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CERTIFIED PUBLIC ACCOUNTANTS

The 2018 New Pass-Through Tax Strategy

You may have heard that we're all going to pay a whole lot less tax on our pass-through entities. That's true, to a point.

It's a complicated formula and so let's start at the beginning.

A pass-through entity is a Sole Proprietorship, a Partnership or an S Corporation. (It also includes an LLC taxed as a Partnership or as an S Corporation.)

If you are a single taxpayer whose taxable income is $157,500 or less or married, filing jointly with $315,000 or less, you are exempt from the service/non-service qualifying tests and the calculation of how much is subject to the reduction. Your business net income will be reduced by 20% when calculating the tax.

Over that, and your first test is whether you are a service or a non-service business. If you have a service business, you may still get a reduction.

A service business is defined as any business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset of such business is the reputation or skill of 1 or more of its employees. In a last-minute change, engineering and architecture were reclassified as non-service businesses. A service business also includes performance of services that consist of investing and investment management, trading, or dealing in securities.

If your service business is less than the second threshold amount, $207,500 for single or $415,000 for married filing jointly, then you can do the calculation for the reduction of taxable business income under the same guidelines that follow for non-service business.

For non-service businesses, the amount of business income reduction you can take is limited to the greater of 50% of wages (guaranteed payment or W-2 income) or 25% of wages plus 2.5% of the unadjusted basis of qualified property. Qualified property is depreciable property that is still in the depreciable period.

Let’s go through this one more time, step by step:

1. Do you have a pass-through business entity? If no, no need to read further. This isn’t applicable to you. If yes, go on to (2).
2. Is your taxable income less than $157,500 (single) or $315,000 (married filing jointly)? If yes, you get to deduct 20% of your business income for tax calculation purposes. If no, continue.
3. Do you have a service business? If yes, go to (4). If no, go to (5).
4. Is your taxable income less than $207,500 (single) or $415,000 (married filing jointly)? If yes, continue on to (5). If no, you’re done. You get no reduction in tax.
5. If you have a service business under the adjusted threshold or a non-service, you can get a deduction of 20% of business income subject to a cap of greater of 50% of wages paid or 25% of wages paid plus 2.5% of qualified property.
6. If you have a partnership with a partner or another shareholder in an S Corporation, you will split the deduction amount based on how you split the profit of the company.

Some of the strategies to think about for 2018:

Make sure there are enough wages paid from your company to qualify for the deduction. If you have a separate entity for payroll or are using a leasing company so that you actually have no wages, you may need to change that strategy for 2018. We’re currently waiting to see how leased employees will fit into this definition. For now, be aware.

If your income is lower than the threshold, you will likely get more of a reduction than someone with income just barely over. Plan carefully, make sure you’re taking into account all of the above the line deductions you can take, realizing that you may be losing your itemized deductions. A C Corporation used in conjunction with your flow through entity may be the best way to adjust your taxable income, so you can qualify for the reduction in tax.

It has never been more important to have good and current financials prior to year-end. The year 2018 is when it all changes and it’ll be awhile before this feels natural. Don’t add to the stress by not having current financials.

This 20% deduction will be a below-the-line deduction which is an important piece to understand. The “line” refers to the AGI line on your tax return which is the bottom line on the first page of your Form 1040. While both above-the-line and below-the-line deductions reduce your taxable income, it’s important to understand the difference between the two.

Above-the-line deductions happen on the first page of your tax return. These deductions reduce your gross income to eventually reach your AGI (adjusted gross income) for the year. The AGI is important because the AGI is used to determine your eligibility for certain tax credits and it will also have an impact on which below-the-line deductions you are eligible for. In general, the lower your AGI is, the more deductions and credits you are eligible to receive.

Below-the-line deductions are reported on lines that come after the AGI calculation. They are comprised mainly of your “standard deduction” or “itemized deductions” and “personal exemptions” (most of which will be gone starting in 2018). The 20% deduction for qualified business income will fall into this below-the-line category. It will lower the income of small business owners but it will not lower their AGI.

However, it was stated in the tax legislation that even though the 20% qualified business deduction will be a below the-line deduction, it will not be considered an “itemized deduction”. If it’s not an itemized deduction, then small business owners can claim the 20% qualified business income deduction and still claim the standard deduction. This is an important note because many small business owners may end up taking the standard deduction for the first time in 2018 due to all of the deductions and tax exemptions that were eliminated in the new tax bill. The tax bill took away a lot of big deductions:

- Capped state and local taxes at $10,000 (this includes state income taxes and property taxes)
- Eliminated personal exemptions ($4,050 for each individual) (Eliminated in 2018)
  - Family of 4 = $4,050 x 4 = $16,200 (Eliminated in 2018)
- Miscellaneous itemized deductions subject to 2% of AGI floor (Eliminated in 2018)

Restrictions On The 20% Deduction

The restriction were put in place to prevent business owners from reclassifying their W2 wages into 100% pass-through income to take advantage of the 20% deduction. They also wanted to restrict employees from leaving their company as a W2 employee, starting

a sole proprietorship, and entering into a sub-contractor relationship with their old employer just to reclassify their W2 wages into 100% pass-through income.

S-Corps

Qualified business income will specifically exclude “reasonable compensation” paid to the owner-employee of an S-corp. While it would seem like an obvious reaction by S-corp owners to reduce their W2 wages in 2018 to create more pass through income, they will still have to adhere to the “reasonable compensation” restriction that exists today.

Partnerships & LLCs

Qualified business income will specifically exclude guaranteed payments associated with partnerships and LLCs. This creates a grey area for these entities. Partnerships do not have a “reasonable compensation” requirement like S-corps since companies taxed as partnerships are not allowed to pay W2 wages to the owners. Also the owners of partnerships are not required to take guaranteed payments. My guess is, and this is only a guess, that as we get further into 2018, the IRS may require partnerships to classify a percentage of a owners total compensation as a “guaranteed payment” similar to the “reasonable compensation” restriction that S-corps currently adhere too. Otherwise, partnerships can voluntarily eliminate guaranteed payments and take the 20% deduction on 100% of the pass-through income.

This may also prompt some S-corps to look at changing their structure to a partnership or LLC. For high income earners, S-corps have an advantage over the partnership structure in that the owners do not pay self-employment tax on the pass-through income that is distribution to the owner over and above their W2 wages. However, S-corp owners will have to weigh the self-employment tax benefit against the option of changing their corporate structure to a partnership and potentially receiving a 20% deduction on 100% of their income.

Sole Proprietors

Sole proprietors do not have “reasonable compensation” requirement or “guaranteed payments” so it would seem that 100% of the income generated by sole proprietors will count as qualified business income. Unless the IRS decides to enact a “reasonable compensation” requirement for sole proprietors in 2018, similar to S-corps. Before everyone runs from a single member LLC to a sole proprietorship, remember, a sole proprietorship offers no liability barrier between the owner and liabilities that could arise from the business.

Income Restrictions

There are limits that are imposed on the 20% deduction based on how much the owner makes in "taxable income". The thresholds are set at the following amounts:

Individual: $157,500

Married: $315,000

The thresholds are based on each business owner's income level, not on the total taxable income of the business. We need help from the IRS to better define what is considered "taxable income" for purposes of this phase out threshold. As of right now, it seems that "taxable income" will be defined as the taxpayer's own taxable income (not AGI) less deductions.

If the owner's taxable income is below this threshold, then the calculation is a simple 20% deduction of the pass-through income. If the owner's taxable income exceeds the threshold, the qualified business deduction is calculated as follows:

The LESSER of:

- 20% of its business income OR 50% of the total wages paid by the business to its employees

Let's look at this in a real life situation. A manufacturing company has a net profit of $2M in 2018 and pays $500,000 in wages to its employees during the year. That company would only be able to take the qualified business income deduction for $250,000 since 50% of the total employee wages ($500,000 x 50% = $250,000) are less than 20% of the net income of the business ($2M x 20% = $400,000).

This creates another grey area because it seems that the additional calculation is triggered by the taxable income of each individual owner but the calculation is based on the total profitability and wages paid by the company. For the owners that required this special calculation for exceeding the threshold, how is their portion of the lower deduction amount allocated? Multiplying the lower total deduction amount by the percent of their ownership? Just more unanswered questions.

Restrictions For “Service Business”

There will be restrictions on the 20% deduction for pass-through entities that are considered a “service business” under IRC Section 1202(e)(3)(A). The businesses specifically included in this definition as a services business are:

- Health
- Law
- Accounting
- Actuarial Sciences
- Performing Arts
- Consulting
- Athletics
- Financial Services
- Any other trade or business where the principal asset of the business is the reputation or skill of 1 or more of its employees

In a last minute change to the regulations, to their favor, engineers and architects were excluded from the definition of “service businesses”.

This is another grey area. Many small businesses that fall outside of the categories listed above will undoubtedly be asking the question: “Am I considered a service business or not?” Outside of the industries specifically listed in the tax bill, we really need more guidance from the IRS.

If you are a “services business”, when the tax reform was being negotiated it looked like service businesses were going to be completely excluded from the 20% deduction. However, the final regulations were more kind and instead implemented a phase out of the 20% deduction for owners of service businesses over a specified income threshold. The restriction will only apply to those whose “taxable income” exceeds the following thresholds:

Individual: $157,500

Married: $315,000

If you are a consultant or owner of a services business and your taxable income is below these thresholds, it would seem at this point that you will be able to capture the 20% deduction for your pass-through income. As mentioned above, we need help from the IRS to clarify the definition of “taxable income”.

Phase Out For Service Businesses

The amounts listed above: $157,500 for individual and $315,000 for a married couple filing joint, are where the thresholds for the phase out begins. The service business owners whose income rises above those thresholds will phase out of the 20% deduction over the next $50,000 of taxable income for individual filers and $100,000 of taxable income for married filing joint. This means that the 20% pass-through deduction is completely gone by the following income levels:

Individual: $207,500

Married: $415,000

Any taxpayer's falling in between the threshold and the phase out limit will receive a portion of the 20% deduction.

Since the thresholds are assessed based on the taxpayer's own taxable income and not the total income of the business, a service business could be in a situation, like in an accounting firm, where the partners with the largest ownership percentage may not qualify for 20% deduction but the younger partners may qualify for the deduction because their income is lower.

Tax Planning For 2018

It's an understatement to say that most small business owners will need to spend a lot of time with their accountant in the first quarter of 2018 to determine the best of course of action for their company and their personal tax situation. For small business owners that don't have an accountant or that don't have a good one, get one!! There are big tax benefits waiting for small business owners but you will need a knowledgeable, proactive tax advisor to help you navigate the rapidly changing tax landscape in 2018.

While we are still waiting for clarification on a number of very important items associated with the 20% deduction for qualified business income, hopefully this article has provided our small business owners with a preview of things to come in 2018.