Tax Impact

July/August 2018

C corporation vs. pass-through

What's the right structure for your business?

Putting the brakes on spending

Add spendthrift language to a trust to protect assets

Tax cost of divorce set to rise in 2019

Tax Tips

Card, Palmer, Sibbison & Co.
4545 Hinckley Parkway
Cleveland, OH 44109–6009
216.621.6100 fax: 216.621.8025
website: www.cps-cpa.com

"A Tradition of Excellence"
is our guiding principle and our enduring trademark. We are committed to serving clients' needs effectively and efficiently.

C corporation vs. pass-through

What's the right structure for your business?

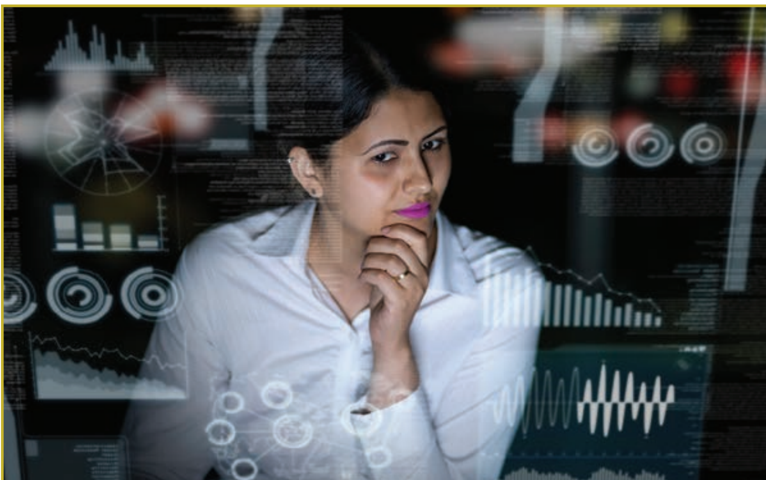
The recent corporate tax cut has many pass-through business owners rethinking their choice of entity. The Tax Cuts and Jobs Act (TCJA) slashed the federal corporate income tax rate to a flat rate of 21% from a top rate of 35%, and eliminated the corporate alternative minimum tax (AMT). Meanwhile, owners of pass-through entities — partnerships, S corporations and LLCs — are taxed on their shares of business income at individual rates as high as 37% (down from 39.6%).

At first blush, it seems that the corporate form offers a substantial tax advantage. Why pay tax at a 37% rate when you can enjoy a 21% tax rate on the same income? Unfortunately, it's not that simple. Let's review some of the factors to consider in determining whether organizing your business as a C corporation would reduce your overall tax burden.

What's your true pass-through rate?

Although the top individual income tax rate is 37%, a pass-through owner's true tax rate may be higher or lower, depending on his or her circumstances. For example, an owner who doesn't materially participate in the business may be subject to an additional 3.8% net investment income tax (NIIT).

Although the top individual income tax rate is 37%, a pass-through owner's true tax rate may be higher or lower, depending on his or her circumstances.



Also, the TCJA created a new "pass-through deduction," which allows owners of certain pass-through entities to deduct up to 20% of their share of qualified business income (QBI) through 2025. The deduction is subject to a variety of limitations and exclusions, depending on the nature of the business and the income levels of its owners. But assuming that a pass-through owner qualifies for the full deduction and that all of his or her income from the business is QBI, the owner's actual pass-through rate will be approximately 29.6%.

What about double taxation?

Even with the benefit of the pass-through deduction, a pass-through entity's effective tax rate is higher than the 21% corporate tax rate. But it's also necessary to consider whether a C corporation's effective tax rate is increased by double taxation. If a C corporation distributes its earnings to its owners in the form of

dividends, that income is taxed twice — once at the corporate level at the 21% rate, and again at the individual shareholder level at rates as high as 23.8% (the 20% qualified dividend rate for high-income taxpayers plus the 3.8% NIIT). Double taxation results in an effective tax rate in excess of the top 37% bracket for individuals.

Some C corporations can defer double taxation by paying out earnings to owners in the form of salaries and benefits or by reinvesting earnings in the business. Note, however, that the accumulated earnings tax (AET) and the tax on personal holding companies (PHCs) may erase the benefits of retaining corporate earnings under certain circumstances.

What's your exit strategy?

Even if a business is able to operate as a C corporation without distributing its earnings, doing so merely defers double taxation rather than avoiding it altogether. If the business is sold, the sale proceeds will be taxed at the corporate level and then again when distributed to the shareholders. If the owners contemplate a sale of the business in the near term, a pass-through entity may be preferable.

What if the TCJA is repealed or modified?

Although the 21% corporate tax rate is characterized as a "permanent" change, that just means that the rate isn't scheduled to expire or "sunset" in 2026, like many of the TCJA's individual income tax provisions. But that doesn't mean Congress won't repeal or modify some or all of the TCJA's corporate provisions down the road.

It's important to consider the possibility that the corporate tax rate will be increased in the future. If you organize your business as a C corporation or convert an existing pass-through entity into a C corporation, and the advantages of C corporation status are eliminated, converting back to pass-through status may prove to be cost prohibitive.

Will you benefit?

Determining whether your business would benefit by operating as a C corporation is a complex process that depends on a variety of tax and nontax factors. (See "Other considerations" above.) Generally speaking, C corporation status *may* be appropriate if 1) your business doesn't plan to distribute earnings, 2) retaining earnings doesn't raise AET or PHC tax concerns, 3) your owners are ineligible for the pass-through deduction, 4) you don't intend to sell the business in the coming years, and 5) you don't expect the TCJA to be repealed or substantially modified in the foreseeable future. ■

Other considerations

The main article discusses some, but by no means all, of the factors you should consider in determining the ideal structure for your business. Here are some other factors to consider:

- Pass-through entities offer greater flexibility to allocate profit and loss according to criteria other than ownership interests.
- Unlike C corporations, pass-through entities are able to pass business losses to their owners.
- Owners of pass-through entities may be able to command a higher purchase price because the buyer obtains a stepped-up basis in the company's assets.
- For certain types of businesses, such as real estate firms, a partnership or limited liability company is the entity of choice for various tax and nontax reasons.
- Pass-through entities may be better suited for certain estate planning techniques.

Finally, don't overlook the impact of state taxes on your choice of entity.

Putting the brakes on spending

Add spendthrift language to a trust to protect assets

Despite its name, the purpose of a spendthrift trust isn't just to protect profligate heirs from themselves. Adding spendthrift language to a trust benefiting one's heirs can help safeguard assets from their creditors, or in the event of relationship changes.

Effects of spendthrift language

With assistance from an estate planning advisor or attorney, set up the trust according to state laws and transfer assets to the trust account. Generally, the assets will consist of securities such as stocks, bonds and mutual funds, and possibly real estate and cash. The appointed trustee then manages the assets.

Essentially, the terms of the trust — the spendthrift language — restrict the beneficiary's ability to access funds in the account. Therefore, the beneficiary can't invade the trust to indulge in a wild spending spree or sink money into a foolhardy business venture. Similarly, the trust assets can't be reached by any of the beneficiary's creditors.

Essentially, the terms of the trust — the spendthrift language — restrict the beneficiary's ability to access funds in the account.

Instead of having direct access to funds, the beneficiary usually receives payments from the trust on a regular basis or "as needed" based on the determination of the trustee. For example, the trust

might call for two scheduled payments to be made during the year for the fall and spring semesters at the beneficiary's college. The trustee is guided by the terms of the trust and must adhere to fiduciary standards.

Be aware that the protection isn't absolute. Once the beneficiary receives a cash payment, he or she has full control over that amount. The money can be spent without restriction and may be attached by creditors.

Choose a trustee carefully

The role of the trustee obviously is an important one. Depending on the trust terms, he or she may

be responsible for making scheduled payments or have wide discretion as to whether funds should be paid, and how much and when.

For instance, the trust may empower the trustee to make set payments or retain discretion over amounts to be paid or even over whether there should be any payment at all. Or maybe the trustee is directed to pay a specified percentage of the trust assets, so the payouts fluctuate depending on investment performance. In the same vein, the trustee may be authorized to withhold payment upon the happening of specific events (such as if the beneficiary exceeds a debt threshold or has to declare bankruptcy).

Designating the trustee is an important consideration, especially in situations where he or she will have broad control. Although it's not illegal to name yourself as trustee, this is generally not recommended. Often, the trustee will be an attorney, CPA, financial planner or investment advisor, or someone else with the requisite experience and financial acumen.

Be aware, however, that you aren't required to name someone with a particular background. You may prefer to name a relative or friend, who'll then have the responsibility to hire the appropriate professionals. You should also name a successor trustee (or multiple successors) in the event the designated trustee dies before the end of the term or otherwise becomes incapable of handling these duties.

Miscellaneous considerations

There are several other critical aspects relating to crafting a spendthrift trust. For example, you must establish how and when the trust should terminate. The trust could be set up for a term of years, or termination may occur upon a specific event (such as a child reaching the age of majority).

Finally, try to anticipate other possibilities, such as enactment of tax law changes, that could affect a spendthrift trust.

Don't try this at home

For some, protecting their wealth after they've transferred it to loved ones is just as important as reducing the tax liability on the transfer. But beware: Drafting a spendthrift trust isn't a do-it-yourself proposition. Consult your estate planning advisor for assistance. ■

Tax cost of divorce set to rise in 2019

If you're divorced or in the process of divorcing, be sure you understand how the Tax Cuts and Jobs Act (TCJA) affects the tax treatment of alimony. For most couples, the tax cost of divorce will go up next year.

What's changing?

Under current rules, a taxpayer who pays alimony is entitled to a deduction for payments made during the year. The deduction is "above-the-line," which is a big advantage, because there's no need to itemize. The payments are included in the recipient spouse's gross income.

The TCJA essentially reverses the tax treatment of alimony, effective for divorce or separation instruments executed after 2018. In other words, starting next year, alimony payments will no longer be deductible by the payer and will be excluded from the recipient's gross income.

Existing divorce or separation instruments, including those executed during the remainder of 2018, aren't affected. Current rules apply even if an instrument is modified after 2018 (unless the modification expressly provides that TCJA rules apply).

What's the impact?

The TCJA will likely cause alimony awards to decrease for post-2018 divorces or separations. Paying spouses will argue that, without the benefit of the alimony deduction, they can't afford to pay as much as they could under current rules. The ability of recipients to exclude alimony from income will at least partially offset the decrease, but many recipients will be worse off under the new rules.

For example, let's say John and Lori are divorcing in 2018. John is in the 35% federal income tax bracket and Lori is a stay-at-home mom who cares for the couple's two children. The court orders John to pay Lori $100,000 per year in alimony. John is entitled to deduct the payments, so the after-tax cost to him is $65,000. Presuming Lori qualifies to file as head of household, and the children qualify for the full child tax credit, Lori's federal tax on the alimony payments is approximately $8,600, leaving her with $91,400 in after-tax income.

Suppose, instead, that John and Lori divorce in 2019. John argues that, without the alimony deduction, the most he can afford to pay is $65,000, and the court agrees. The payments are tax-free to Lori, but she's still left with $26,400 less than she would have received under pre-TCJA rules.

The current rules essentially shift income recognition from the paying spouse to the recipient, reducing the couple's overall tax liability (assuming the recipient is in a lower tax bracket). The new rules eliminate this tax advantage. Of course, in the event that the recipient is in a *higher* tax bracket than the payer (an uncommon but not impossible situation), a couple is better off under the new rules.

What if you're already divorced?

The new rules won't affect existing divorce or separation instruments, even if they're modified after 2018. However, spouses who would *benefit* from the TCJA rules — for example, because their relative income levels have changed — may voluntarily apply them if the modification *expressly* provides for such treatment.

> ***The TCJA essentially reverses the tax treatment of alimony, effective for divorce or separation instruments executed after 2018.***

Act quickly

If you're contemplating a divorce or separation and would benefit from the alimony deduction, act quickly to ensure that it's finalized before the end of the year. If you're already divorced or separated, determine whether you would benefit by applying the new rules to your alimony payments. If you would, a modification of your divorce or separation instrument may be in order. ■

Tax Tips

Time to revisit the research credit

The Tax Cuts and Jobs Act (TCJA) expands the federal research credit (often referred to as the "research and development," "R&D" or "research and experimentation" credit) to a greater number of businesses. The TCJA didn't modify the credit directly, but it eliminated the corporate alternative minimum tax (AMT) and temporarily increased the exemption amounts and phaseout thresholds for individual AMT, making the credit available to many corporations and pass-through entities for the first time. ■

Does your estate plan have a formula clause?

If your estate plan contains a "formula-funding clause," consider revising it to avoid unintended consequences. These clauses typically fund a credit shelter, or "bypass," trust with the greatest amount that can pass free of federal estate tax, with the excess going to your surviving spouse or a marital trust. The Tax Cuts and Jobs Act increased the gift and estate tax exemption to $11.18 million through 2025, so if your estate is less than that amount a formula clause will funnel all of your wealth into the bypass trust. Depending on the language of the bypass trust, you may inadvertently be essentially disinheriting your spouse. Funding the bypass trust can also trigger a substantial state estate tax bill, if you live in a state with an estate tax.

To avoid this result, use funding provisions designed to minimize both federal and state estate taxes while still achieving your wealth distribution goals. They should be flexible enough to ensure that your trusts are funded properly regardless of future changes in exemption levels. ■

Make the most of the 0% capital gains rate

If you're holding highly appreciated investments, there may be techniques you can use to avoid federal income taxes on the gain. High-income earners pay tax on long-term capital gains at rates of 15% or 20%, plus an additional 3.8% net investment income tax (NIIT), if applicable. But lower-income earners enjoy tax-free capital gains. Currently, capital gains are taxed at 0% for federal income tax purposes until taxable income reaches $38,600 for individuals or $77,200 for joint filers.

One strategy is to give appreciated investments to lower-income parents, children or other family members. Keep in mind, however, that the "kiddie tax" essentially erases the benefits of this strategy if you transfer investments to a dependent child under the age of 19 (age 24 for a full-time student).

Another strategy is to sell appreciated investments during low-income tax years, such as years in which you or your spouse is unemployed or between jobs, or years after you retire but before you turn age 70½ (when required minimum distributions from retirement accounts begin). ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2018 TXIja18

Card Palmer
Certified Public Accountants

Card, Palmer, Sibbison & Co.
4545 Hinckley Parkway
Cleveland, OH 44109–6009
216.621.6100 fax: 216.621.8025
website: www.cps-cpa.com

Card, Palmer, Sibbison & Co. has been serving as a trusted advisor and management consultant to owners and businesses in Northeast Ohio since 1920. We have expertise in both the privately held company and not-for-profit area. As certified public accountants we perform the traditional financial and tax services but also provide a wide array of other business services.

James E. Stroh, CPA : 216-274-3220

Jim is the firm's President. He focuses his practice on providing small business consulting and tax planning. His areas of concentration include manufacturing, construction and personal service corporations. Mr. Stroh has assisted clients in mergers and acquisitions, restructuring for tax planning purposes and small business generational planning. **jstroh@cps-cpa.com**

Daniel S. Gibel, CPA : 216-274-3230

Dan focuses his area of practice in performing small business advisory and assurance services. He devotes time to both closely held businesses and tax-exempt organizations. He has over twenty years experience in consulting with privately held businesses and their owners on issues related to profitability and tax planning. **dgibel@cps-cpa.com**

Arthur P. Ward, Jr., CPA, MT : 216-274-3228

Art is the firm's tax director. Art's philosophy is to be proactive with his clients and guide them through the complexities of the tax code. He serves as a trusted business advisor to his clients who consult him regularly as a source of creative tax-saving strategies, research, and general business counsel. **award@cps-cpa.com**