Individualized Systems

Your Aggressive De-TAX Professionals

UNDERSTANDING THE TAX CUTS AND JOBS ACT

HOW IT IMPACTS YOU

Dear Client:

The new Tax Cuts and Jobs act is the most sweeping tax reform I have seen in my 30-plus years in this industry and, over the course of this year, I am going to do my best to explain the provisions of this 185-page document to you with an eye on its direct impact on your finances and the overall economy.

This first monthly installment covers the two most important of the provisions that will impact the majority of business taxpayers. There is a 7-page general summary on our website which I hope you will review as well.

If you have a particular concern or question, don't hesitate to ask.

The New 20% Deduction

The new 2018 20% business deduction that you can claim on your IRS Form 1040 is a HUGE deal. There are many rules (all new, of course), as a business owner, your odds of benefiting from this new deduction are excellent.

If you operate your business as a sole proprietorship, partnership, or S corporation, your 2018 income from these businesses can qualify for some or all of the new 20 percent deduction.

You also can qualify for the new 20 percent 2018 tax deduction on the income you receive from your real estate investments, publicly traded partnerships, real estate investment trusts (REITs), and qualified cooperatives.

When can you as a business owner qualify for this new 20 percent tax deduction with no complications? OK, almost no complications. I mean, it's the government! Right?

To qualify you need two things:

First: you need qualified business income from one of the sources above to which you can apply the 20 percent.

Second, to avoid complications, you need "defined taxable income" of

- $315,000 or less if married filing a joint return, or
- $157,500 or less if filing as a single taxpayer.

What is Qualified Business Income? VERY simply, it is the profit from your business. Of course the Government has a very complicated way of stating that, but, essentially, that's what it is, the NET income, not the Gross income.

Example. You are single and operate your business as a proprietorship. It produces $350,000 of gross income. After expenses, the net profit is $150,000 of "qualified business income". Your other (non-business) income and deductions result in defined taxable income (the taxable line of your tax form 1040 on page 2 of the form) of $153,000. You will qualify for a deduction of $30,000 ($150,000 x 20 percent) against your taxable Income.

If you operate your business as a partnership or S corporation with the same income numbers above, you still qualify for the same $30,000 deduction.

The same is true if your income comes from a rental property, real estate investment trust, or limited partnership.

Service Professions "Out of Favor"

Unfortunately, some unfriendly rules apply to what is called "A specified service trade or business" such as Lawyers, Doctors and (DARN!) Accountants, and Actors (is that a redundancy?) plus athletes, brokers, insurances, and any other trade or business where the principal asset is the reputation and/or skill of 1 or more of its employees (except engineers and architects which are not, it seems, included in the out-of-favor group).

But, in the spirit of helping the little guy, if the service provider has defined taxable income less than the listed thresholds they still qualify for the full 20 percent deduction on his or her qualified business income.

Once you are above the thresholds and phaseouts ($50,000 single, $100,000 married filing jointly), you can qualify for the Section 199A deduction only when

- you are not in the out-of-favor service-industry group <u>and</u>
- your qualified business pays W-2 wages and/or has property.

Phaseout for New 20% Deduction

If your pass-through business is an in-favor business and it qualifies for tax reform's new 20 percent tax deduction on qualified business income, you benefit <u>at all times</u>, with no phase-in or out ranges.

However, if your business is in the out-of-favor group and you benefit only when you are in or below the phaseout range, once your taxable income exceeds the threshold amounts above, you arrive at four possible positions:

1. Phase-in range for a non-specified service trade or business
2. Phaseout range for a specified service trade or business
3. Above the phase-in range for an in-favor non-specified service trade or business
4. Above the phaseout range for an out-of-favor specified service trade or business

If your taxable income is going to be above the threshold amounts that trigger the phase-in or phaseout issues, contact us so we can spend some time on your tax planning.

How the 20% Deduction Works for a Specified Service Provider

When you are a member of the out-of-favor group, your Section 199A deduction on your out-of-favor business is zero when you have taxable income of more than

- $415,000 if married filing a joint return, or
- $207,500 filing as a single taxpayer.

Preserve the Deduction with an S Corporation

Will your business operation create the 20 percent tax deduction for you?

If not, and if that is due to too much income and a lack of (a) wages and/or (b) depreciable property, a switch to the S corporation as your choice of business entity may produce the tax savings you are looking for.

As mentioned above, to qualify for the full 20 percent deduction on your qualified business income under new tax code you need defined taxable income of less than $157,500 (single) or $315,000 (married).

If your taxable income is greater than $207,500 (single) or $415,000 (married), you don't qualify for the Section 199A deduction unless you pay W-2 wages or have property.

Example. Sam is single, not in the out-of-favor specified service trade or business group (doctors, lawyers, consultants, etc.), operates a sole proprietorship that generates $400,000 of proprietorship net income, and has taxable income of $370,000. In this condition, Sam's gets no 20% deduction.

The S corporation can help by paying Sam a reasonable salary, let's say that's $100,000. With this salary, Sam saves:

1. $10,871 on his self-employment taxes, and
2. $17,500 on his newfound 20 percent deduction under new tax code