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Impact of New US Tax Law on High Net Worth Individuals, Trusts and Family Offices

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The newly enacted U.S. tax law makes significant changes to provisions of the Internal Revenue Code affecting high net worth individuals, their investment entities and family offices. These changes are likely to spur gift planning, increase the use of trusts to reduce exposure to state income taxes, give rise to new compensation arrangements and other changes within family offices, and provoke questions about conversion to corporate form.

Gift Planning

The act doubles the amounts that a U.S. person can transfer free of the federal estate and gift tax and the generation-skipping transfer (GST) tax. In 2017, each individual had an estate and gift tax exemption and a GST exemption of $5.49 million. Beginning on January 1, 2018, these exemptions were increased to approximately $11.2 million, indexed for inflation in future years.

The higher exemption amounts are scheduled to return to their lower pre-act levels after December 31, 2025. Accordingly, high net worth individuals should consider making gifts equal to their increased exemption amounts prior to this date. And because any appreciation in gifted assets should be protected from future wealth transfer taxes, a gift of property in 2018 may be a better use of an individual's exemption than a gift in 2025.

The act does not change the federal income tax treatment of assets owned by a decedent at the time of his or her death. This means that unrealized appreciation in an asset held by an individual during his or her lifetime will never be subject to income tax if the individual holds the asset at the time of death. Conversely, assets that are given away during a donor's lifetime generally will have a basis in the hands of the recipient equal to the basis of the donor. In structuring lifetime gifts to take advantage of the new increased exemption amounts, donors and their advisers should consider income tax consequences and potential planning opportunities in connection with a sale of assets by the gift recipient.

Individuals also should review their wills and revocable trust agreements in light of the changes in the new law. These documents frequently include dispositions that are based on estate and GST exemption amounts. In view of the changes to these exemption amounts, dispositions included in testamentary documents may not work as intended in some cases.

Income Tax Planning in View of Changed Deductions

The act makes significant changes to the income tax laws affecting individuals and trusts. These changes also are set to expire on December 31, 2025, after which time pre-act law will apply.

The act modifies the income tax rates applicable to individuals and trusts, with the top income tax rate now 37 percent instead of 39.6 percent. However, the act eliminates or restricts a number of important income tax deductions, including one for state and local income taxes. The restriction of this deduction should increase focus on utilizing trusts that are not subject to state or local income tax.

The act also eliminates the ability to deduct certain miscellaneous itemized deductions. These include deductions for expenses incurred in the production of income, such as investment management expenses and tax preparation fees. Family offices may consider approaches that potentially enable these items to remain deductible either by causing them to be trade or business expenses, or by structuring some of the payments as a profits interest rather than as a fee.

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While the act eliminates a number of income tax deductions, it adds a significant 20 percent deduction for individuals, trusts and estates that receive income from a "qualified trade or business" held in pass-through form, such as a partnership or an S corporation. There are, however, limitations on the ability of individuals and trusts with income in excess of certain thresholds to benefit from this deduction.

The new 20 percent deduction may generate planning opportunities for family offices and investment entities. As one example, families with holdings that are likely to qualify for the new deduction might consider compensating family office executives with a profits interest in a family investment partnership rather than W-2 wage income. The profits interest arrangement may enable executives to enjoy the lower tax rate resulting from the deduction while further aligning the interests of the family office and the executive.

Conversion to Corporation?

The act significantly reduces the corporate tax rate to 21 percent, down from a top rate of 35 percent. Unlike the provisions applicable to individuals, trusts and estates, this rate reduction does not expire on December 31, 2025. Rather, it is drafted to be permanent. (See "US Tax Reform Enacts the Most Comprehensive Changes in Three Decades.") Moreover, corporations retain the ability to deduct state and local income taxes. These factors may prompt high net worth individuals to consider whether they should hold investment assets through corporations. In many cases, this may not make sense due to factors including (1) the additional shareholder-level taxes that may be imposed on a removal of assets from the corporation (either as a dividend or on a redemption of corporate stock), (2) a tax on appreciation in the assets held by the corporation, which would not have been imposed if the same assets had been held by the shareholder at the time of his or her death, and (3) the potential application of taxes such as the personal holding company tax and accumulated earnings tax, which may apply to the undistributed earnings of certain corporations that do not conduct active businesses.