THE TAX CUTS AND JOBS ACT FOR BUSINESS

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In another article, we addressed major changes enacted in US tax law, effective with the 2018 tax returns that we'll file in Spring 2019. That article explained some provisions that affect individuals. They include a nearly-doubled standard deduction, an increased child tax credit, the loss of personal exemption amounts, and lower tax rates.

In this article, we will address some new provisions that affect businesses. For instance, depreciation of equipment has been liberalized. Under Section 179, up to $1,000,000 worth of new or used equipment can be fully deducted in the year it is placed in service; the previous limit was $500,000. Or, you can use the revised bonus depreciation provisions, under which 100% of all such purchases are deducted. Tip: Usually it's better to use the Section 179 provisions. In some situations, bonus depreciation provisions are better. For instance, bonus depreciation in many cases will require deducting 100% of all the equipment you buy during the year, while Section 179 allows you to set the dollar amount of the deduction. This is useful if it is not most advantageous to deduct 100% of equipment purchases. You may need a tax expert to help navigate this issue.

One of the biggest changes is that the tax rate for C corporations is now 21%, which is a significant decrease. It brings the US tax rate on C corporations more in line with the rest of the world; thus, there is less incentive for C corporations to shift their operations to lower-tax countries (think Apple, Microsoft, and the likes).

Few of our clients file as C corporations; that entity type tends to be utilized mostly by very large businesses. However, since the big businesses were given such a generous tax break, Congress wished to give a similar break to smaller businesses and farmers, nearly all businesses that aren't C corporations. It is called the 20% QBI deduction, for Qualified Business Income. The details of it are complex, but we'll try to summarize how it will affect most of our clients.

First, who can take this deduction? It can be taken for any business profit reported, and thus taxed, on the Form 1040 U.S. Individual Income Tax Return. This includes the profit of sole proprietors (Sch. C filers) and farmers (Sch. F filers). It also includes the income of partners, S corporation shareholders, and LLC members that file as either of these; these types of filers receive Sch. K-1 from their business for reporting the business profit on their individual tax returns. In addition, most rental property owners will qualify. In other words, it applies to all businesses except C corporations.

How much is it? Before we answer that, let's explain the difference between business profit and taxable income. Business profit is the amount left after a business pays its overhead and operating expenses, such as labor, materials, tools, feed, seed, veterinary, and everything else. In contrast, taxable income is what is left to pay federal income tax on after other allowable deductions, such as itemized deductions or the standard deduction.

In simple terms, the new QBI deduction equals 20% of the lesser of business profit or taxable income. To illustrate, assume the profit of a business is $50,000. The tax return on which it is reported has a taxable income (after such deductions as the standard deduction, for example) of $25,000. 20% of the $50,000 business profit is $10,000; 20% of the $25,000 taxable income is $5,000. The lesser amount of $5,000 is taken for the new QBI deduction, and the taxable income becomes $20,000 instead of $25,000. Thus, if

the only income on the tax return is the business profit of $50,000, the lesser amount is 20% of taxable income, not the full profit.

When might the deduction be 20% of the business profit instead of 20% of the taxable income? This can occur when the tax return has other income on it besides the business profit. For example, suppose the above taxpayers are also wage-earners with jobs that earn them $50,000 of wages in addition to the business profit of $50,000. Now their total income is $100,000, and their taxable income is around $75,000 after deducting the standard deduction. 20% of business profit is still $10,000; 20% of taxable income is $15,000. The QBI deduction will be the lesser amount of $10,000. The taxable income on the return will now be $65,000 instead of $75,000.

There are some caveats. For example, if the taxable income on Form 1040 is between $315,000 and $415,000 for the Married Filing Jointly status, and between $157,500 and $207,500 for everyone else, the 20% deduction isn't automatic. Instead, it may be gradually phased out if the business is a Specified Service Business, such as doctors, lawyers, and accountants. It may also be phased out if certain other tests are not met, which we'll get to in the next paragraph. Above those thresholds, it may be eliminated altogether.

Note: You can skip this paragraph if you are sure your taxable income will be below the thresholds described above. I can't come up with a simpler way to explain this, but we'll give it a try. What happens if the taxable income is above the thresholds? If the business is NOT a Specified Service Business (doctors, etc.) AND it paid wages and/or owns buildings and/or equipment, it still gets a deduction. Instead of being a flat 20% of profit or taxable income, the deduction is determined by a formula that uses the amount of wages paid to employees and/or the amount invested in buildings and equipment. The higher the wages paid and/or the higher the investment in buildings and equipment, the higher the QBI deduction will be. However, the deduction can never exceed 20% of business profit or taxable income, whichever is lower. Clear as mud? I had to wade through it several times before it began to make sense.

This note only applies to S corporation filers: The amount your S corporation pays you in wages does not qualify for the 20% QBI deduction. And here is a note for partnerships filing Form 1065: The amount you are paid that is labeled 'guaranteed payments' on your Form K-1 does not qualify for the deduction. Guaranteed payments are the equivalent of wages for partners since partners are not allowed to be treated as employees. Tip: For S corporation and Form 1065 partnership filers, your wages or guaranteed payments can be reviewed to see if a decrease in the amounts would be beneficial, as well as legal in the case of S corporations. This might qualify you for a higher QBI deduction.

Self-employed business owners (sole proprietors, farmers, and Form 1065 partners) always owe two taxes when they file Form 1040. One is regular federal income tax and the other is self-employment social security tax. It is important to note that the 20% QBI deduction will not affect self-employment social security tax, only federal income tax. In the two examples above, the self-employed business owners are subject to this tax, and they will owe it on the full business profit of $50,000 in both cases.

And there are some traps. One trap involves dairy farmers and other livestock producers who sell animals they have used for dairy and/or breeding stock that they raised from their own calves. This is often a major source of income on dairy farm tax returns. This income has always been taxed at the lower capital gains rates, and the new tax law says such income cannot be used in calculating the QBI

deduction. However, capital gains rates are lower than regular tax rates, so all is not lost. Half a loaf is better than none.

Another point involves some construction, manufacturing, and farm businesses that have had employees on payroll in past years. For the past several years, such businesses have qualified for a 9% deduction, referred to as DPAD, that other businesses did not qualify for. DPAD was replaced with the new 20% QBI deduction. The new 20% QBI deduction will not seem as generous to them because they had already been getting a 9% deduction. So, it's like they will be getting an additional 11% instead of 20%. I'm not sure if it is correct to label this as a trap, but nonetheless such businesses will not be getting as large a decrease in taxable income compared to prior years as those that did not qualify for DPAD. Again, half a loaf is better than none.

Someone estimated that at least 95%, perhaps even more, of US taxpayers will have a lower tax liability under the new tax law, resulting in more money in taxpayers' pockets. Like a long-ago employer of mine used to say when he handed out paychecks, "Watch how you spend it!"