What Business Owners Need to Know about Tax Reform

The Tax Cuts and Jobs Act of 2017 (TCJA) made significant changes to the tax code that could impact a company’s short- and long-term goals. To illustrate the complexity of the legislation, just one code section has over 180 pages of regulations that clarified some questions and raised others.

Generally, there appears to be advantageous business restructuring planning opportunities to consider, as well as several pitfalls to navigate through, in order to maximize the ability to use the new deductions available to pass-through businesses. Changes would need to be integrated into estimated tax payments.

New 20 Percent Deduction for Qualifying Pass-Through Income

One of the most beneficial provisions of the TCJA is the new 20 percent deduction that may be available to individual owners of pass-through businesses. Through 2025, individuals, trusts, and estates that own a pass-through business are eligible for a 20 percent deduction from their allocable combined qualified business income (QBI). The deduction is to be taken as a reduction of the taxpayer’s overall taxable income, not against adjusted gross income (AGI), and is therefore not affected by whether or not the taxpayer itemizes. (This also means that the deduction does not actually reduce the business net income, which could still be subject to self-employment tax and the Medicare surtax.)

The deductible amount for purposes of computing the combined QBI is generally the lesser of:

- 20 percent of the taxpayer’s QBI with respect to each qualified business, or
- A W-2 wage/qualifying property limitation defined as the greater of:
  - 50 percent of the W-2 wages with respect to the qualifying business, or
  - The sum of 25 percent of the W-2 wages with respect to the qualifying business, plus 2.5 percent of the “unadjusted basis immediately after acquisition” of all “qualified property.”

However, the above limitation will not apply to taxpayers with less than $315,000 (married filing jointly, or MFJ) or $157,500 (all other filing statuses) of taxable income before the deduction, and the limitation is phased in under a complex calculation over the next $100,000 (MFJ) or $50,000 (all others) of taxable income before limitation. Additionally, a taxpayer may be able to claim the deduction even if they are above the AGI thresholds, and also be able to claim the deduction if they do not have W-2 wages in the business (i.e., such as operating through a sole proprietorship), as long as they have tangible assets in the business.

One huge obstacle, however, is if the income is from a “specified service trade or business.” According to the Congressional Conference Report to the TCJA, a specified service activity means “any trade or business activity involving the performance of services in the fields of health, law, engineering, architecture, 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. The regulations provide much more guidance, and the statute excludes engineers and architects. This exclusion from eligible businesses will not apply to taxpayers with income less than $315,000 (MFJ) and $157,500 (single filers). The threshold is phased out over the next $100,000/$50,000, respectively.

The statutory operational rules are quite complex, with numerous definitions, limitations, and exceptions. It has raised dozens of practical implementation questions. For example, if the core business has a minor amount of a disqualifying service business, would it disqualify the entire business? How would such a de minimis rule be applied—amount of revenue, income, or assets? Could the disqualifying business be carved out? What if it is central to the core business’s operations? What is specifically included in qualifying business income? What is included in W-2 wages? Which assets are included in the qualified property test, and at what basis if the taxpayer elected to expense the assets?

Choice of Entity After Tax Reform – C or Pass-Through

Congress lowered the tax rate for entities operating as C corporations, from a federal rate of 35 percent to 21 percent. This applies to businesses not operating as a pass-through type. That is an attractive rate compared to the top personal marginal federal rate of 37 percent that applies to income from a pass-through business. However, there are several other factors that should be considered before choosing to change or keep your present organizational form.

If a pass-through owner could take advantage of the new 20 percent deduction outlined above, (ignoring other complications described below), the top effective federal rate would be 29.5 percent. But that is still about 8.5 points greater than the 21 percent C corporation federal rate.

However, consider a few other complications: state income taxes, how much the company distributes in dividends, possibly selling the business someday, and the applicability of preferential rates and the Medicare surtax on certain types of income. Let’s assume your business operates only in Pennsylvania, it distributes all of its earnings, and you plan to sell the business someday. The effective overall combined business and personal tax rate if the business is held in C corporation form is a staggering 48 percent. If held in pass-through form, and you could take advantage of the new pass-through deduction discussed earlier, your effective tax rate would be a more attractive 36.5 percent.

There are several additional significant factors to consider: whether you retain at least some earnings for growth; whether you want to hold on to the business for the next generation; if you sell, would you sell assets or stock; if you could take advantage of certain gain exclusions upon a future sale; you operate in more than one state; whether you are a passive or active owner; what is your inside tax basis of assets and your outside tax basis in your ownership interest; certain tax-related transitional and conversion issues; and whether rates change again in the future (i.e., individual rate cuts are scheduled to go back to pre-tax-reform levels in 2026).

100 Percent Immediate Expensing of Certain Property

Effective for property acquired and placed in service after Sept. 27, 2017, and before 2023, taxpayers can take an immediate expense of 100 percent of the cost of the acquisition of new or used machinery, equipment, and furniture, and—depending on technical corrections and future Treasury guidance—certain qualified improvement property. (Especially with respect to this latter category of qualified improvement property, taxpayers may want to perform a careful breakdown of what qualifies and what does not qualify for immediate expensing, since the alternative would be considerably slower recovery of such property, potentially up to 39 years.)

Immediate 100 percent expensing is generally phased down by 20 percent per year beginning in 2023, until it is completely gone in 2027. There are various complexities for property un-
under contract on Sept. 27, 2017. Also, immediate 100 percent expensing will generally not apply to certain industries or businesses with “floor plan financing indebtedness.”

**Increased Section 179 Expensing**

Effective for property placed in service in taxable years beginning after Dec. 31, 2017, Section 179 allows up to $1 million of immediate expensing of new or used machinery, equipment, and furniture, and qualified real property, as long as such expenditures do not exceed $2.5 million in that year.

**Miscellaneous Other Business Provisions**

**Active Business Losses** – For “active” individual business owners who experience a business loss, such losses at one time could be used in full to offset other income, such as wages, etc. Now, effective for 2018, active business losses can only be used against other income to a maximum of $500,000 for MFJ taxpayers, and $250,000 for all other filing statuses. Any unused excess loss can be carried over to future years. (The new law did not change the limitation that passive losses can only be used to offset passive income.)

**Entertainment Expenses** – The tax reform law repealed the deductibility of entertainment expenses, including club dues, as well as several other employee fringe benefits.

**Like-Kind Exchanges** – Section 1031, Like-Kind Exchanges, was repealed for all property except real estate not primarily held for sale.

**Domestic Manufacturing Deduction** – The new law repealed the ability to deduct up to 9 percent of the gross profit from a U.S.-based manufacturer or producer.

**Accounting Method Relief for Small Businesses**: There are several provisions that provide for simpler accounting methods for small businesses. The new law expanded the availability of such methods to businesses with $25 million of annual receipts. These simpler methods include the ability to use the cash method, and not having to use inventory accounting or the “super full absorption” rules.

**Limitations on Interest Expense Deductibility** – Although the new law did provide new and complex limitations on the ability to deduct excess business interest expense, these provisions will generally not apply to taxpayers with average annual gross receipts under $25 million; taxpayers with “floor plan financing;” regulated public utilities; and, by election, certain real property trades or businesses involved in development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business, as well as any farming business or lodging facility.

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The PICPA worked carefully to prepare this guide, but it cannot be used as official tax advice that would protect taxpayers from penalty due to the complexity of tax law, individual taxpayer facts and circumstances, and changes enacted after this writing. We encourage taxpayers to seek advice from our member CPAs about the items contained in this resource, as well as other tax issues and planning opportunities. See separate brochure for individual tax considerations.

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