PNC CENTER FOR FINANCIAL INSIGHT

Business Planning Opportunities after Tax Reform

The recently enacted tax reform legislation contains a substantial number of business-related changes to the Internal Revenue Code. Here we introduce key provisions of the new law, the impact on businesses, and opportunities they present to business owners.

PNC Center for Financial Insight℠ builds bridges from thought to action, creating practical, applicable strategies to help benefit you and your family.

Contributing Author:

David Foster, ChFC®, CAP®, FLMI

Senior Resident

The new tax laws have answered many of the concerns and wishes of the business community—reducing corporate tax rates, providing business deductions, and fine tuning business-related sections of the tax code. They will likely create opportunities—and some challenges—over the coming months and years which may require businesses to make decisions in a number of different areas.

An important aspect of the new tax law, in our view, is that the majority of the provisions applicable to businesses are meant to be permanent. While a future Congress may decide to repeal or modify the tax laws, the absence of an expiration date may provide business owners with a level of confidence regarding federal taxation rules and allow them to plan accordingly.

Below we introduce key issues business owners may want to address, and a number of planning opportunities they may want to discuss with their professional tax and legal advisors. (To review key provisions, please see table on page 5.)

Entity Evaluation

One of the most frequent questions we have received is, "What is the best entity for my business?" The nontax reasons for choosing an entity structure remain the same. However, changes in the tax code could make this an appropriate time to consider whether a change in entity would be beneficial.

Revisions Revisited

The corporate tax rate applicable to C corporations has been reduced from 35% to 21%, and the corporate alternative minimum tax (AMT) has been repealed. Congress anticipated that a number of S corporations may decide to convert to C corporations and included provisions that provide more favorable tax treatment when a business decides to make this status change.

At the same time, pass-through entities—S corporations, partnerships, and sole proprietors—may now take advantage of a new 20% deduction on qualified business income even if the business entity has no wages.

The new tax laws also contain numerous other tweaks to business-related sections of the tax code, many of which will likely benefit businesses in different ways depending on their specific circumstances. Certain qualified professional service corporations—for example, those that provide services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or

PNC WEALTH MANAGEMENT

Example 1: Implementing Multiple Entities

The business: A manufacturer that has 100 employees and assets, including equipment and machinery, a large plant, vehicles, and a large parcel of land.

The entity: The owners operate as a C corporation due to the need to attract venture capital in the future.

The opportunity: A late addition to the new tax laws permit the 20% deduction for pass-through entities even if the business entity has no wages but owns substantial qualified properties. The manufacturer may decide to have its real estate owned by a separate pass-through entity to take advantage of the 20% deduction, and continue operating the main business as a C corporation.

consulting—will now be subject to a substantially lower 21% tax rate, down from a flat tax rate of 35%.

Using Multiple Entities

Many businesses are structured under multiple entities for various tax- and nontax-related reasons. A real estate developer may segregate projects under multiple limited liability companies (LLCs). A manufacturer may have its buildings and equipment owned by a C corporation while the property on which these buildings are located is owned by a separate S corporation. Changes in the tax law may present additional opportunities to take advantage of multiple-entity structures.

Buy-Sell Agreements

Business owners may want to review the structures for any proposed buy-outs in their buy-sell agreements.

For example, there are a number of tax and nontax reasons why a C corporation may prefer a stock redemption buyout agreement over a cross-purchase agreement. However, under the former tax code, a key tax consideration led many owners of C corporations to implement cross-purchase agreements.

A stock redemption buy-sell agreement requires the company to redeem the stock of the deceased owner upon his death. A cross purchase agreement requires remaining owners to buy the shares of the deceased owner.

Companies often use life insurance to fund stock repurchases. Prior to the tax law changes, the growth of the cash values of life insurance policies and the death benefit were subject to the corporate AMT. This is no longer the case now that the corporate AMT has been repealed.

Estate Planning

There is a window of opportunity to consider making gifts of family business interests to the next generation free of gift taxes.[1] The estate and gift tax exemption has

[1] Under the new law, the Treasury is called upon to prescribe regulations as may be necessary or appropriate to clarify the implications as a result of differences between the basic exclusion amount in effect at the time of the decedent's death and at the time of any gifts made by the decedent.

been doubled from $5 million for an individual and $10 million for a married couple to $10 million for an individual and $20 million for a married couple. With indexing this means that a married couple may exempt $22.4 million from estate and gift taxes in 2018. In addition, the step-up in basis rules remain in effect and allow the beneficiary of inherited property to adjust the basis of the property to the fair market value at the date of death. When combined, these tax provisions may result in the avoidance of estate taxes on $22.4 million and little to no capital gains tax when the property is sold by heirs. Prior to modifying estate plans and documents, it is important to recognize that the increase in the estate and gift tax exemption expires at the end of 2025.

The generation-skipping transfer tax exemption has also been increased to $11.2 million for an individual and $22.4 million for a married couple. This may provide an opportunity to make additional contributions to an existing generation-skipping trust, also referred to as a dynasty trust, to benefit grandchildren and future generations.

Profit Distributions:

For smaller closely held businesses that operate as C corporations, it may be appropriate to revisit the method in which profits are distributed from the business as the 14% reduction in the C corporation tax rate and the elimination of the corporate AMT could make it advantageous to change how profit distributions are made.

For example, the question of year-end cash bonuses versus qualified dividends may have a different answer based on the cumulative changes in the tax laws. The tax treatment for qualified distributions has remained unchanged, with the highest rate being 20% (plus 3.8% net investment income tax at higher levels of income). The highest individual tax rate has been reduced by 2.6% and numerous deductions are no longer available.

Executive Compensation

The tax law changes are generally favorable for owners of both C corporation and S corporation stock. The new tax treatment of qualified equity grants may provide improved tax treatment for nonqualified stock options and restricted stock units. This may motivate key employees to request stock ownership as part of their compensation. It is important to take into consideration the nontax implications of granting stock to employees, including minority shareholder oppression laws, increased fiduciary obligations, and other concerns. An alternative would be a phantom stock plan or stock appreciation rights plan. Both provide additional tax-deferred compensation that is tied to the success of the business, similar to direct stock ownership, but without creating additional shareholders.

Nonqualified Deferred Compensation

A nonqualified deferred compensation plan allows a key employee to defer compensation, therefore deferring taxation on compensation. Employers typically offer such arrangements to a select group of key employees as part of a comprehensive executive compensation package. One advantage for the employee is the deferral of taxes. The coinciding disadvantage for the employer is the deferral of a deduction for compensation paid. With only a modest reduction in the highest individual tax rates, the decision for

Proceed with Caution

As business owners evaluate the tax law changes, their impact, and the opportunities presented, there are a number of considerations to keep in mind:

- **Not business as usual**—Many of the provisions related to businesses represent significant changes to existing tax laws and will require professional analysis to determine steps that may be appropriate.
- **One size does not fit all**—Many of the provisions related to businesses may apply to specific businesses differently depending on a host of factors. These include the type of entity, for example, C corporation, S corporation, or LLC; the type of business, for example, manufacturing, health services, or construction; wages paid; the value of capital assets held; and others.
- **An unfinished product**—With such comprehensive and complex tax reform, additional guidance, clarification, and direction can be expected. The new law requires the Treasury Secretary to provide guidance on a number of different provisions. In some cases it may be appropriate to delay action until such clarifications have been made.

the employee to defer compensation has not changed substantially. However, since corporate income tax rates have dropped, the cost of the deferred deduction has dropped substantially. Now may be a good time to explore whether adding such a plan would be appropriate.

Summary of Key Tax Provisions Affecting Businesses

The following are key provisions contained in the Tax Cuts and Jobs Act,[2] specifically relating to businesses and business owners.

	Summary of Key Tax Provisions	
Provision	**New Law**	**Effective / Expiration Dates**
AMT (Corporations)	Corporate AMT repealed.	Effective January 1, 2018
Corporate Income Tax Rates **Professional Service Corporations**	Eliminates the graduated corporate rate structure and instead taxes corporate taxable income at 21%. No special rate for professional service corporations previously taxed at a flat rate of 35%.	Effective January 1, 2018
Dividend-Received Deduction	Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations. The amount of the deduction is reduced from 70% to 50% of the dividend received. In the case of any dividend received from a 20%-owned corporation (that is, 20% or more of the stock is owned by the taxpayer), the amount of the deduction is reduced from 80% to 65%. The deduction percentages were reduced to 50% and 65% to reflect the lower corporate tax rate of 21%, resulting in a corporate tax rate on dividends received of 10.5% and 7.35%. Due to the decrease in the corporate tax rate from 35% down to 21%, this change was made to the dividend-received deduction simply maintains the same top tax rate of 10.5% and 7% (for 20%-owned companies) that were currently in place.	Effective January 1, 2018
Expensing of Business Assets	A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization. The new tax laws enhance a number of existing exceptions to this general rule: 100% immediate expensing of qualified property placed in service from September 27, 2017 through December 31, 2022. Changes the definition of qualified property to include used property.	Effective September 28, 2017 Expires December 31, 2027
Business Interest Expense Deduction	The deduction of net interest expense for corporate borrowers is capped at 30% of adjusted taxable income (ATI). ATI equates roughly to earnings before interest, taxes, depreciation, and amortization (EBITDA) from 2018 through 2021, and EBIT after that. The limitation does not apply to real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business or farming business. The cap does not apply to businesses in which the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million.	Effective January 1, 2018

[2] The official title of the legislation is "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," however it is commonly referred to as the Tax Cuts and Jobs Act.

Provision	Summary of Key Tax Provisions	
	New Law	**Effective / Expiration Dates**
Conversion of S Corporation to a C Corporation	In the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account to the amount of the accumulated earnings and profits. Any section 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (for example, a change from the cash method to an accrual method) is taken into account ratably during the six-taxable-year period beginning with the year of change. An eligible terminated S corporation is any C corporation which (1) is an S corporation the day before the enactment of this bill, (2) during the two-year period beginning on the date of such enactment revokes its S corporation election under section 1362(a), and (3) all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment.	Effective December 22, 2017
Expensing under Section 179	The provision increases the maximum amount a taxpayer may expense under section 179 to $1 million, and increases the phase-out threshold amount to $2.5 million. Expands the definition of qualified real property.	Effective January 1, 2018
Like-Kind Exchanges	Preserves the tax-free treatment of like-kind exchanges of real property not held primarily for sale, but does away with such treatment for personal property. Items no longer eligible may include business assets such as planes, automobiles, machinery, equipment, copyrights, franchise licenses, computers, software, or any other asset that is not real property.	Effective January 1, 2018
Business Deductions for Entertainment	No deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation; (2) membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes; or (3) a facility or portion thereof used in connection with any of the above items.	Effective January 1, 2018
Small Business Accounting	Expands the use of cash method of accounting for small businesses by increasing the threshold to $25 million in average annual gross receipts over the last three years, increasing the number of small businesses that may deduct expenses earlier. Also expands the definition of what may be expensed and allows more small businesses to deduct inventory expenses when purchased.	Effective January 1, 2018

Provision	Summary of Key Tax Provisions	
	New Law	**Effective / Expiration Dates**
Employer Credit for Paid Family Leave	New tax credit for employers—The provision allows eligible employers to claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is at least 50% of the wages normally paid to an employee.	Effective January 1, 2018 Expires January 1, 2019
Tax Treatment of Pass-Through Income	Each taxpayer with qualified business income (QBI) from a partnership, S corporation, or sole proprietorship is allowed a deduction equal to 20% of QBI. If the taxpayer's taxable income is above the threshold amount, the deduction is limited based on the business's W-2 wages and/or the unadjusted basis of qualified property. The threshold amount is $157,500 (twice that amount or $315,000 in the case of a joint return), indexed. The deduction is phased out on a prorated basis for a specified service trade or business with taxable income above the threshold amount, with the deduction fully disallowed at taxable income of $415,000 (joint filers) and $207,500 (all others). A specified service trade or business includes, but is not limited to, those in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. Engineering and architecture services are excluded from the definition of specified service trade or businesses. The deduction is available to trusts and estates with QBI as well.	Effective January 1, 2018
Excessive Compensation Deduction Limits	The limit of $1 million deductible compensation paid to covered employees of public corporations remains. The legislation revises the definition of covered employee to include both the principal executive officer and the principal financial officer, and the three (rather than four) most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer). The exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit have been eliminated.	Effective January 1, 2018
Qualified Equity Grants	Provides an opportunity for qualified employees of certain nonpublic companies to defer taxation upon the receipt of stock from the exercise of nonqualified stock options, or when restricted stock units (RSUs) vest. Taxation may be deferred up to five years. A qualified employee is one who is not an individual who first becomes a 1% owner or one of the four highest compensated officers in a taxable year, notwithstanding that such individual may not have been among such categories for the 10 preceding taxable years.	Applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017

Provision	Summary of Key Tax Provisions	
	New Law	Effective / Expiration Dates
Deduction for Work-Related Expenses of an Employee	Previously, unreimbursed business expenses incurred by an employee were deductible, but only as an itemized deduction and only to the extent the expenses exceeded 2% of adjusted gross income. The deduction of all miscellaneous itemized deductions that are subject to the 2% floor has been suspended.	Effective January 1, 2018 Expires December 31, 2025
Employer-Provided Moving Expenses Reimbursement	Repeals the exclusion from gross income and wages for qualified moving expense reimbursements paid by an employer except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order.	Effective January 1, 2018 Expires Dec. 31st, 2025
Estate/Gift/Generation-Skipping Transfer Taxes	Doubles the exclusion amount to $10 million, indexed for inflation starting in 2011 (2018 exclusion of $11.2 million for an individual and $22.4 million for a married couple). IRC Sec. 1014 (step-up in basis rule) is still available, which allows for an adjustment to the basis of property acquired from a decedent to its fair market value upon death. The IRC Sec. 691(c) deduction is still available. This provides an income tax deduction equal to estate taxes paid to reduce income taxes a beneficiary incurs on assets they receive such as qualified plans, IRAs, among others.	The increase in the exclusion amount is effective January 1, 2018 and expires January 1, 2026

For more information, please contact your Wealth Management advisor.

The PNC Financial Services Group, Inc. ("PNC") uses the marketing name PNC Wealth Management® to provide investment, wealth management, and fiduciary services and the marketing name PNC Center for Financial Insight℠ to provide wealth planning education to individual clients through its subsidiary, PNC Bank, National Association ("PNC Bank"), which is a **Member FDIC**, and to provide specific fiduciary and agency services through its subsidiary, PNC Delaware Trust Company or PNC Ohio Trust Company. Standalone custody, escrow, and directed trustee services; FDIC-insured banking products and services; and lending of funds are also provided through PNC Bank. This report is furnished for the use of PNC and its clients and does not constitute the provision of investment advice to any person. It is not prepared with respect to the specific investment objectives, financial situation, or particular needs of any specific person. Use of this report is dependent upon the judgment and analysis applied by duly authorized investment personnel who consider a client's individual account circumstances. Persons reading this report should consult with their PNC account representative regarding the appropriateness of investing in any securities or adopting any investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. The information contained in this report was obtained from sources deemed reliable. Such information is not guaranteed as to its accuracy, timeliness, or completeness by PNC. The information contained in this report and the opinions expressed herein are subject to change without notice. Past performance is no guarantee of future results. Neither the information in this report nor any opinion expressed herein constitutes an offer to buy or sell, nor a recommendation to buy or sell, any security or financial instrument. Accounts managed by PNC and its affiliates may take positions from time to time in securities recommended and followed by PNC affiliates. PNC does not provide legal, tax, or accounting advice unless, with respect to tax advice, PNC Bank has entered into a written tax services agreement. PNC does not provide services in any jurisdiction in which it is not authorized to conduct business. PNC Bank is not registered as a municipal advisor under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act"). Investment management and related products and services provided to a "municipal entity" or "obligated person" regarding "proceeds of municipal securities" (as such terms are defined in the Act) will be provided by PNC Capital Advisors. **Securities are not bank deposits, nor are they backed or guaranteed by PNC or any of its affiliates, and are not issued by, insured by, guaranteed by, or obligations of the FDIC, the Federal Reserve Board, or any government agency. Securities involve investment risks, including possible loss of principal.**

"PNC Center for Financial Insight" is a service mark of The PNC Financial Services Group, Inc.

©2018 The PNC Financial Services Group, Inc. All rights reserved.