Big Tax News for Small Business

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October 2018

The passage of the Tax Cuts and Jobs Act (TCJA) in December 2017 has not delivered the simplicity that I had hoped it would; however, it has produced some tax cuts that are exceptional if addressed before the tax year ends.

An important aspect of the TCJA is the 199A tax code. While the code is complex and has many exceptions, in general, the tax code can provide a significant tax deduction for sole proprietorships, S-Corps, partnerships, and rental properties. The exceptions to the code are service-related industries where the business's principal asset is the expertise or skill of one or more owners or employees. A few examples include services such as health, law, accounting, actuarial science, athletes, financial services, and performing arts. While I think it's important to know that this is still an evolving part of the tax code, it is also equally important to understand that the basic framework has been put in place by the TCJA of 2017. The IRS will need to provide more guidelines, but I believe the framework below should remain in place.

In its simplest form, the code provides a deduction for Qualified Business Income (QBI) based on the taxable income of the taxpayer. Taxable income determines the calculation method. Taxable income over $315,000 (joint tax returns) and $157,500 (all other tax filers) must use the W-2 limitation method while income under this amount is not restricted by the W-2 limitation method. Service-related industries with taxable income above $415,000 (joint) and $207,500 (all others) are ineligible to use either method (phase-out occurs between $315,000/$157,500 and $415,000/$207,500 for service-related industries).

For income over $315,000/$157,000, the taxpayer can deduct the lesser of (a) 20% of QBI or (b) the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of unadjusted basis, i.e., rental property.

If the new tax law sounds confusing, then you are correct. The following is one example of probably thousands of different scenarios that might apply to a taxpayer:

Example A: Joint taxpayer has LLC rental income of $600,000 from a property with an unadjusted basis of $8 million (rental property) and no W-2 income. The taxpayer can deduct the lesser of:

a) **0% x $600,000 = $120,000 or greater of**
b) **50% of W-2 wages ($0) = 0**
   25% of W-2 wages ($0) + 2.5% x $8,000,000 = $200,000

The deduction is $120,000 for the taxpayer.

As it often goes, tax law is written, and then loopholes or deficiencies are often found in the original tax law. At the time of this writing, the IRS has already issued guidance on W-2 Calculations. While the IRS states that taxpayers should refer to the original law for calculations other than W-2, it is in my opinion that there will be additional guidance forthcoming.

What I do think will remain constant is the phase-out thresholds that are listed in the tax law. Taxable income is critical to the 199A tax benefit, especially for service-related industries. Therefore, I think it is essential to start planning now since all income sources will be considered when seeking the 199A deduction, including portfolio income, passive income, non-passive income, S-Corp and LLC income, and W-2 income. Reducing these income sources below the threshold amount requires advanced planning rather than waiting until the end of the tax year. Taxpayers have many tools available to reduce their income to include the use of tax-free municipals, defined benefit plans (DBP), 401(k)s, SEP-IRAs, and many other income-reducing resources. (Please note that DBP and 401(k)s need to be set up before the end of the tax year and time should be afforded to ensure the necessary regulations are satisfied and that a Third-Party Administrator (TPA) is selected.)

I have touched only on a few parts of the new tax code, and this article is not tax advice; however, I think the subject is worth exploring with your accountant and financial advisor, as the possible benefits are significant.

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