it may be worthwhile to re-evaluate redemption agreements.

Corporate policies: Plans involving life insurance premium payments by corporate employers should be reviewed because of the significantly reduced corporate tax rate and the repeal of the corporate AMT. Life insurance death benefits, such as from key person policies, payable to C corporations may be more efficient.

Tax savings reinvestment: Since tax relief for many corporations and pass-through businesses should result in more cash on hand, they may want to consider allocating more resources to other assets and programs, including business continuation plans, key person executive benefit programs, such as nonqualified deferred compensation and split-dollar plans, as well as the permanent funding of buy-sell arrangements.

Short-term premiums: Since the 20% deduction for pass-through businesses is scheduled to expire after eight years, business-related policies could be fully funded with premiums paid over terms such as five or seven years.

Outdated policies: One option is to just cancel a policy. Another is to surrender the policy, such as by selling it back to the issuing carrier. However, a more practical alternative to canceling or surrendering old cash-value policies could be a life settlement, where the policy is sold to someone other than the issuing company. Generally, life settlements are available for insureds age 65 or older. Basically, the legislation modified the tax-reporting rules for life settlements, making it easier to calculate the taxable gain, if any, from a settlement. That should make it more attractive for qualified individuals to dispose of an unnecessary policy and maximize the sale proceeds.

OTHER CONSIDERATIONS

Carried interests: Companies engaged in the business of capital investment and related activities that grant profits interests to individuals in exchange for services provided should consider that disposition of those interests within three years of grant generally results in short-term capital gain treatment for the recipient service provider. Companies may wish to take steps to increase the likelihood that these interests will be held for at least three years before a sale, so the individual service providers will obtain the benefit of long-term capital gain tax rates. Companies may want to consider less complicated forms of incentive compensation, even if they don’t produce income taxed at preferential rates.

Capital investment: Businesses should consider taking advantage of the 100% bonus depreciation provision, applicable from 2018 through 2022, which allows businesses to immediately expense in the year of purchase the entire cost of certain business property. Those needing to make capital purchases of up to $2.5 million should consider utilizing the Section 179 expense deduction, which doubled to $1 million beginning in 2018.

Family and medical leave: Businesses can claim a tax credit equal to 12.5% of wages paid to employees who qualify for the Family and Medical Leave Act (FMLA), but only for wages paid in 2018 and 2019, generally. Employers must meet strict requirements to qualify for the credit, and in some situations, this credit can increase to 25% of wages paid. Business should consult with their tax advisors to see if they are eligible for this temporary credit.

2020 UPDATES

PAYROLL TAX DEFFERAL

A key provision of the stimulus bill provides employers the ability to delay the payment of employer payroll taxes until Dec. 31, 2021. At that time, half of the payroll tax will be due with the rest due by Dec. 31, 2022. This is intended to try to alleviate the burden on employers who have struggled to make payroll. This also includes self-employed individuals. Businesses that take out paycheck loans may not be eligible for this deferral.

NET OPERATING LOSS (NOL) CARRY BACK

Businesses will be able to carry back NOLs again, which were allowed prior to the 2017 Tax Cuts and Jobs Act. The NOL carry back option allows businesses to use the losses against prior year income, which helps to reduce prior year income and claim refunds. The 2017 tax act disallowed the option to use an NOL for prior years and only to be carried forward indefinitely (offsetting income in future years).

The CARES Act allows businesses to use their 2018, 2019 or 2020 NOL to be carried back up to five years, which could provide refunds to some businesses needing cash. Another provision changes the amount of the NOL that could be used against income. Under the 2017 tax act, businesses could only use an NOL to offset 80% of taxable income, whereas the CARES Act allows businesses to offset up to 100% of taxable income for 2018, 2019 and 2020.

The CARES Act also removes the 2017 tax act's limitation on business losses for non-corporations. Businesses should speak with their CPA to discuss the use of prior year NOLs or suspended losses.

EMPLOYEE RETENTION CREDIT

The CARES Act provides an employee retention credit for qualified businesses with reduced revenue due to government restrictions in COVID-19. Operations must have been fully or partially suspended and gross receipts (revenue) must have declined by more than 50% compared to the same quarter in the prior year. The credit is equal to up to 50% of qualified wages and up to $10,000 (including health benefits) per employee, resulting in a maximum credit of $5,000 per employee.

There are different stipulations for different business sizes based on qualified wages and number of employees (less than 100 or 100 or more). Any wages used for the new payroll tax credit for family leave or sick leave in previous coronavirus bills or used for SBA paycheck protection program cannot be used.

Another provision includes a temporary increase of limits on business interest expenses from 30% to 50% of adjusted taxable income for tax years 2019 and 2020. This provides higher deductions, which lowers taxable income.

Let's work together with your tax and legal professionals to determine how the legislation affects you directly.

While we are familiar with the tax provisions of the issues presented herein, as financial advisors of Raymond James, we are not qualified to render advice on tax or legal matters. You should discuss tax or legal matters with the appropriate professional.

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