The Impact of the 2003 Tax Act on Privately Held Business

Samuel P. Starr
William & Mary
Annual Tax Conference

The Impact of the 2003 Tax Act on Privately Held Business

Sam Starr
PricewaterhouseCoopers LLP

November 20, 2003
The political and economic context of the 2003 tax cut

- The JGTRRA was designed as a "short term" stimulus
- Sunset provisions apply in order to balance spending needs
- There are advocates for curbing the rate cuts, those for extending them, and those who wish to make them permanent

- Planners need to address the opportunities now, and maintain an awareness of when they will be phased out
<table>
<thead>
<tr>
<th>Benefit</th>
<th>Effective Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>15% Dividend tax rate</td>
<td>1/1/2003 – 12/31/2008</td>
</tr>
<tr>
<td>Increased Small Business Expensing (§179)</td>
<td>1/1/2003 – 12/31/2005</td>
</tr>
<tr>
<td>Bonus Depreciation (§168(k))</td>
<td>5/6/2003 – 12/31/2005</td>
</tr>
</tbody>
</table>
## Choice of Entity Considerations

<table>
<thead>
<tr>
<th>C Corporation</th>
<th>Pass Through</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Old Regime</td>
</tr>
<tr>
<td>Tax Inc.</td>
<td>$100</td>
</tr>
<tr>
<td>Entity Tax</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>65</td>
</tr>
<tr>
<td>Tax on Distribution</td>
<td>26</td>
</tr>
<tr>
<td>Cash in pocket</td>
<td>$39</td>
</tr>
</tbody>
</table>
Other choice of entity factors remain the same after JGTRRA:

1. Is the business plan facilitated with an entity that is flexible?
2. Do the owners want to allocate income gain, loss, deduction, and credits among themselves in proportions differing from their ownership interests?
3. Is the business generating or expected to generate either operating or capital losses?
4. Will the owners contribute cash or property in exchange for an interest in the business? Are distributions of property expected?
5. Will employment taxes be a driver in choosing a business entity?
6. Is equity participation important in compensating employees?
7. Is a business merger or acquisition expected? (exit strategy)
8. Financing Needs
# Reduced Capital Gain Rates

- Maximum capital gain rate decreased from 20% to 15%
  - 18% rate for 5-year property repealed
  - Reduced 15% rate applies for AMT purposes

- The preference for capital gains rather than ordinary income is increased (old spread 18.6%, new spread 20%)
  - Similarly preference for long-term over short-term gain
  - Techniques to convert ordinary income to capital gain?
Be aware that a “blended” capital gain rate effectively applies in the 2003 tax year to account for pre-5/6/2003 gains.

Potential for planning to use projected rate reduction that applies to taxpayers in the 10 or 15 percent income tax brackets (generally individuals with <$28,400 of taxable income):

- Rates reduced from 15% to 5% through 2007, and to 0% in 2008.
- Use the gift tax exemption to pass long-held, appreciated property at a stepped-up basis, and reduce or even avoid tax on gain.
- 0% capital gain rate for lower bracket taxpayers is equivalent to step-up in asset basis at death.
• IRS Announcement 2003-56
  - Detailed guidance for individuals, estates, trusts, and pass-through entities filing 2002-2003 fiscal year returns. The guidance explains what forms to use, and on what lines to enter net capital gain, to reflect changes made in the capital gains tax rates by the JGTRRA.
Planning considerations surrounding contribution of capital gain property to C corporations

- New law creates incentive to keep capital gain property out of corporate solution
  - Consider licensing/rental to corporate entity
  - Pass-through entities are preferred if capital gain income anticipated

- Section 1202(a)(1) still available - permits exclusion of 50% of the gain on the sale of qualified small business stock held for 5 years
  - Special AMT rates expire 12/31/2008
Maximum rate for "qualified dividends" received by an individual reduced to 15%

- "Qualified" means paid by non-exempt domestic corporations, mutual savings banks, savings and loan institutions, or qualified foreign corporations
  - "Qualified foreign corporations" are those incorporated in a US possession, corporations eligible for the benefits of a comprehensive tax treaty with the U.S., or corporations traded on a U.S. securities market
- Dividends are no longer "net investment income" for investment interest expense purposes unless you elect out of 15% rate
- Dividends received by fiscal-year taxpayers in years beginning in 2002 and ending in 2003 are not "qualified" dividends. Similarly, fiscal-year 2002-2003 p'ships, S corps, and estates cannot pass through qualified dividends to their partners, shareholders, or beneficiaries.
• Tax on accumulated earnings for corporation with excess E&P and personal holding companies is also reduced to 15%
  ▪ Will the IRS pursue the penalty taxes at a 15% rate?
  ▪ Does our advice to clients change?
  ▪ As with the dividend and capital gain rates, sunset 12/31/08

• The collapsible corporation rules have been repealed

• To preserve stock basis, corporations that intend to begin paying dividends may be required to review accumulated E&P calculations in order to assure dividend treatment rather than return of capital
  ▪ If preserving stock basis is not a concern, distribution out of accumulated E&P and in excess of basis are both taxable at 15% rate
• Increase in maximum amount that may be deducted (as opposed to depreciated) under section 179 for tangible business-use property
  ▪ Max deductible increased from $25K to $100K
  ▪ Phase-out limit increased from $200K to $400K
  ▪ Valid for 2003 – 2005 (sunset)
    ▪ Strong push to make this permanent
Bonus Depreciation

- Bonus depreciation of 50% may be taken in the first year for qualifying property
  - Expansion of 2001 30% incentive
  - Acquired after 5/5/2003 and before 1/1/2005 (sunset)
  - Not applicable if binding commitment to acquire pre-5/6/2003
  - Subject to recapture on disposition

- Qualified property is new MACRS property with recovery period <20 years, water utility property, 3-year life computer software, qualified leasehold improvement property
  - Qualified leasehold improvement property = an improvement to an interior portion of nonresidential real property (whether or not depreciated under MACRS) by a lessor or lessee
From the perspective of stockholders and creditors, there will be a reduced preference for interest income generated from corporate securities

- Although interest remains deductible for the corporation, dividends are now taxed at much lower rate than interest income
- Issuer classification of the instrument will be more closely monitored
- Service has new incentive to attempt to recharacterize purported equity as debt in the hands of lender

- What is the cost of restructuring from debt to equity?
• Possible resurgence as an attractive investment vehicle
  ▪ Permits cheaper “borrowing”
  ▪ Improved financial accounting balance sheets

• Qualified foreign corporations have new incentive to treat inbound payments as dividends for U.S. purposes
Do dividends at reduced tax rates make a good alternative to compensation taxed as ordinary income?
- Corporate deduction for compensation remains
- Less incentive for the IRS to challenge unreasonable compensation because of lower tax rate on dividend income
- Does our advice to clients remain the same?

Executives may want a strong component of dividend income in their compensation packages
Is deferral still the right option for non-qualified deferred comp?
  - Tax bracket in later years
Or, is exercising, holding and receiving dividends the better choice?
  - Section 83(b) election to recognize income
• Is the section 1014 basis step-up at death as necessary for estate planning as capital gain rates are reduced?
  ▪ Size and make-up of assets
  ▪ Gifts to 5% taxpayers

<table>
<thead>
<tr>
<th>Year</th>
<th>Exemption</th>
<th>Highest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>1,000,000</td>
<td>49</td>
</tr>
<tr>
<td>2004</td>
<td>1,500,000</td>
<td>48</td>
</tr>
<tr>
<td>2005</td>
<td>1,500,000</td>
<td>47</td>
</tr>
<tr>
<td>2006</td>
<td>2,000,000</td>
<td>46</td>
</tr>
<tr>
<td>2007</td>
<td>2,000,000</td>
<td>45</td>
</tr>
<tr>
<td>2008</td>
<td>2,000,000</td>
<td>45</td>
</tr>
<tr>
<td>2009</td>
<td>3,500,000</td>
<td>45</td>
</tr>
<tr>
<td>2010</td>
<td>N/A (taxes repealed)</td>
<td>0</td>
</tr>
<tr>
<td>2001</td>
<td>675,000</td>
<td>60</td>
</tr>
</tbody>
</table>
- No AMT rate reductions or exemption phase-out changes
  - Reduced 15% capital gain and dividend rates do apply for AMT
  - Taxpayer in the new 35% bracket with $100 of ordinary dividend income saves $20 for regular tax purposes (35% rate vs. 15% rate), but $13 for AMT purposes (28% rate vs. 15% rate)