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Understanding the impact of tax reform on small businesses

The Tax Cuts and Jobs Act delivered a significant tax-rate reduction to corporations as well as many changes affecting small businesses.

The passage of the Tax Cuts and Jobs Act (TCJA) represented the most sweeping changes to the tax code in more than 30 years, affecting individual and corporate taxes as well as estate and gift taxes.

The corporate tax rate saw a significant reduction, to 21% from 35%, as well as a shift from a worldwide system of taxation to a territorial system. There were also major changes affecting other firms, including small businesses.

While the new corporate tax rate is permanent, most tax law changes impacting individuals, trusts, estates, gifts, and pass-through businesses are set to expire after 2025.

New 20% deduction on business pass-through income

In the tax reform debate, lawmakers sought to align the taxation of pass-through entities with the taxation of C Corporations. The law introduced a new provision (IRC Section 199A) that allows certain taxpayers to generally deduct 20% of qualified business income (QBI) on their tax return. Business income from sole proprietorships, partnerships, LLCs, and S Corps may qualify for the new deduction.

How to determine QBI

QBI is net business income after expenses are deducted and does not include compensation income (salaries and guaranteed payments to partners) and investment income (capital gains, dividends, interest income). QBI can also include certain income derived from real estate activity (e.g., real estate investment trusts), public partnerships (e.g., master limited partnerships), estates, and trusts.

The deduction is:

- Generally limited to 20% of QBI, or 20% of household taxable income, whichever is less*
- Only available on income derived from domestic activity
- Considered a "below the line" deduction that doesn't impact adjusted gross income (AGI)
- Applicable to income from several business interests owned by an individual if that income is considered QBI

There is no requirement to itemize deductions so taxpayers can still claim the standard deduction and benefit from the QBI deduction.

Limitation for "specified service activities"

Certain types of businesses — defined as specified service trade or business (SSTB)— may be limited when taking the deduction. The law states, "A specified service activity means any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or investing, trading, or dealing in securities, partnership interests, or commodities."†

- Architects and engineers are not considered SSTB
- The deduction begins to be phased out when taxable income exceeds $157,500 ($315,000 for married couples filing a joint return). Full phase-out at taxable income of $207,500 ($415,000 for married couple filing a joint return).

* Above certain taxable income thresholds, an alternate test may apply based on a percentage of total wages of the business or a combination of wages and unadjusted cost basis of qualified property.

† Source: Joint Explanatory Statement of the Committee of Conference.

How to determine the QBI deduction

Summary of the new deduction

Taxable income (Single)	Non-specified service business	Specified service business	Taxable income (Married, filing jointly)
	Deduction fully subject to wage limitation*	No deduction	
$207,500			$415,000
	Deduction available, wage limitation begins to be phased in*	Income phase-out applies – partial deduction available	
$157,500			$315,000
	20% deduction	20% deduction	
$0			$0

* The wage limitation refers to an alternate test that must be applied to determine the deduction for QBI (for non-specified service businesses) when taxable income exceeds $157,500 for individuals and $315,000 for couples.

Alternate test for non-specified service businesses

Some businesses not considered SSTB may calculate the deduction differently depending on their household taxable income.

- Taxpayers with income exceeding $157,500 ($315,000 for married couples filing a joint return) may face a limitation based on wages and property. At taxable income of $207,500 ($415,000 for married couples filing a joint return), this limitation is fully phased in.
- The alternate test is as follows:

The QBI deduction is limited to the lessor of A or B:

A	B
20% of qualified business income (QBI)	The greater of (i) 50% of the total wages paid by each business or (ii) 25% of W-2 wages paid by each business plus 2.5% of the unadjusted basis of qualifying property (meaning the original cost of the property, not adjusted for depreciation)

How the 20% deduction on QBI works

Deduction for a non-specified service business

Bob owns a landscape architecture business. After expenses, he earns $100,000 in business pass-through income. Taxable household income for him and his wife is $200,000. **He can deduct $20,000** (20% of $100,000 in QBI) on their joint tax return.

Income phase-out for a specified service business

Karen, an attorney, earns $375,000 in partnership income annually. Her husband Greg, a teacher, earns $100,000 a year. After deductions, their taxable income is $425,000, which exceeds the threshold for specified service businesses ($415,000 in taxable income for married couples). **The taxpayers cannot claim a QBI deduction** for Karen's partnership income.

Alternate test for a non-specified service business

Rodney owns a small manufacturing firm filing a single tax return. He earns $400,000 in net business pass-through income. Total wages paid from the business are $140,000. Because his taxable income is over the threshold amount ($207,500 for single filers), he is subject to the alternate test to determine the QBI deduction.

His deduction is the lesser of A or B:

A	B
20% of QBI ($400,000) = $80,000	The greater of: 50% of wages ($140,000) = $70,000 OR 25% of wages ($140,000 x 0.25 = $35,000)+ 2.5% of unadjusted cost basis of property (assumed to be $800,000) = $55,000
In this case, his deduction for QBI would be $70,000.	

Planning considerations for small business owners

Strategies to utilize or maximize the new 20% deduction on pass-through income

INCOME

Managing or reducing income to avoid income phase-outs. Strategies to reduce taxable income, such as contributing to a retirement plan or health savings account (HSA), may allow a business owner to **benefit from the new 20% deduction by avoiding phase-outs** at certain income levels. Other strategies around realizing or deferring income (timing of invoices, tax loss harvesting, careful recognition of capital gains, etc.) may also aid in managing the amount of taxable income.

For example, consider a self-employed owner of a specified service trade or business (SSTB) who reports $180,000 in net business income. The QBI deduction begins to be phased out above $157,500 (for single filers) in taxable income. If the owner contributes 20% of net earnings ($36,000) to a SEP-IRA, which lowers taxable income to $144,000, the phase-out for the deduction no longer applies.*

* Assumes the business owner does not have taxable income from other sources.

TAXES

Tactically filing separate returns for married couples. In the case where one spouse has a professional service business (consulting, for example) subject to the income phase-outs on specified service activities, it may not allow a deduction if the other spouse's income causes them to exceed the threshold for married couples ($415,000 in taxable income). For example, assume one spouse has a consulting business earning $100,000 in net business income and the other spouse earns $400,000 in salary as an executive. **If they file a joint tax return,** their taxable income will exceed the threshold and the 20% deduction on QBI will not be available. However, **if they file separately,** the consultant spouse would generally be able to take a 20% deduction on the $100,000 of consulting income since the amount is below the threshold for married/filing separately ($157,500 in taxable income). There may be other tax implications, so careful analysis of both tax returns is needed.

EMPLOYMENT

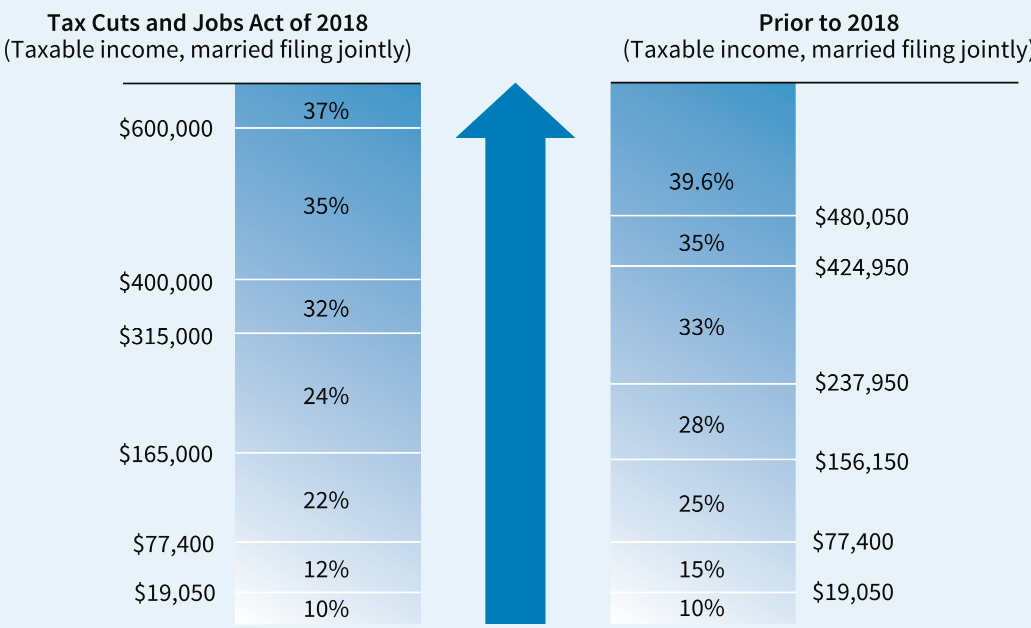
Move independent contractors to salaried employees. Business owners at higher income levels may be subject to the alternate test to determine the QBI deduction. Since the alternate test is based on total wages paid by the business, it may be beneficial to move contractors to salaried employees to increase the total amount of W-2 wages paid by the business.

Other changes impacting small business owners

Lower marginal tax rates

Many small businesses are taxed as pass-through entities. This means that the net business or partnership income is taxed at rates and brackets applicable to individual taxpayers. Business owners will benefit from these lower tax rates.

Comparison of tax brackets for married filing jointly taxpayers



Enhanced expensing of capital expenditures (Section 179)

The law also provides that small businesses can expense the full purchase price of certain qualified equipment or property (including used equipment) in that tax year, instead of capitalizing the cost over several years. The deduction applies to tangible property used in a business, e.g., computers, office furniture, manufacturing equipment, and qualified real property.

- The amount deductible was increased to $1,000,000 a year in 2018 (from $500,000 in 2017)
- Total equipment purchased cannot exceed $2,500,000 (a phase-out applies above that amount)
- For more information consult IRS publication 946, “How To Depreciate Property”

Bonus depreciation available through 2022

In addition to enhancements under Section 179, businesses can elect bonus depreciation on equipment placed in service over the next five years. This means a business can deduct 100% of the cost of qualified assets (software, for example) in that tax year. The provision applies to new assets but also extends the tax benefit to used assets as well. Depending on the circumstances, business owners typically will apply Section 179 up to current limits before applying bonus depreciation on assets and equipment thereafter.

Elimination of certain deductions for employers

The deduction for client entertainment expenses (sporting events, golf, etc.) has been eliminated. Prior to the tax law, businesses could generally deduct 50% of these costs. Business meals are generally still deductible (limit of 50%). The law also eliminates an employer's ability to deduct the cost of providing certain transportation and commuting benefits to an employee, including parking and mass transit passes.

Limitation on deducting net operating losses

A net operating loss (NOL) occurs when business expenses exceed income. Prior to the tax law, taxpayers reporting an NOL were able to carryback the NOL at least two years prior, or carryforward the NOL against future income for a maximum of 20 years. Under the TCJA, taxpayers cannot apply an NOL to prior tax years (i.e., NOL carryback), but instead must carryforward an NOL for an unlimited amount of years until that NOL is exhausted. Additionally, under a new provision, taxpayers are allowed to deduct NOLs only up to 80% of taxable income in that year.

Some business owners may want to consider a structural change

With the drastic reduction in the corporate rate, some owners of pass-through businesses may want to convert the business to a C Corp to take advantage of the tax-rate reduction. But this decision may be more complicated than it seems. On the surface, it may seem preferential for a business to be taxed at the lower 21% corporate rate than the maximum pass-through rate of 37%. Even if you consider the full 20% deduction for qualified business income (QBI), the maximum tax rate for pass-through businesses would be 29.6% (37% tax rate less the 20% QBI deduction), still higher than the 21% tax rate applied to C Corps.

However, business owners must consider the double taxation of corporate profits. For example, if an owner/shareholder of a C Corp sells business property or takes distributions from the business, the proceeds are generally taxed first at the corporate tax rate (21%), and then taxed to the C Corp shareholder as a dividend (to the extent the company has current or accumulated earnings or profits). Of course, there may be other factors to consider such as the C Corp owner/shareholder's ability to retain earnings within the business rather than being distributed as a dividend. Considering other complex tax issues related to C Corps, including the accumulated earnings tax (AET) and personal holding company (PHC) tax, it is critical to consult with a corporate tax expert when assessing a change of business entity.

Tax planning required

The Tax Cuts and Jobs Act (TCJA) introduced the most significant changes in the tax code in decades. Given the complexity of the law, there is likely to be ongoing clarification and guidance from the IRS on many provisions. It is important to consult with a financial advisor and tax professional when evaluating tax law changes including the eligibility to claim the 20% deduction, and when considering advance planning strategies to take advantage of the new law. It is also important to remember that key tax law changes affecting pass-through businesses are not permanent and are set to expire after 2025. Still, there is a window of opportunity for small-business owners, and seeking expert guidance can help navigate the new tax landscape.

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