02 Individual tax planning

INDIVIDUAL TAX PLANNING

Planning for today with your eye on tomorrow

When the Tax Cuts and Jobs Act of 2017 (TCJA, P.L. 115-97) was enacted, it overhauled significant portions of the tax landscape, particularly for individuals and the companies in which they may invest. From an income tax perspective, the change in tax rates along with the shift for some to the standard deduction, may have fundamentally changed the tax planning issues on the table. Additionally, from a transfer tax perspective, the TCJA substantially increased the amount that could be transferred during lifetime or at death (known as the basic exclusion amount (BEA)) creating a window of opportunity for estate planning. However, as many of the provisions of the TCJA are scheduled to sunset at the end of 2025, and revert to back to prior law, it is important to broaden the lens on today's planning and ask important questions to understand the interconnected nature of these potential changes.

This section of the Guide poses a few important questions that may be applicable to achieving your goals in a tax efficient manner. Don't wait for what you may see on the horizon and lose opportunities to plan for today with your eye on tomorrow.

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Basic overview of specific provisions of the TCJA

The TCJA ushered in several new provisions and, consequentially, new tax planning considerations. (For a more detailed background of the TCJA, please refer to the *2019 Essential Tax and Wealth Planning Guide: Individual Income Tax Planning*). You should consult your tax advisor to understand how particular changes may affect your planning. However, for purposes of the tax planning questions posed here, we will concentrate on the implication of a few specific provisions:

Lower overall rates: The TCJA maintained seven individual income tax brackets but shifted the thresholds for the upper brackets. It also reduced the highest tax bracket from the prior level of 39.6% to 37%. In 2025, the 37% tax bracket applies to single filers with taxable income over $626,350 and for married filing joint taxpayers with taxable income over $751,600. The changes to the individual income tax brackets and rates are scheduled to sunset. However, the lower corporate income tax rate of 21% under the TCJA is permanent.

The deduction for domestic qualified business income: To attempt to create parity with the lower corporate 21% corporate income tax rate, the TCJA created a new 20% deduction under Internal Revenue Code* section 199A for certain qualified income from passthrough entities for individuals, estates, and trusts. This provision is scheduled to sunset.

The business interest expense limitation: The TCJA imposed a new limitation on the deduction for business interest expense under section 163(j). Disallowed business interest deductions can be carried forward indefinitely. Certain trades or businesses are exempt from the business interest expense limitation, including those performing services as an employee, certain utility businesses, electing real property trades or businesses, and electing farming businesses. In addition, the limitation does not apply to “small businesses”—those with average gross receipts of less than $25 million over a three-year period. The new business interest expense limitation does not sunset.

* All references herein to “Code” or “section” refer to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

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The excess business and net operating loss provisions: Under section 461(l), the TCJA provided that an excess business loss is not allowed in the current year and is carried forward and treated as a net operating loss (NOL) in subsequent years. While there are broader technical considerations, an excess business loss exists when a taxpayer's aggregate trade or business deductions exceeds the sum of the taxpayer's aggregate trade or business gross income and gain plus a threshold amount, which for 2025 is $313,000 (or $626,000 for a married filing joint return). This provision is eliminated for tax years beginning after December 31, 2028. Additionally, the TCJA altered the NOL ruleset such that, with limited exceptions, NOLs arising in tax years beginning after 2017 may only be carried forward (not back up to two years as under prior law) and NOLs may be carried forward indefinitely (as opposed to up to 20 years under prior law). This provision does not sunset.

The limitation on the state and local income tax deduction: One area of the TCJA that substantially altered planning from a deduction perspective was the limitation of the aggregate of nonbusiness (1) state and local property taxes, and (2) state and local income taxes (SALT) or sales taxes to only $10,000 ($5,000 for married taxpayers filing a separate return). In response to this limitation, many states adopted elective passthrough entity tax (PET) regimes where a passthrough entity elects to make state taxes a liability of the entity and thus pay, which would not be subject to the SALT cap. This limitation is scheduled to sunset.

Bonus depreciation: Under the TCJA, the 100% rate for bonus depreciation has been phasing down in annual increments of 20 percentage points since 2023. (A 60% rate is in effect for 2024, but will be reduced to 40% for 2025, 20% for 2026, and zero for property placed in service after December 31, 2026.) The TCJA also provides that research and development expenditures paid or incurred in taxable years beginning after December 31, 2021, are subject to capitalization over five years for research conducted within the US and 15 years for research conducted outside the US.

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A summary of these and a few other provisions relevant to our discussion is captured below:

	Current law	Upon sunset of the TCJA
Top ordinary income tax rate	37%	39.6%
Section 199A deduction	In affect	Eliminated
Bonus depreciation	Decreases 20% per year from 2023 until completely phased out for property placed in service after 12/31/2026	
Section 461(l) limitation	Applies to tax years beginning before 1/1/2029	Eliminated for tax years beginning after 12/31/2028
Charitable deduction	Cash gifts to public charity offset 60% of adjusted gross income (AGI)	Cash gifts to public charity offset 50% of adjusted gross income (AGI)
Limit on SALT deduction	$10,000	None
Mortgage limitation	$750,000 acquisition indebtedness	$1M acquisition indebtedness +$100,000 home equity
Miscellaneous deductions subject to the 2% floor	Eliminated	Reinstated
Overall limitation on itemized deductions	Eliminated	Reinstated
Standard deduction	2024 - $29,200 married filing joint/$14,600 single 2025 - $30,000 married filing joint/$15,000 single	Reverts to pre-TCJA amounts
Personal exemption	Eliminated	Reinstated

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Tax planning through the lens of potential change

With the potential for such broad change to the tax provisions affecting individuals and the entities in which they invest, several planning questions may arise that do not have simple answers. As you consider these questions, some of the factors may be either unknown or not within your control. For example, you may not be able to control the timing of income received, but you may be able to control the timing of a substantial charitable contribution. Regardless of the unknowns in either law or facts, it is important to remember that reviewing your personal tax situation broadly and committing to thoughtful tax planning today may provide a more tax efficient result.

Thus, as we consider the potential changes on the horizon, what are some of the questions that may be relevant to ask about planning today?

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Question 1:

Income from businesses that are held in a passthrough entity is passed out to the owners and thus subject to individual income tax rates. As noted above, the lower individual income tax rates under the TCJA may sunset and increase to prior rates. Therefore, the owner of a business held in a passthrough entity may ask, "Should I accelerate income before tax rates increase due to the potential sunset of the TCJA?"

Interconnectedness: Effect of accelerating ordinary income prior to sunset

Ordinary income

- Ordinary income taxed at lower rates
- More ordinary income creates less exposure for alternative minimum tax (AMT)—may be important for PET planning
- May create increased state tax liability. Although this may be helpful for PET planning, it may cause the PET deduction to possibly offset lower rate income
- May also increase net investment income (NII) or Self-Employed Contributions Act (SECA)

Deductions

- Increased income may allow for increase in the qualified business income deduction and increased adjusted taxable income (ATI), which may assist in avoiding the limitation on deducting business interest expenses
- But deductions may offset lower rate income
- Higher adjusted grow income (AGI) base provides opportunity for increased amount of charitable contributions at a 60% AGI limitation
- Be mindful of what character of income would be offset by controllable deductions
- Increased income may allow for PET planning

Other considerations

- Accelerating income may cause implications for deducting excess business losses in future years
- Cash flow implications
- Large asset acquisitions (e.g., an airplane)
- Market conditions
- Interest rate environment

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Question 2:

Many tax and non-tax reasons affect the decision about what type of entity should be used for a closely held business. Considering the potential for change in some of the relevant tax factors, how does that affect the overall decision regarding the choice of entity to use?

Choice of entity and addressing entity conversion considerations: Key provisions to consider

Considering the potential for many changes if the TCJA sunsets, if you have an existing buiness venture or are contemplating a new one, then you may be motivated to reconsider the structure of the business. However, it is important to think through a wide variety of consequences, including the tax consequences, before making a conversion.

Consider, for example:

- the entity's likely future distributions policy,
- the likelihood and potential timing of a sales transaction as the exit strategy, and
- whether such a sale is likely to be an asset sale or a sale of an equity interest

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Sample considerations for analyzing a conversion from passthrough to C corporation:

- Annual distributions—now and into the future
- Qualification for section 199A deduction
  - o US-sourced vs. non-US sourced income
  - o Qualified Business Income (QBI)
- Character of income recognized
  - o Long term capital gains and qualified dividends
  - o Section 212 portfolio deductions
- Owners of the company
- Growth of the business assets vs. growth of cash distributed
- Section 351 considerations
- International considerations
  - o Structure
  - o Foreign tax credit planning
  - o Certain gain recognition provisions such as overall foreign loss recapture and section 367
  - o Impact on dual consolidated loss rules
- Potential future changes in tax law
- Carryforward attributes of partners
- Accumulated adjustments account distribution planning for terminated S corporations
- Estate planning
- Implications of section 7519 payments for fiscal year filers
- Exit strategy considerations
  - o Sale of partnership interest
  - o Stock vs. asset deal of coproration
  - o Holding period upon exit
  - o Purchase price considerations
- State tax implications
  - o State sourcing and income tax rates
  - o Investment partnership rules
  - o Compliance costs
  - o State tax footprint of the entity
  - o State tax footprint of the owners

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Question 3:

Similarly, when a closely held business considers the purchase of a large asset, there are also significant tax and non-tax aspects that may affect the decision. For example, from a tax perspective, part of the TCJA includes a phaseout of bonus depreciation. What are some other factors that could be considered?

Planning considerations around timing for large asset acquisitions

When planning for a large asset acquisition, consider:

- Which taxpayer could acquire the asset
- Implications of placed-in-service date on bonus depreciation
- Whether the deduction will offset higher or lower rate income
- Timing of the expense may create issues. For example:
  - Whether a section 461(l) limitation is created due to the expensing of a large asset acquisition
  - Understanding when the loss will be allowed and what income it will offset
  - Impact on the section 199A deduction
  - If planning to finance the acquisition, recognize impact of higher interest rate environment
  - Whether the additional expense will cause section 163(j) limitations
  - Reducing taxable income with a large asset acquisition could negatively impact PET planning

Question 4:

The TCJA affected individual taxpayers in ways that went beyond just tax rates. It also affected various deductions, including the substantial increase of the standard deduction. For those who still itemize, charitable donations may be the largest controllable deduction. Given that tax rates might increase in the future, should individuals consider delaying their charitable contributions to potentially offset higher rate income?

Interconnectedness: Effect of delaying a large charitable contribution

Offsetting income

- Even if tax rates increase, it is possible that a deduction prior to the increase could be more valuable than a deduction after rates increase
- What type of income will be offset and at what rate?
- Does this negatively affect a qualified business income deduction due to the "overall limitation?"

Issues affecting deduction

- Sunset of 60% AGI limitation
- Type of entity (public charity, private foundation, other) to which the type of asset (cash, long term capital gains, short term capital gains, tangible personal property, etc.) is donated
- Giving during lifetime versus through estate
- Charitable contribution carryover

Other

- Phaseout of itemized deductions
- Effect of market conditions for asset being donated
- Model the tax implications of the donation

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Question 5:

For those individuals who own a passthrough entity that previously elected to participate in state PET planning, the sunset of the limitation on the SALT deduction could affect both individual owners and the entities. Therefore, one may ask, "If the SALT cap is repealed, then would PET planning still be relevant?"

Interconnectedness: Planning for the PET

Tax effect

- Even with an environment where SALT would be deductible in full, PET may be more beneficial since it is effective at mitigating AMT tax implications
- Recall the AMT exposure that existed prior to the TCJA

Future of PET

- State SALT regimes differ: some sunset with the TCJA and some do not
- What changes to PET environment could occur as Congress addresses SALT legislation

Other

- Will regulations be issued, as stated in Notice 2020-75?
- Will we see an enviroment that allows for an increased SALT deduction as well as PET—or would an increased SALT deduction cause re-evaluation of the PET regime?

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Question 6:

Finally, in *Accessing your wealth transfer legacy in 2024*, we addressed that, for estate and gift tax planning purposes, the excess of the individual's assets owned or controlled at death over the BEA in effect at the individual's date of death (currently $13.61 million in 2024 and increasing to $13.99 million in 2025) will be subject to a 40-percent tax. Absent legislative action, this enhanced BEA reverts to $5 million (adjusted for inflation) in tax year 2026. Therefore, planning strategies may be identified to utilize the temporarily enhanced exemption. What are some of the factors that you could consider when contemplating a wealth transfer?

Interconnectedness: Effect of TCJA sunset on transfer tax planning

Step 1

- Consider what your goals are for making the transfer. Concern that the basic exclusion amount will later be diminished is an insufficient reason, by itself, for engaging in tax planning
- In order to make a completed gift for tax purposes, the donor must relinquish dominion and control over the transferred property

Step 2

- The enhanced BEA for 2025 is $13,990,000 per taxpayer, or $27,980,000 for a married couple
- Begin by calculating the remaining enhanced BEA available to make gifts prior to sunset. Any excess enhanced BEA that is not utilized by the end of 2025 may be lost

Other

- Consider other options for transfer tax planning in addition to utilizing the enhanced BEA
- Consider planning with trusts

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Question 7:

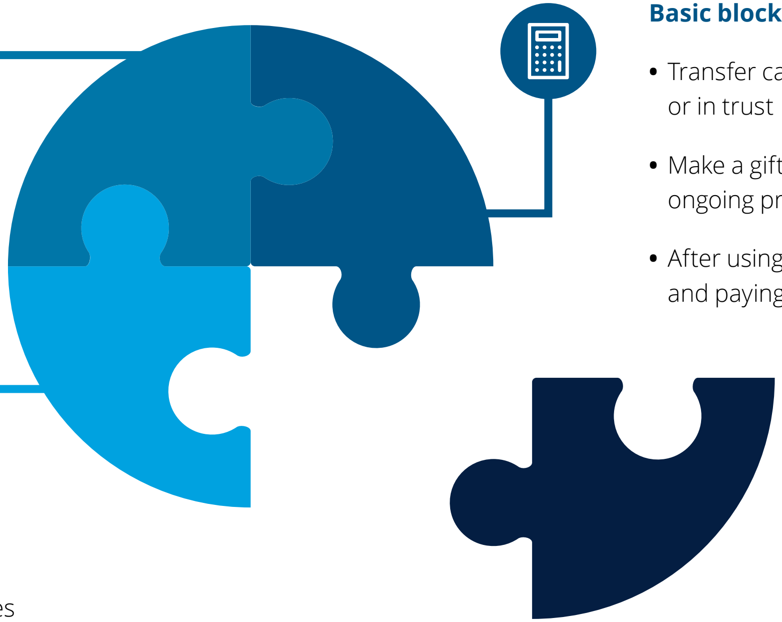
For those who may be interested in transfer tax planning, one question may be, “What transfer tax strategies can I employ to utilize my enhanced BEA prior to the expected sunset?”

Tune up prior planning

- Evaluate intrafamily debt
- Analyze family limited partnerships (FLPs)
- Evaluate potential opportunities for late allocation of GST tax exemption

Enhance generational wealth

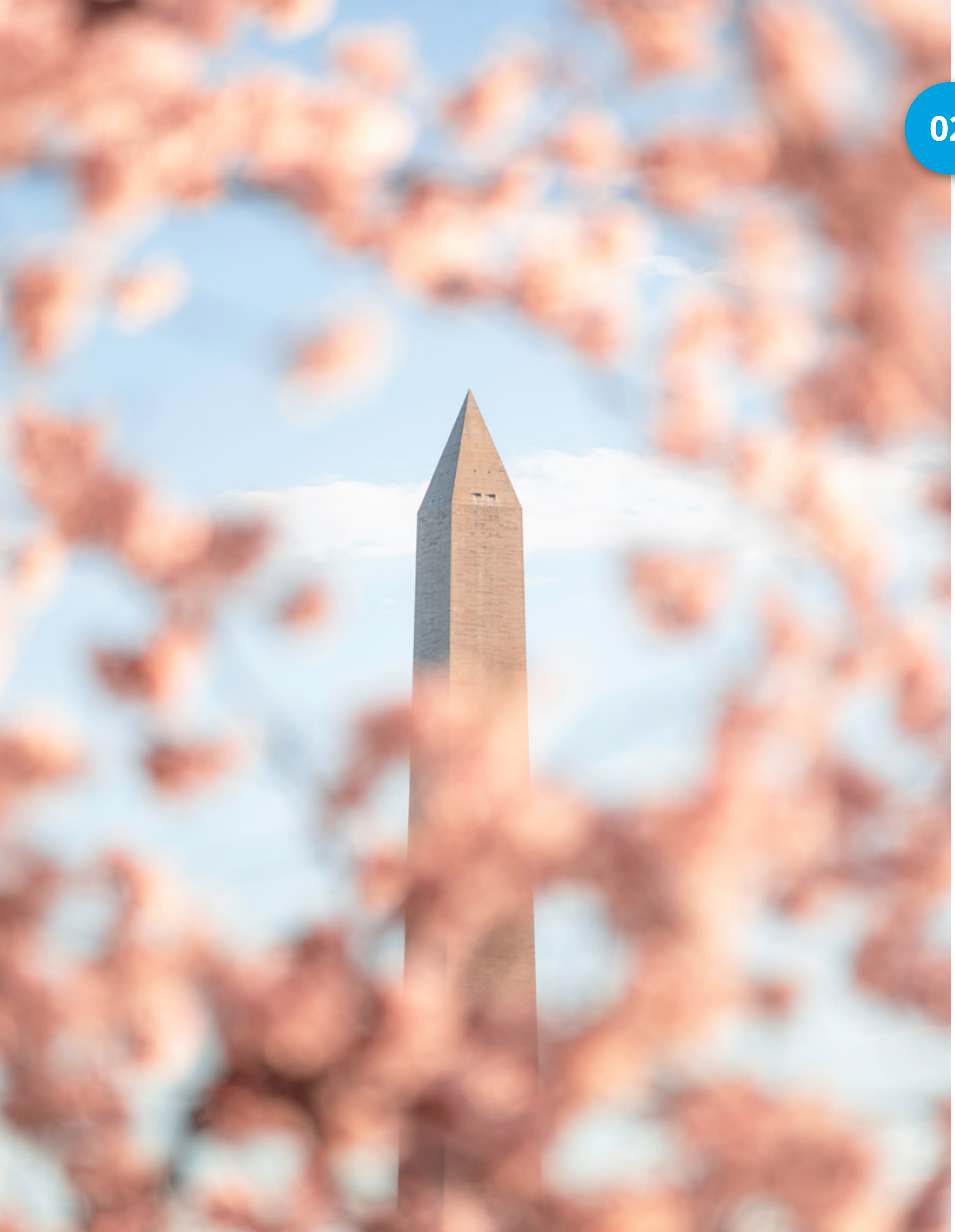
- Use dynasty trusts to transfer assets to children and more remote descendants
- Combine gifts to these trusts with leveraged sales
- Grantor type trusts are efficient estate planning vehicles



Basic blocking and tackling

- Transfer cash or marketable securities outright or in trust
- Make a gift to a life insurance trust to fund ongoing premiums
- After using the BEA, consider making taxable gifts and paying gift tax

Caution: Know the citizenship and domicile status of individual donors, trustees and trust beneficiaries. Additional planning considerations apply for non-US persons.



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Keeping your goals front and center

Hopefully the examination of these questions has painted a broader vision for you of why planning for your income and transfer tax planning goals is so important. Your peripheral view may include glimpses of change in areas such as tax rates or applicable deductions, but don't let that cloud your vision of what should be considered relevant today. Your current goals and objectives need to be front and center. Consider what is in plain view, because those distractions may turn out to be very costly. By concentrating your view on planning opportunities that are available to you today with an eye towards tomorrow, you may realize a more tax-efficient result for you and your family.