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Practice Management

Tax Reform and How it Affects Small Business

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BUSINESS VALUATION NEWSLETTER FOR BUSINES OWNERS

May 2018

The Good, The Bad, The Value

Tax Reform and How it Affects Small Business

We are five months into the new tax reform era, better known as the Tax Cut and Job Act (TCJA), so how is it going? This reform was designed for individuals and small businesses. Congress touted their phrase; "*This tax law will be for the middle class..., "It will put more money into your pockets..., "It will help stimulate the small business sector..."* These and many more, have been comments made about TCJA. The question still holds – exactly how has this new tax reform help business owners actually?

In this month's newsletter, we will tackle three distinct areas of interest when it comes to understanding the implications of the TCJA and small business, which we will refer to as *The Good, The Bad and The Value*

Before we dive into understanding those three areas, it would be beneficial to understand that this tax reform does not only impact small business owners, this tax law impacts all Americans. However, our focus will be on the Pass-Through Entities. These are businesses that are classified as S Corporations, LLCs, Sole Proprietors or Partnerships. Each formation allows income generated from the respective business to passes through to the business owner.

The Good

There are several good things pertaining to TCJA. Two areas that will have an immediate impact for businesses are the tax rate changes and the bonus deprecation. Both are considered as a win for business owners, especially for small businesses.

The business tax change is a permanent reduction in the federal corporate income tax rate from 35% (top marginal rate) to a flat rate of 21%. In addition to the flat tax rate, under the Internal Revenue Code (IRC) 199A this will have a direct impact on the business mainly on the business owners by providing them with a 20% reduction on their Qualified Business Income (QBI).

For example: if you generate qualified business income of $350,000, you as a business owner will now be able to deduct $70,000 ($350,000 * 20%) on your schedule C. In other words, instead of filing $350,000 as your Adjustable Gross Income (AGI) as a pass-through entity, you may now file it as $280,000. A significant difference.

Another benefit that TCJA presents to businesses are for the ones that deal with purchasing equipment and property. Due to the TCJA, they will now be able to take advantage of the bonus depreciation. A business that purchased equipment under the terms of the ACT, may deduct up to 100%. Pre-TCJA the deduction was only 50%. In order to benefit from this deduction, purchases of assets new or used, must be purchased and placed into service after September 27, 2017 and before January 1, 2023. After 2022, this 100% declines by 20 percentage points per year until 2027, when the percentage becomes zero.

The Bad

We have discussed some very tangible benefits of TCJA. However, if you peel back the onion on a few of the new tax rules, you may be alarmed at what you find. For instance, receiving the 20% deduction on your QBI is a benefit but not for every type of business. The new provision of the IRC 199A which allows up to a 20% deduction for the Qualified Business Income for a specified service business, as defined in the code 1202 (e)(3)(A). A specified service business, by IRS definition is as follows:

"any trade or 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 trade or business where the principal asset of such business is reputation or skill of 1 of its employees"

In essence, if you are a special service business, the IRC 199A deduction will start to phase out for single filers at $157,000 of taxable income and completely phase out after $207,500. For married filing jointly, the deduction begins to phase out at $315,000 and completely gone at $415,000.

The Value

At the end of last year, Onyx Partners Group published an article, "How Business Owners Can Get Off to Fast 2018" *(November 2017)* the purpose of the article was to encourage business owners to establish, if they have not done so already, an All-Star Team. A team that includes an *attorney*, a *business lawyer*, a *wealth manager* and a *valuation expert*. Having a team help you

understand the ins and outs of the TCJA will prove to be time well spent and a great investment in your business. Each member of your team will be able to bring something significant to the table that will ultimately impact and benefit your business when it comes to the TCJA.

For example, if growth of your business is a primary factor, having a valuation expert, who understands your industry, will work with you to establish and implement a sustainable business process to assist in the growth of value. This can be done by understanding *Forecasting.* Understanding forecasting will allow business owners to see where deficiencies in their business may lie and it will also show where opportunities may be for future growth. Both areas of understanding forecasting will have an impact on the bottom line, potential increase of cash-flow.

Once cash flow begins to increase, understanding what to do with the additional income is an area where your Wealth Manager and an accountant will be able to discuss options such as a SEP, 401K or a Define Benefit Plan, which allows business owners to defer compensation into the retirement plan. Let's go back to our earlier example, the business owner with qualified business income of $350,000. If that owner, established a DBP and funded it with $100,000 his reportable business income is now $250,000. And if the owner is married, that owner now is eligible to take advantage of the

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IRC 199A because the phase out level does not begin until you reach $315,000.

The TCJA was designed to provide small businesses with opportunities to compete with large businesses and even global competitors. Business owners can use their tax savings to hire new employees, increase employee wages, purchase inventory, expand work space, pay down debt or reduce product prices. There is an enormous amount of benefits that come with the TCJA notwithstanding it brings some underlining pitfalls as well. As I like to say, it is better to know what you do not know, than to not know at all.

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