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Tax Tips

Corporations: Watch out for the PHC tax

Since the Tax Cuts and Jobs Act reduced the top federal corporate income tax rate to 21%, an increasing number of business owners are contemplating establishing their businesses as C corporations or switching their pass-through entities to C corporation status. Previously, corporate income was taxed at graduated rates ranging from 15% to 35%.

Entity choice is a complex decision that involves consideration of several financial, tax and legal factors. One factor that shouldn't be overlooked is a closely held C corporation's potential liability for the personal holding company (PHC) tax.

Double taxation

A 21% tax rate is attractive, especially when you consider that owners of pass-through entities — partnerships, S corporations and LLCs — are currently taxed on their shares of business income at individual rates as high as 37%. But for a true apples-to-apples comparison, take into account pass-through owners' effective tax rates (which may be substantially lower than 37%) as well as the potential impact of double taxation.

A C corporation's income is subject to two levels of tax: 1) at the corporate level at the 21% rate, and 2) at the individual shareholder level when that income is distributed. Qualified dividends are currently taxed at rates up to 20%.

One way to avoid, or at least defer, double taxation, is to hold earnings in the corporation rather than distribute them to shareholders as dividends. But if a corporation is considered a PHC, doing so can trigger the PHC tax. Even if a corporation isn't a PHC, retaining earnings can result in accumulated earnings taxes (AET). (See "Is your corporation subject to AET?" on page 3.)

Tax trap

The PHC tax was originally created to prevent individuals from using C corporations to shelter passive income. But despite its name, the tax isn't limited to corporations that hold only passive investments. Even active businesses can be ensnared by the tax if they meet the requirements.

A PHC is a C corporation that meets two tests:

1. Ownership. At any time during the last half of the tax year, more than 50% of the value of its outstanding stock is held, directly or indirectly, by or for five or fewer individuals.

2. Income. At least 60% of its adjusted ordinary gross income (AOGI) for the tax year is PHC income — that is, dividends, interest, rents, certain royalties, income from certain personal service contracts and other primarily passive income.

Is your corporation subject to AET?

Even if your corporation isn't a personal holding company (PHC), be aware of the accumulated earnings tax (AET). Similar to the PHC tax, the AET is a flat 20% additional tax on undistributed taxable income. The AET can apply to any C corporation, but, unlike the PHC tax, it doesn't apply automatically. The IRS may assess the tax, upon audit, if it finds that the corporation has accumulated an unreasonable amount of earnings with the intent of avoiding income tax.

Generally, the first $250,000 in accumulated earnings ($150,000 for certain personal service corporations) is exempt from the AET. But accumulated earnings above that threshold may be subject to the AET.

To avoid the tax, consider distributing some earnings to shareholders to bring your accumulated earnings below the threshold. Otherwise, be prepared to convince the IRS (or a court) that your accumulated earnings are reasonable in light of your business needs.

Some corporations are excluded from the definition of PHC, including tax-exempt entities, banks, life insurance companies and foreign corporations.

If a corporation is a PHC, the tax applies at a flat 20% rate — in addition to regular corporate income tax — to its undistributed PHC income. Note that PHC income for purposes of the income test and undistributed PHC income are two different concepts. The latter calculation starts with the corporation's taxable income. Then adjustments are made for certain taxes paid, charitable contributions, net capital gains, dividends paid and other items.

Potential workarounds

If your corporation meets the definition of a PHC in a given year, you can use several possible strategies to avoid the tax. One option is to increase the number of shareholders. For example, if you give or sell stock to others, it may be possible to reduce the holdings of the top five shareholders to less than 50%. Keep in mind, however, that the "constructive ownership" rules treat stock owned by certain related individuals or entities as owned by you.

Another strategy is to boost ordinary income — for example, by accelerating business income from next year into this year — so that PHC income drops below 60% of AOGI. Likewise, you could defer PHC income to next year or reduce investments that generate PHC income.

Finally, you could reduce or eliminate undistributed PHC income by paying dividends to shareholders. Of course, this option triggers double taxation. But that's usually preferable to paying the PHC tax, which can result in triple taxation when PHC income is ultimately distributed.

Monitor your PHC status

The applicability of the PHC tax is reassessed annually. So, it's a good idea to monitor your corporation's ownership, income mix and accumulated earnings to determine your liability. Even if you've never been subject to the tax before, an economic recession or other events can cause your business income to decline in relation to investment or other passive income. If this happens, it can increase your potential exposure to the dreaded PHC tax. ■

Asset values and the COVID-19 pandemic

Depressed values can affect your estate plan

A variety of estate planning strategies require having accurate, supportable and well-documented valuations of assets. Indeed, the tax implications of these strategies depend on the fair market value of your assets when they're transferred.

The values of many assets may be temporarily depressed because of the COVID-19 pandemic. So, now may be an ideal time to gift them, either directly to family members or to irrevocable trusts and other estate planning vehicles. Hiring a qualified valuation expert is essential to updating your estate plan for this limited-time opportunity.

Weighing the pros and cons

On the plus side, transferring assets while values are low allows you to use less of your federal gift and estate tax exemption ($12.06 million for 2022), maximizing the amount available for future gifts or bequests. As the economy recovers and asset values rebound, your beneficiaries should enjoy substantial growth outside your taxable estate.

> ***Generally, valuators consider three approaches: the income, market and asset approaches.***

On the downside, the pandemic has created a situation that's truly uncharted territory for valuation professionals. Unlike other economic crises in recent years, most of the current economic damage has resulted from lockdowns, business closures and restrictions, and other measures designed to help contain the virus.

Tackling valuation challenges

For business valuation professionals, the current environment presents several challenges, including:

Whether events were known or knowable. A fair market valuation generally doesn't consider "subsequent events" — that is, events that occur after, and weren't "known or knowable," on the valuation date. The effects of the pandemic should be considered when valuing a business or other asset only to the extent that the effects were known or knowable on the valuation date. Experts generally agree that the COVID-19 pandemic wasn't known or knowable as of December 31, 2019. But that may be difficult to determine for valuation dates in the early part of 2020.

Note that even if an expert concludes that a subsequent event wasn't known or knowable on the valuation date, professional standards may require the expert to disclose its potential impact on value in his or her report.

Which valuation approach to use. Generally, valuators consider three approaches: the income, market and asset approaches. The pandemic may affect the relative appropriateness of each approach and the amount of weight it should be assigned.

For example, the market approach, which relies on data about actual transactions involving comparable businesses, may be less relevant today if the transactions happened before the pandemic.

However, it may be possible to adjust pricing multiples to reflect the pandemic's impact.

Many valuators are currently emphasizing the discounted cash flow (DCF) method, which involves projecting a business's future cash flows and discounting them to present value. The advantage of the DCF method is that it provides a great deal of flexibility to model a business's expected financial performance based on current conditions as well as assumptions about its eventual return to "normal" over the next several years.

Regardless of the method or methods used, it's important for valuators to consider a business's available cash and expected cash needs to assess its viability as a going concern. These considerations will be critical in evaluating a business's risk and the impact of that risk on value.

Getting professional assistance

If you're unsure how the pandemic has affected the value of your assets, consider obtaining professional valuations. Once you have those in hand, contact your estate planning advisor to make any necessary revisions to your estate plan based on current asset values. ■

Are scholarships taxable?

For parents faced with the soaring cost of higher education, a scholarship can provide welcome financial relief. Most parents assume that scholarships are tax-free, but that's not always the case.

Scholarships 101

Scholarships received by degree candidates are tax-free to the extent they're used to pay for qualified tuition and related expenses. These expenses include:

- Tuition and fees required to attend the school, and
- Fees, books, supplies and equipment required for courses at the school.

This tax break isn't available for other school-related expenses, such as room and board, travel, and research. Also, with certain exceptions, scholarships aren't tax-free to the extent that they represent payment for teaching, research or other services required as a condition for receiving the award.

Suppose, for example, that your child receives a full-ride scholarship totaling $70,000 per year. It covers $55,000 in qualified tuition and related expenses, plus $15,000 for room and board. Assume that the child isn't required to perform any services in exchange for the scholarship. The $55,000 used for qualified tuition and expenses is tax-free, but the $15,000 used for room and board is taxable.

Exceptions to the payment-for-services rule

Certain scholarships are tax-free even though they're tied to the performance of services. Examples include awards received under:

- The National Health Service Corps Scholarship Program,
- The Armed Forces Health Professions Scholarship and Financial Assistance Program, or
- A comprehensive student work-learning-service program operated by one of a handful of federally recognized "work colleges."

There's also an exception for qualified tuition reductions received by employees of an educational organization. Graduate students who receive tuition reductions or waivers in exchange for teaching or research activities need not report these benefits as income. Similarly, tuition reductions enjoyed by an educational organization's employees or their family members are tax-free, provided the program doesn't discriminate in favor of highly compensated employees.

What about scholarships tied to the recipient's participation in certain activities, such as athletic or music performance scholarships? Generally, these scholarships are tax-free, provided the student is expected, but not required, to participate in a particular sport or music ensemble. In other words, to avoid taxation, the scholarship must continue even if the recipient is injured or simply chooses not to participate.

Reporting and kiddie tax rules

If a scholarship is partially taxable, the student should report this income on Form 1040. Income that constitutes payment for services is considered earned income and will be included on the student's Form W-2. Form 1098-T, prepared by the educational organization, will show scholarships received and amounts paid for qualified tuition and related expenses. Review this information carefully, however, because some qualified expenses, such as books and equipment, may not be included.

A scholarship is taxable to the extent that money that's not payment-for-services exceeds qualified tuition and related expenses. For example, scholarship funds used for room and board are taxable.

> ***Scholarships received by degree candidates are tax-free to the extent they're used to pay for qualified tuition and related expenses.***

The taxable amount is also considered unearned income for purposes of the "kiddie tax." So, depending on the recipient's other income sources, a portion of this income may be taxed at the *parents'* marginal rate. Your tax advisor can help determine whether the kiddie tax applies to your child.

No surprises

Scholarships can do wonders to offset the high cost of a college education. To avoid tax surprises, however, be sure to familiarize yourself with the tax treatment of these awards. ■

How closely held business owners can defer estate taxes

Depending on the size of your closely held business, estate taxes can be a significant burden when you pass ownership from one generation to the next. Fortunately, the tax code provides some relief, allowing eligible estates to defer the payment of certain estate taxes for up to 14 years. To qualify, several conditions must be met:

- The deceased must have been a U.S. citizen or resident at the time of his or her death,
- The deceased's business must have been closely held — that is, it was either 1) a sole proprietorship, or 2) an interest in a partnership, limited liability company or corporation that meets certain ownership requirements,
- The business must be engaged in an active trade or business (as opposed to holding passive investments), and
- The value of the deceased's interest in the business must be more than 35% of his or her adjusted gross estate.

If your estate qualifies, the executor may elect to defer the portion of estate tax that's attributable to the closely held business interest for up to 14 years. The estate pays interest only for four years and then pays 10 annual installments of principal and interest. ■

Alternative IRA investments: Handle with care

Most people use their IRAs to hold stocks, bonds and mutual funds. But some people opt to place their IRA funds in alternative investments — such as real estate, closely held business interests, precious metals or cryptocurrencies — in an effort to boost their returns. To do so, your IRA custodian must permit such investments, or you must open a "self-directed" IRA.

Alternative investments can be risky, so consult your tax advisor to avoid potential tax traps. For example, if the IRS concludes that an IRA investment involves self-dealing or prohibited transactions with related persons or entities, you may immediately be subject to taxes and penalties on your entire account balance.

In a recent case, the Tax Court held that a couple wasn't permitted to invest IRA assets in gold and silver coins stored in a safe in their home. Because they had complete, unfettered control over the coins and were free to use them in any way they chose, the value of the coins was treated as a taxable distribution. ■

Increased annual gift tax exclusion for 2022

For the first time in several years, the IRS has raised the annual gift tax exclusion, from $15,000 to $16,000 per recipient, effective January 1, 2022. If you regularly make annual exclusion gifts to children or grandchildren, or contribute to trusts or college savings plans for their benefit, consider increasing the amounts of those gifts. ■

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