2018 Business Income Tax law changes

First, a quick reminder. Currently, you can structure your business in a few ways, including:

- A **sole proprietorship** is the most simple 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 Company** 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** is what most people think of when it comes to business. 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, 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 (the new tax rates for individuals are here). You can imagine how that could have been problematic without more changes: If companies were taxed at a lower rate than individuals, the pass-through scheme doesn't work. But creating a new tax rate for the entities would take away the pass-through nature of the entity. Congress' 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 tax rates less a deduction of up to 20% to bring the rate lower.

It sounds easy but it quickly can become tricky since the deduction is subject to limits and restrictions. To understand those, you need some definitions:

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. You'll use the "normal" rules when figuring QBI, so capitalize and amortize expenditures accordingly. One last note: QBI is determined on a per business, not a per taxpayer, basis.

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.

Now that we’ve got those definitions down, here’s how to figure the deduction:

If your taxable income is below the threshold amount, the deductible amount for each of your businesses is simply 20% of your QBI with respect to each business.

- So, if your income is $50,000 and your QBI is $40,000, then your deduction is $8,000, or 20% of your QBI. You’re under the threshold amount so no need to do any more math.

Easy, right?

If you are above the threshold amount, you are subject to limitations and exceptions which are determined by your occupation and a wage (and capital) limit.

Let’s look at *specified service trade or businesses* first. To figure QBI for a specified service trade or business, you take into account the applicable percentage of qualified items of income, gain, deduction, or loss, and allocable W-2 wages. When figuring the wage (and capital) limit, you’ll include total wages paid to employees during the tax year but not those which are properly allocable to QBI (in other words, don’t double count).

Here’s how it works: Figure 20% of your QBI (a) and compare that to an additional formula (b): the greater of 50% of W-2 wages with respect to your trade or business *or* the sum of 25% of W-2 wages + 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property. Don’t forget to take into account the applicable percentage rate – 100% less the excess of the taxable income over the threshold amount divided by the range amount or in more simple terms, it’s pro-rated for the amount you’re over the threshold.

- So let’s say that you are a single taxpayer with taxable income of $200,000. Let’s also say that included in that amount is $100,000 in income from your law firm with applicable W-2 wages of $90,000.

- For purposes of figuring the deduction, calculate the applicable percentage. The applicable percentage is 15%, or 100% *less* 85% [($200,000 - threshold amount of $157,500)/$50,000 = 85%].

- Apply the applicable percentage to QBI (15% of $100,000 = $15,000) and W-2 wages (15% of $90,000 = $13,500).

- After applying the applicable percentage, your deduction is the lesser 20% of includible QBI (20% of $15,000 = $3,000) or 50% of W-2 wages (50% x $13,500 = $6,750), or $3,000.

If you are a specified service business and your taxable income exceed the threshold amount plus the phase in range ($207,500 for individual taxpayers and $415,000 for married taxpayers filing jointly), then you lose the deduction completely. In that case, the old pass-through rules apply meaning you pay tax using your individual tax rate.

For all other businesses, if your taxable income exceeds the threshold amount, the wage (and capital) limits begin to kick in. The wage (and capital) limit applies fully for a taxpayer (other than a specified service business) when taxable income exceeds the threshold amount plus the phase in range ($207,500 for individual taxpayers and $415,000 for married taxpayers filing jointly).

Before we do a deeper dive on how the phase in affects the final numbers, let's look at the wage (and capital) limit: the greater of 50% of W-2 wages with respect to your trade or business *or* the sum of 25% of W-2 wages + 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property. The addition of qualified property to the formula accommodates businesses which rely on the acquisition of capital, like real estate businesses. In other words, the "W-2 rule" under the Senate plan has been expanded to include wages paid plus capital.

Here's an example of how the wage (and capital) limit is intended to work:

- Let's assume you have $5,000 in W-2 wages, and you buy equipment worth $200,000 and place it in service during the year.
- According to the formula, 50% of W-2 wages = $2,500
- And, according to second part of the formula: 25% of W-2 wages + 2.5% of unadjusted basis of the machine = $6,250.
- The greater of the two amounts is $6,250: use that amount to figure your deduction. Note in this example that we're aren't figuring the actual deduction since we don't have enough information, like total income or QBI. This is just an illustration of how you use the formula to determine the wage (and capital) limit when you have capital and W-2 wages.

If you sell the qualified property before year end, it's no longer available for use and is not used in the formula. It's not yet clear under the law what will happen in circumstances such as like-kind exchanges or involuntary conversions – expect guidance from the Internal Revenue Service (IRS).

If you put QBI together with the wage (and capital) limit, you can figure your deduction. *Remember that this only applies if you are over the threshold amounts.*

Here's an example of how the whole formula works together:

- Let's say you and your spouse file a joint return reporting taxable income of $350,000. Your business (not a specified service business) income was $75,000 and your share of W-2 wages paid by your business was $20,000. There is no qualified property.
- Under the formula, (a) is 20% of your qualified business income, or $15,000.
- Under the formula, (b) is 50% of W-2 wages, or $10,000 (since 25% of W-2 wages + 0 = $5,000 and you use the bigger number under the wage (and capital) limit part of the formula).
- Since (b) is less than (a), the wage (and capital) limit applies and your deduction is reduced according to the phase in. The applicable percentage is ($350,000 – $315,000 threshold amount)/$100,000, or 35%.
- You'll reduce the tentative QBI deduction of $15,000 (a) by the difference between (a) and (b) (or $5,000) times the applicable percentage of 35% ($5,000 x 35% = $1,750).
- Your deduction should be $13,250 (or $15,000 – $1,750).

You should be able to deduce that the higher the applicable percentage, the more that the wage limit applies. Let's switch up the numbers in the above example to have income of just $1,000 less than the top of the range:

- The applicable percentage is ($414,000 – $315,000 threshold amount)/$100,000, or 99%.
- You'll reduce the tentative QBI deduction of $15,000 (a) by the difference between (a) and (b) (or $5,000) times the applicable percentage of 99% ($5,000 x 35% = $4,950).
- Your deduction should be $10,050 (or $15,000 – $4,950).

And if you've reached the top of the range? The wage limit applies in full.

No matter which variation of the formula applies, your deduction may not exceed your taxable income for the year (reduced by net capital gain). If the net amount of your QBI is a loss, you'll carry it forward as a loss to the next tax year.

And remember, these deductions from income reduce your taxable income on your individual return. It does not change how you calculate your taxable income inside your business. Business expenses remain deductible.

Got all that? Admittedly, I am relying on “easy” rules and examples for purposes of explanation. Additional rules apply to qualified cooperative dividends, qualified REIT dividends, and qualified publicly traded partnership income. Also complicating matters? Losses. If those items affect you, consult with your tax professional. Although, who are we kidding? Even if they don’t apply to you, you should consult with your tax professional.

And yes, there are a million “what ifs?” to be considered. Remember, this is just an overview. With respect to questions about the value of incorporating and other planning issues, there is no one size fits all answer but I will be following up with some general planning tips shortly.