WHAT TAX REFORM MEANS FOR SMALL BUSINESSES & PASS-THROUGH ENTITIES

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"TAX CUT AND JOBS ACT"

- The new tax law, called the "**Tax Cut and Jobs Act**" (TCJA), was signed into law on December 22, 2017 and is the largest overhaul of the US tax system since 1986.

- **Things you need to know about the tax changes:**
  - This is the first significant reform to the U.S. tax code since 1986.
  - Changes have been made to both individual and corporate tax rates. Individual provisions in the new legislation expire by the end of 2025. Most of the corporate provisions are permanent.
  - The standard deduction has essentially doubled.
  - The personal exemption is gone.
  - The state and local tax deduction now has a cap.
  - The child tax credit has been expanded.
  - There's a new tax credit for non-child dependents, like elderly parents.

- **Expiration:**
  - Under the new bill, many tax provisions for individual taxpayers, including the new tax rates, kicked in on January 1, 2018 and will expire at the end of 2025. At that time, the law will go back to the way it was prior to 1/1/18.

TAX BRACKET UPDATES

Old Rate	New Rate
10%	10%
15%	12%
25%	22%
28%	24%
33%	32%
35%	35%
39.6%	37%

CAPITAL GAINS & STANDARD DEDUCTION

- **Capital Gains Rates**
  - If you hold assets for one year or less, any capital gain at sale or disposal is considered short-term and generally taxed at your ordinary income rate. If you hold assets for more than one year before you get rid of them, your capital gain is called long-term and is taxed at rates of up to 20%.
  - Under the new bill, the same capital gains rates will apply but the brackets will be adjusted.
- **Standard Deduction**
  - The standard deduction amounts for 2018 – before tax reform – would have been $6,500 for individuals, $9,550 for heads of households, and $13,000 for married couples filing jointly.
  - Under the new bill, the standard deduction amounts will increase to $12,200 for individuals, $18,300 for HOH, and $24,4000 for married filing jointly.
- **Additional Standard Deduction**
  - If you are over 65, blind or disabled, you can tack on $1,300 to your standard deduction ($1,600 for unmarried taxpayers).

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PERSONAL EXEMPTIONS, MORTGAGE INTEREST DEDUCTION, STATE/LOCAL TAX DEDUCTIONS

- **<u>Personal Exemptions</u>**
  - Before tax reform, you could claim $4,050 personal exemption for yourself, your spouse, and each of your dependents.
  - Under the new bill, personal exemptions disappear.

- **<u>Mortgage Interest Deduction</u>**
  - Before tax reform, if you itemized your deductions, you could deduct qualifying mortgage interest for purchases up to $1 million plus an additional $100,000 for equity debt. The $1 million cap applied to mortgage on your primary residence plus one other home.
  - Under the new bill, mortgages are capped at $750,000 for the purpose of the home mortgage interest deduction. For mortgages taken out before December 15, 2017, the limit will be $1 million. Beginning 2026, the cap will also be $1 million, no matter when the debt was incurred. Additionally, the deduction for interest on home equity debt (meaning re-fis not related to improving your home) will be eliminated beginning in 2018 – but it will return in 2026.

- **<u>State and Local Tax Deductions</u>**
  - Before tax reform, if you itemized your deductions, you could deduct state and local income taxes or sales taxes and you could deduct state and local property taxes.
  - Under the new bill, state and local tax deductions will remain in place but will be capped at $10,000 for state and local sales, income and property taxes.

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MEDICAL EXPENSE, MISC. ITEMIZED, ABOVE THE LINE DEDUCTIONS

- **Medical Expense Deduction**
  - Before tax reform, if you itemized your deductions, you could deduct qualifying medical expenses which exceed 10% of your AGI.
  - Under the new bill, the medical expense deduction will remain in place with a lower floor of 7.5% for tax years 207 and 2018.
- **Miscellaneous Itemized Deductions**
  - Before tax reform, if you itemized your deduction, you could deduct those miscellaneous deductions which exceeded 2% of your AGI.
  - Under the new bill, misc. deductions which exceed 2% of your AGI will be eliminated. This includes deductions for unreimbursed employee expenses, home office expenses, and tax preparation expenses.
- **Above the Line Deductions**
  - Before tax reform, you could deduct certain expenses including student loan interest ($2,500 per tax return), moving expenses, alimony, and teacher expenses ($250 per teacher), as above-the-line deductions, meaning that you do not have to itemize to take advantage of the deduction.
  - Under the new bill, the deductions for student loan interest and out-of-pocket teacher expenses will be retained with the current caps. The alimony deduction will be repealed – but not until 2019: The change applies to any divorce or separation instrument executed or modified after December 31, 2018 (the modification must expressly state that the new rule applies).

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FRINGE BENEFITS, 529 PLANS, CHILD TAX CREDIT

- **Fringe Benefits**
  - Previously, employers could provide certain benefits, like adoption assistance, dependent care assistance, and moving reimbursements, to employees on a tax-free basis.
  - Under the new bill, the tax break for moving reimbursements will be eliminated (except as it applies to the military) but the breaks for dependent care assistance and adoption assistance will remain in place.

- **529 Plans**
  - Prior to reform, neither the earnings nor distributions in 529 plans were taxable for federal purposes so long as the plan is used for costs associated with college like tuition and room and board as well as fees, books, supplies, and equipment.
  - Under the conference bill, up to $10,000 of 529 savings plans can be used per student for public, private and religious elementary and secondary schools.

- **Child Tax Credit**
  - The credit is currently $1,000 and is refundable.
  - Under the new bill, the child tax credit will double to $2,000 per child and will be refundable up to $1,400, subject to phaseouts. The bill also includes a temporary $500 nonrefundable credit for other qualifying dependents (for example, older adults).

OBAMACARE INDIVIDUAL MANDATE, ALTERNATIVE MINIMUM TAX

- **Obamacare Individual Mandate.**
  - Under current law, you are required to pay a penalty if you do not have minimum health care coverage or claim a waiver or exemption (typically based on hardship).
  - Under the new bill, the penalty would be eliminated.

- **Alternative Minimum Tax (AMT)**
  - The AMT is a secondary tax put in place in the 1960s to prevent the wealthy from artificially reducing their tax bill through the use of tax preference items.
  - Under the new bill, AMT will be repealed for corporations. The AMT will remain for individuals but the exemptions will be increased to $70,300 for individuals and $109,400 for married taxpayers filing jointly, which means it will apply to fewer taxpayers.

PASS-THROUGH ENTITIES, CORPORATE TAX RELIEF, FEDERAL ESTATE TAX

- **Pass-Through Entities**
  - Businesses use structures like limited liability companies (LLCs) or S corporations to pass income through to the owners without paying tax at the company level: Income is taxed at individual rates.
  - Under the new bill, owners of pass-through companies AND sole proprietors (as written "taxpayers other than corporations") will be taxed at their individual tax rates less a 20% deduction (to bring the rate lower) for business-related income, subject to certain wage limits and exceptions. The deduction would be disallowed for businesses offering "professional services" above a threshold amount; phase-ins begin at $157,500 for individual taxpayers and $315,000 for married taxpayers filing jointly.

- **Corporate Tax Relief**
  - Corporations which do not pass through their income pay tax on profits at the corporate level.
  - Under the new bill, the corporate tax rate would be lowered to 21% beginning next year.

- **Federal Estate Tax**
  - Currently, the federal estate tax is imposed on estates which exceed $5.49 million, or nearly $11 million per married couple.
  - Under the new bill, the federal estate and gift tax will remain in place but the exemption would double.

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WAYS TO STRUCTURE YOUR BUSINESS

- Currently, you can structure your business in a few ways, including:
  - A **sole proprietorship** is the simplest form of business entity. Taxpayers do not file a separate tax return and instead, business income and expenses are reported on a federal form 1040, Schedule C.
  - A **partnership** is an association of two or more persons to carry on a business and can take different forms (like limited or general partnerships). A partnership files a separate return, a federal form 1065, and passes income and losses to the individual partners who are responsible for reporting that information on their individual tax returns.
  - A **Limited Liability Company (LLC)** is a hybrid entity that offers the option to be taxed as a partnership or a corporation.
  - **A Single Member Limited Liability Corporation** is an LLC with a single member, typically treated as a "disregarded entity" for federal tax purposes. That means there's no separate tax form and income and expenses are reported on a Schedule C, just as with a sole proprietorship.
  - A **C corporation** files a federal form 1120 and pays any tax due. Shareholders also pay tax at their individual income tax rates for dividends or other distributions from the company (this is where the term "double tax" comes from).
  - A **Professional or Personal Service Corporation** is a corporation for certain occupations – typically service professions like lawyers, doctors, and architects.
  - An **S Corporation** is a corporation with tax treatment similar to a partnership. An S corporation files a federal form 1120-S which passes most items of income or loss to shareholders who are responsible for reporting that information on their individual tax returns.

CORPORATE TAX RATES

- Corporate tax rates, like individual tax rates, are progressive. For 2017, corporate rates range from 15% to 39% (except for personal service corporations which are taxed at 35%) while individual tax rates range from 10% to 39.6%. While the brackets vary, the rates for individuals and corporations are pretty closely aligned.

- The new tax law now provides for a flat 21% tax rate for corporations. This could have been problematic – if companies were taxed at a lower rate than individuals, the pass-through scheme wouldn't work and creating a new tax rate for entities would take away the pass-through nature of the entity. The solution? Business income that passes through to an individual from a pass-through entity and income attributable to a sole proprietorship will be taxed at individual rates less a deduction of up to 20% to bring the rate lower.

IMPORTANT TERMS:

- **Qualified business income (QBI)**.
  - QBI is generally net income from your business without regard for any amount paid by an S corporation that is treated as reasonable compensation, any guaranteed payment for services in business, or any amount paid or incurred to a partner for services outside his or her capacity as a partner.
- **Qualified property**.
  - Qualified property is tangible property (typically, things you can touch) subject to depreciation and available for use in your business at the end of the tax year. You must use the property to produce qualified business income (as defined above).
- **Specified service trade or business**.
  - A specified service trade or business is any business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or "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 owners." I like to think of it this way: if the success of your business depends on you and not on something that you sell, you're pretty much included (except for engineering and architecture services, which were specifically excluded). The definition also includes a business where the performance of services consists of investing and investment management trading, or dealing in securities, partnership interests, or commodities.
- **Threshold amount**.
  - The threshold amount is the amount above which both the limitation on specified service businesses *and* the wage limit apply. The threshold amount is $157,500 for individual taxpayers and $315,000 for married taxpayers filing jointly. Phase-ins apply: that means that the benefit decreases as income increases.

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FIGURING THE DEDUCTION

- If your taxable income is below the threshold amount, the deduction amount for your businesses is 20% of your QBI.
- **Pass-through Entities**:
  - This includes **sole proprietorships, partnerships, LLC's and S-Corporations**.
  - Will receive a 20% deduction on their Qualified Business Income (QBI or basically "net income"). So, if you make $100,000/year in net income, you'll only be taxed on $80,000.
  - This deduction applies to individuals making less than $157,500 and married couples making less than $315,000 – the deduction is reduced as you exceed this income up to $207,500 for individuals and $415,000 for married couples (at which point the deduction is largely eliminated).
  - This deduction is either excluded or reduced for the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or "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 owners."

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FIGURING THE DEDUCTION

- **C-Corporations:**
  - **The C-Corporation tax has been lowered from 35% to 21%.** So, the US has gone from one of the highest corporate tax rates in the world to one of the lower.
  - Note that this is still a "double-tax" because the C-Corporation owner will pay taxes once on the business income and again when the profits are added to their personal tax return as dividends.
  - So, the C-Corporation has suddenly become much more attractive than before. However, the same overall strategy would apply as before: if you own a C-Corporation, you want to maximize expenses through the corporation which would lower your overall net profit (and hence, how much taxes you would pay).

FIGURING THE DEDUCTION

- **Summary:**
  - Overall, if you own a C-Corporation or a Pass-through Entity (and you make under $157,500 (individual) or $315,00 (married filing jointly)) you're going to get a tax break – this is the vast majority of small businesses in the US. The law is complex with many variables but overall is a net positive for small business.

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