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THOUGHT LEADER FORUM

# TAX REFORM IMPLICATIONS

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# TAX REFORM IMPLICATIONS

Recent changes to tax laws have resulted in questions and uncertainty for both individuals and corporations. The Puget Sound Business Journal recently held a Thought Leader Forum on the topic with **Kelly Keydel**, Advisor and Principal with Private Ocean; **Gary Kirk**, Shareholder with Lane Powell and **Charles Purcell**, Partner, at K&L Gates. **Emory Thomas**, PSBJ's Publisher, led the discussion.

**What industries are you finding are the most, or you expect to be most, affected by the legislation?**

**Purcell:** One of the concerns is how the Act is going to affect the renewable energy industry. It's not clear yet how that's going to work, but there probably will be less demand by folks interested in investing in renewable energy because a lot of the benefits for investors are tax benefits. A lot of people are saying that the reduction in the corporate tax rate is going to reduce the demand for these types of investments.

**Keydel:** Potentially real estate. Particularly as you look at cities like Seattle and San Francisco, and given the reduction in mortgage interest deductions, that may have an impact on the housing industry. It may also have an impact on lending.

**Do you see this as a potential chipping-away of that mortgage tax deduction overall? Is it the start of a, if not slippery slope, slipperier slope?**

**Kirk:** The new tax legislation includes limitations on miscellaneous itemized deductions and mortgage interest deductions. I would not conclude that these changes are designed to implement a new direction in tax policy – beyond resulting in higher taxes on the affected taxpayers to offset tax cuts. You could argue that tax cuts are the true slipperier slope.

**You mentioned inquiries that you've gotten so far. What has the flow been like? Can you elaborate?**

**Keydel:** We're hearing from our clients with general concerns and a lot of questions such as "How will this affect me and my personal situation?" Again, regarding mortgage and home equity loans, clients are asking "should I now consider paying these off?" Up to this point, the equation has been fairly straight forward - with such low-costs to borrow, it hasn't made sense to pay off the loans early. But I think we're at a point where that needs to be reevaluated.

**Purcell:** There's a lot more thought that has to go into any kind of given structure and deciding whether you're going to conduct business in a C corporation, an S corporation, an LLC. Those are

much more complicated decisions now than they used to be. Part of it is that everything is so new. These are very major changes for LLCs, for LPs, and more on the foreign side. Understanding how to use the rules in the best way is complicated.

**Kirk:** I largely work for individual families and closely-held businesses and we've been looking at the same things except they're very client specific. One family may evaluate the benefits from converting from an S Corporation to a C Corporation to take advantage of the lower tax rates for C Corporations under the new tax legislation. Another family may consider moving the opposite direction. The unique

**Purcell:** Deferral on foreign income has been limited very significantly in most cases. So that if you have a foreign licensing company, you're not going to be able to avoid tax on that. The good news is that the tax rate on that income is going to be less than it would be if you recognized it directly.

**What about the incentive for U.S. companies to keep operations in the U.S. versus elsewhere?**

**Purcell:** If I have the choice as a U.S. person to build a factory in Arizona or build it in, say, Costa Rica, all things being equal, I'd rather build it in Costa Rica because the tax rate on that income will either be subject to the GILTI rules

**Do you think a lot of taxpayers haven't yet realized how much it complicates their situation, or how many more things they need to think about?**

**Keydel:** Our clientele is not strictly business owners, so for the individuals and families we work with I don't think it's quite on their radar yet other than as a myriad of questions.

**How about the change in the deductibility of state income taxes? What does that do?**

**Kirk:** Certain states are considering the ability to make a charitable contribution to the state in lieu, and get a credit against your state taxes. The second area is that it's very possible to move income-producing assets into states that don't have a state income tax. That's for people who are able and willing to transfer wealth away from them into a trust for their family. Again, it's a limited number, but it's something we've certainly done, and I think everybody's had clients in states where they have a business, say, in Oregon, and they want to sell their business, and so first thing you tell them is, "Maybe you don't want to live in Oregon when you sell your business." So, that's the same kind of theory as, can you do what you do somewhere else that doesn't have a state income tax?

**Keydel:** It's another factor people are going to take a closer look at to determine how it impacts them. It's more of a sharpen the pencil, and let's see how this is going to impact your unique situation.

**How about interest deductions on the use of leverage. How might that affect highly-leveraged businesses?**

**Kirk:** We were going through a transaction in which there was going to be a lot of borrowed money. So, on one hand, we had a C corporation which had a lower tax rate, allowing a lot more cashflow. It made the transaction more complicated because of the inability to finance the transaction, and that's still ongoing, so I don't know how that's going to work out.

**Purcell:** I think it's not entirely clear how it's going to affect industries with a lot of leverage, like private equity. There's a wide variety of ways that people use leverage in that industry. Some firms take on, you know, 60 or 70% leverage in their acquisitions. With increasing interest rates and this limitation, it's going to make things very interesting. The limitation on the deductibility of interest is key to 30% of your taxable income. So, when your income goes down, your ability to claim interest deduction goes down, and your taxes

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**KELLY KEYDEL**  
Private Ocean

characteristics of each closely-held business often lead to the business owners needing to make different decisions. One aspect of that analysis is whether the owners will continue to pay the business profits in the form of dividends to the shareholders, which will lead to double taxation for C corporations and the shareholders, or will they recapitalize the profits into the business at the new C Corporation income tax rates. We also review the new deduction for qualified business income. Will passive rental activity qualify as business income? What types of income-producing activity will qualify as business income? How will trusts take advantage of that? And then, we have a large transaction where the new interest rate restrictions came into play. So, it's been a different question and a different analysis for every client.

**How will companies with foreign operations be affected?**

at 11% or subject to the participation exemption, whereas the Arizona income will be fully taxed at 21%. So, it's maybe not what was intended, but I think that's the way the incentives seem to run right now.

**What about the effect of tax reform in the form of entity that taxpayers will choose for their activities. Mainly, it's about the Byzantine complication of determining the right one, right?**

**Kirk:** My practice is limited to family-owned businesses or closely-held so the issues are focused more on shareholder tax levels and how to get money to shareholders. The C corporation tax rate is 21 percent but there's a dividend tax rate at the individual level. It's less expensive now, but where does that end up for your family in terms of family members who might work for the business and get paid a salary versus other family members who require a dividend?

go up. So, not the result that you would want for somebody who's in a declining income situation. This could potentially exacerbate some problems in the future.

**Let's identify opportunities that individuals and couples have with the new tax situation in place. What should they be especially attuned to exploring?**

**Keydel:** I would certainly start the conversation with what do we have in the way of a comprehensive plan, and not let any one specific aspect of the tax reform act or even the tax reform act in its entirety drive a decision. At the same time, I think individuals and couples can reap some benefit due to the lowering of the tax brackets potentially resulting in additional cashflow. In addition, giving through a donor-advised fund can allow individuals to gift a larger amount in a given year, utilizing the deduction more effectively, and then spread that gift out over a desired time period to their chosen charities. As noted earlier, this is a good time to reevaluate whether carrying a mortgage or a HELOC makes sense or not. One other opportunity to explore is the possibility of doing more family gifting as it relates to estate planning. Given the new higher lifetime exemption amount, there may be unique opportunities for closely held business owners, who may be looking to transfer that business to the next generation. This may be an ideal time to gift some of that ownership.

**How about small business owners? How can they take advantage of the new tax law to maximize retirement savings?**

**Keydel:** Small business owners may benefit from the tax reform act through both lower personal taxes, and by qualifying for a 20% deduction of income. The result of these benefits may be greater cash flow for the business owner, allowing them to add more to tax advantaged retirement plans. This is a good opportunity to evaluate the

type of plan that the business owner is currently using. And ask the question "is there something that I could be using that would enhance my tax-deferred savings?" For instance, if the business doesn't already have a profit share plan or a cash balance plan, both of which have greater contribution levels, I see this as a good time for small business owners to explore these options.

**Should you rebalance your investment portfolio in light of the tax reform act?**

**Keydel:** The tax reform act may provide a catalyst for reviewing and rebalancing your portfolio, particularly if there's a life transition that you're facing. For instance, in the case of divorce, the tax reform act brought about a major change regarding the tax treatment of alimony or maintenance payments that may need to be re-evaluated. Further, part of the divorce process may require a settlement payment, initiating the need to rebalance the portfolio to free up capital for that payment. One thing that didn't change with the tax reform act were capital gain rates. We still have historically low capital gain rates ranging from 0 to 20%. As it relates to rebalancing, now is a good opportunity to look at the run-up that we've experienced with the stock markets, and perhaps rebalance into lower-risk investments such as muni bonds, if that's appropriate to a client's situation, taking advantage of the tax-free income.

**Purcell:** We're starting to see some interest in the so-called opportunity zones, where if you invest in an opportunity zone you're permitted to defer payment of tax. If you have gains, and you invested in the opportunity zone, you could defer that gain for up to 10 years. Potentially that's a great opportunity. You have to find good businesses in the zones, but it could apply to real estate.

**It sounds like most people should revisit their gift and estate tax plan.**

**Keydel:** I would say that just about everyone should.

**Kirk:** If you've done your estate plan in the last 10 years, there have been three or four major state law changes, and there's been a huge federal change in terms of increasing exemptions. A lot of times, especially in older estate plans, the language used was phrased in terms of how much the federal credit was. So, if you can imagine over time, when the federal credit was \$600,000, that meant one thing. When it was \$5 million dollars, that was something else. Now it's \$11 million, and that's something else. If you have an older estate plan that is structured that way, you absolutely need to get it changed.

**What should clients do to educate themselves? What are the best things they can do?**

**Purcell:** If you've got your own business, it's really important to reassess what exactly you need to be doing. You're not going to be able to figure it out yourself. You need to talk to a professional.

**Keydel:** That's true. People need to reach out to use their trusted advisors. Leverage that expertise, whether it is in estate and trust planning, tax planning, financial planning, or wealth management. That's what we're here for, and we can help clients make sense of the new tax laws and how they might impact their own unique situation.

**What are other important considerations?**

**Kirk:** The 20 percent deduction on qualified business income. You probably read that they've excluded service providers from that deduction — lawyers, accountants, doctors. Now the threshold is \$315,000 for taxable income for a married couple. If you're below that threshold, everyone, including service providers can claim the qualified business deduction, if they have qualified business income. The

upper threshold is \$415,000. Everybody above that is subject to limitations. If you're a service industry provider, you don't get the deduction at all. Anybody else, you have to satisfy one of two tests. The qualified business deduction can't be greater than 50 percent of the compensation you paid your employees, that includes the owners, or it's 25 percent of compensation, or 2.5 percent of unadjusted basis of the business assets. For couples with taxable income between \$315,000 and \$415,000, the deduction is phased out. The qualified business deduction and the changes to the corporate income tax rate make business entity choice an important decision again.

**Purcell:** I was practicing back in '82. A long time ago. At that time, the structure of the tax law changed to bring the corporate tax and the individual tax to about the same rate. Before that, the corporate tax rate was significantly lower than the individual rate. So, when I started practicing, there were a lot of these family corporations. Not S corporations, but real corporations. And over time, those became less. You found that people structured out of them all the time. Someone with a portfolio might say, "Well, I don't want to pay 37% on my investment income, so I think I'm going to put that into a corporation." Now, that's not a good choice, because there's something called the Personal Holding Company Rules that prevent you from getting the 21% rate on that. That tax, the Personal Holding Company Tax, has been kind of a dead letter for the past 30 years or so, but you know, that's something we're all going to have to think about because there are incentives to try and get your investment income into a corporation. Be very careful if you're planning on doing that.

**Keydel:** There's a clear call to action. This is an ideal time to revisit your plan, with a professional, to be sure you are still on the right track.

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**B. KELLY KEYDEL**  
CFP®, MBA, CDFA®  
Advisor & Principal, Private Ocean  
Wealth Management



B. Kelly Keydel, CFP®, MBA, CDFA® is a principal advisor specializing in advanced financial planning at Private Ocean, an innovative West Coast wealth management firm. She believes in taking a personal approach to addressing complex situations, reconciling each client's unique financial behavior with their lifestyle and goals to help guide them toward smart, practical decisions. An avid outdoor enthusiast and proud Pacific Northwesterner, Kelly earned her B.S. in Psychology from the University of Washington and her M.B.A. from Seattle University. She has been a financial advisor since 2006.



**GARY M. KIRK**  
Shareholder, Lane Powell



Gary advises high net worth individuals and families on estate and tax planning. He works with business entities and owners in connection with operating agreements, reorganizations and income tax issues. Gary also counsels owners of family-owned and closely-held businesses regarding sales of ownership interests to third-parties or family members for liquidity or succession planning purposes, including advising clients on income tax and estate planning considerations. He has significant experience counseling clients with respect to their reporting obligations under the Hart-Scott-Rodino Antitrust Improvements Act of 1976.



**CHARLES H. PURCELL**  
Partner, K&L Gates



Charles works extensively in the alternative investments areas with a focus on federal and international tax issues. He has broad experience in the formation of domestic and foreign investment funds including private equity, venture, real estate and infrastructure funds and fund-of-funds; large joint venture transactions; mergers and acquisitions; financing and banking transactions; venture capital investments and start-up companies; and compensation of managers, executives and promoters. He represents numerous domestic and foreign institutional investors in connection with their alternative investment activities. Charles also has a robust practice working with developers and investors in alternative energy projects. Charles received his B.A. and J.D. from the University of Virginia.





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Contact Marijane C. Milton:  
206-876-5447 or [mmilton@bizjournals.com](mailto:mmilton@bizjournals.com)

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