Tax Bill Passed and Signed into Law: What High Net Worth Clients Need to Know

On December 15, 2017, a final tax bill emerged from a House-Senate Conference Committee and was subsequently put up for vote and passed separately in the House of Representatives and the Senate. President Trump signed the bill into law on December 22, 2017. The bill was titled H.R. 1, and is referred to as "The Tax Cuts and Jobs Act." H.R. 1 was passed via the budget reconciliation process, which required a majority vote of both houses of Congress. The new law is Pub. L. No. 115-97.

The following is a summary of certain issues pertinent to high net worth clients.[1] This is not an all-encompassing summary and is not a substitute for professional tax advice. All clients should consult their tax advisors for specific guidance. We will also provide some initial thoughts on the valuation impact of tax law changes on the closely held business owner, an area that MPI has focused on for many months.

Highlights of the new law include:

1. Estate, Gift & GST Tax

    a. The lifetime credit for estate, gift and GST tax purposes is doubled starting on 1/1/18 to approximately $11.2 million per individual and $22.4 million per couple, and is indexed to inflation annually thereafter. The higher exemption amounts are set to sunset on 1/1/26 like other changes related to personal income taxes.

    b. The step-up in the tax basis of assets to fair market value at death is maintained. This will further increase the importance of the step-up in wealth planning. This may cause some taxpayers and families to be motivated to take action to effectively reverse previous transactions and bring assets back into the gross estate of elder family members. This would enable taking full advantage of the higher exemption and the step-up in basis at death. For some families, the use of general powers of appointment to fully utilize unused and newly available lifetime credit amounts of elder family members may be an option.

[1] Sources for information contained herein include the Conference Report published by the Senate-House Conference Committee; taxfoundation.org; Bloomberg.com; and Forbes.com.

2. Personal Income Tax Rates and Deductions (these provisions expire after 12/31/25)

   a. For individuals, the top marginal rate is 37.0% for income over $500,000.

   b. For married couples filing jointly, the top marginal rate is 37.0% for income in excess of $600,000.

   c. For trusts and estates, the top marginal rate is 37.0% for income over $12,500.

   d. Standard Deduction – increased (nearly doubled) to $24,000 for married individuals, $18,000 for head-of-household filers, and $12,000 for all other individuals.

   e. Personal Exemption – suspended/repealed through 2025.

   f. Child Tax Credit - increases the child tax credit to $2,000 per qualifying child. The credit is further modified to temporarily provide for a $500 nonrefundable credit for qualifying dependents other than qualifying children. For those taxpayers where the credit pushes their tax liability into a negative position, the maximum amount refundable may not exceed $1,400 per qualifying child. These credits are not available for individuals earning over $200,000 and married couples earning over $400,000.

   g. SALT Deduction – taxpayers may only deduct state and local taxes (including property taxes) up to $10,000 when calculating taxable income for federal income tax purposes.

   h. 529 Plans – the IRC will now permit cash distributions from 529 plans up to $10,000 annually to cover expenses for tuition in connection with elementary or secondary public, private, or religious school, and expenses for curriculum materials, online materials, tutoring or educational classes outside of the home from unrelated parties, and educational therapies for students with disabilities.

   i. Capital Gains and Dividends Tax Rates – virtually unchanged save some tweaking given the new tax brackets. The Net Investment Income Tax (or "Medicare Surtax") of 3.8% is preserved.

   j. Medical expenses – the deduction for unreimbursed medical expenses is maintained, but for 2017 and 2018, the threshold is reduced from 10.0% to 7.5% for all taxpayers. Thus, for these years, deductions will be allowed to the extent medical expenses exceed 7.5% of AGI.

k. Mortgage interest deduction for new homebuyers phased out at $750,000 on primary residences only, versus $1.0 million under existing law.

l. Obamacare Mandate is repealed.

3. Corporate Income Tax Rates

   a. Flat 21% tax rate vs. current marginal tax rate structure containing a 35% tax rate on income above $335,000. This implies, for a C corporation based in the U.S. with nominal foreign-sourced income, that their effective tax rate could drop from 38% (including state and local taxes) to 25%. A decrease in the tax rate by 13 points could mean an approximate increase in net income of 21.5%, all other factors held constant. The availability of deductions for interest, depreciation and other items would impact this differential. The corporate tax rate cut is "permanent" (does not sunset) due to the structuring of the bill. This of course does not preclude a future Congress from changing the rate through a new bill.

   b. Repatriation of Overseas Profits: There is a deemed repatriation in the taxable year 2017 of foreign-sourced income previously held overseas. The law specifically calls for treatment of deferred foreign income upon transition to the participation exemption system of taxation, where mandatory inclusion uses a two-tier rate. In exchange for a waiver of dividend taxes, the legislation taxes cash at 15.5%, while "illiquid" assets face an 8.0% rate. The bill approved lists several kinds of assets that will be treated as cash: net accounts receivables; the fair market value of similarly liquid assets, such as personal property actively traded on an established financial market (except for stock in specified foreign corporations); government securities; certificates of deposit; and short-term obligations.

   c. Capital Expensing: The new law permits full and immediate expensing of short-lived capital investments for five years. The Section 179 expensing limitation is raised from $500,000 to $1 million.

   d. Deduction of Interest Expense: The new law places a limit on the deductibility of net interest expense to 30% of EBITDA for four years, and 30% of EBIT thereafter. In a capital-intensive business, EBIT is by definition lower than EBITDA, thus the tax benefits of using debt financing will shrink in 2018 and shrink further in 2022.

   e. NOLs – The law eliminates the ability to carryback net operating losses, and limits net operating loss carryforwards to 80 percent of taxable income.

f. Section 174 amended such that a deduction for research and experimental expenditures is no longer allowed. Such amounts are charged to the taxpayer's capital account and may be amortized over a five-year period. This section does not apply to oil, gas and mineral exploration and certain other property expenditures.

4. Changes Specific to Pass-Through Entities

   a. Subject to various limitations, owners will be entitled to a deduction equal to 20% of their allocable share of business income.

   b. The deduction cannot exceed the greater of (1) 50% of the owner's share of the W-2 wages paid by such business and (2) 25% of the owner's share of the W-2 wages paid by the business, plus 2.5% of the unadjusted basis (original purchase price) of property used in the production of income.

   c. The deduction is available to owners of S Corporations, LLCs, partnerships and sole proprietors except those defined as "specified service trades or businesses" where the owner's income is greater than $207,500 (if filing as single) and $415,000 (if filing as married). If owners are under these income thresholds and generate income from pass-through entities, the deduction is available fully up to $157,500 (if filing as single) and $315,000 (if filing as married), and phases out over the next $50,000 and $100,000 of income, respectively.

   d. "Specified service trades or businesses" are defined as any trade or business activity involving the performance of services in the fields of health, law, 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 or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.."

      i. Notably, trades classified as architecture and engineering were removed from the earlier version of the definition.

      ii. Time will tell whether or not a bifurcated system for the taxation of pass-through entities will give rise to loopholes, increased complexity, blurred lines, classification confusion, or all of the above.

   e. Trusts are eligible for the deductions, unlike earlier versions of the bill.

f. The 20-percent deduction is not allowed in computing adjusted gross income, and instead is allowed as a deduction reducing taxable income. Thus, for example, the provision does not affect limitations based on adjusted gross income. The deduction is available to both nonitemizers and itemizers.

g. The pass-through entity tax deductions are permitted only until 12/31/25.

5. Carried Interest

a. The bill inserts into the IRC a new Section 1061 - Partnership Interests Held in Connection with Performance of Services. This new section provides that, for applicable partnership interests, capital gains previously classified as long-term will be treated as short-term capital gain unless the gains were generated from assets held for more than three years. Short-term capital gains are subject to a marginal federal income tax rate, including the Medicare surtax, of approximately 43.4%. In contrast, current law allows performance allocations (carried interest) generated from the sale of assets held for more than one year to maintain treatment as long-term capital gains, which are taxed at the more favorable marginal federal tax rate, including the Medicare surtax, of approximately 23.8%. A near 20-point increase in the effective tax rate is implied for carried interest generated from gains on sales of assets held between one and three years.

b. The bill will likely affect those hedge funds that have longer-term investing strategies (e.g., activist investors that build large equity positions and seek significant and long-term change through board representation or otherwise), and a meaningful percentage of private equity deals that are harvested in less than three years. A recent Bloomberg article stated that approximately 24% of private equity deals are sold within three years. Some commentators have suggested that the new section does not go far enough, leaving room for most private equity carried interest to maintain treatment as long-term capital gain. That is a policy debate beyond the scope of this summary. It is clear that the effective tax rates of many hedge fund and private equity managers will be meaningfully impacted by this change.

6. Potential Earnings and Valuation Impact

a. C corporations

i. For C corporations, the marginal federal tax rate was just reduced from 35% to 21%. Moreover, taxes are simplified in that the federal rate is now a flat rate of 21%. Other factors that will impact a company's effective tax rate on pre-tax income include the ability to immediately expense short-lived capital investments and limits on the tax deductibility of interest expense.

ii. In the long run, a key question for business owners, executives and analysts will be whether or not tax savings get "competed away." In other words, since after-tax returns on capital are ultimately what are sought, one could imagine in a highly competitive business that any tax savings may be offset by a reduction in prices/revenues. It will be important to consider the impact of tax reform on both the top line and bottom line of the income statement.

iii. For closely held C corporations in New York, New Jersey, Illinois, Florida, or California, before taking into account the impact of the new capital expensing and interest expense rules, excluding local taxes, and assuming all or virtually all income is domestically sourced, we can reasonably estimate the following:

	New York C Corp.	New Jersey C Corp.	Illinois C Corp.	Florida C Corp.	California C Corp.
EBT	100.00	100.00	100.00	100.00	100.00
State (a)	6.50%	9.00%	7.75%	5.50%	8.84%
Federal	21.00%	21.00%	21.00%	21.00%	21.00%
Taxes Payable (b)	(26.14)	(28.11)	(27.12)	(25.35)	(27.98)
Net Income	73.87	71.89	72.88	74.66	72.02
Effective Tax Rate - New	26.14%	28.11%	27.12%	25.35%	27.98%
Effective Tax Rate - Old (c)	39.23%	40.85%	40.04%	38.58%	40.75%
Rate Differential	13.09%	12.74%	12.92%	13.23%	12.76%
Implied Earnings Differential	21.54%	21.54%	21.54%	21.54%	21.54%

Notes: (a) source: taxfoundation.org.
(b) Factors in deductibility of state taxes at the federal level.
(c) Applies same formula above, except uses a 35% federal tax rate.

iv. An important component of a business valuation will be assessing the secondary effects of tax reform, including how businesses will react to new rules regarding interest expense deductions and capital expensing, and whether competition in the pricing of goods and services will offset the benefits of tax savings.

v. The interest expense deductibility cap could be problematic for private equity firms that typically employ a significant amount of leverage to finance buyouts and generate acceptable returns.

b. Pass-Through Entities

i. The impact of the new tax law on pass-through entities will be different from one entity to another, and will depend on a number of factors including where the business is located, owners' wages, and the industry in which the business operates. This is largely due to the formula summarized in paragraph 4(b) above and the rules about those companies classified as engaging in specified service trades or businesses.

ii. For certain non-service businesses, it is conceivable that the effective marginal federal tax rate given the pass-through deduction will approximate 29.6% relative to the stated marginal federal rate of 37%. In other words, if a business owner qualifies for the full 20% pass-through deduction, his or her marginal federal tax rate may be computed as 37% times (1-20%), or 29.6%.

iii. A key valuation consideration going forward will be whether or not a pass-through entity is more advantageous from a cash flow perspective than an otherwise equivalent C corporation.

The above text is a summary of certain issues pertinent to high net worth clients. We will continue our examination of the tax law and provide further insights in due time. For questions pertaining to this topic or further information on MPI's financial, valuation and litigation advisory services, please contact your local MPI representative.

More Information

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