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## NEWSLETTER

Written entirely *in-house* and published occasionally as a service to clients and friends.

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### HOW THE NEW TAX ACT AFFECTS SMALL BUSINESS

You have probably already read or heard a lot about how the new Tax Cuts & Jobs Act, which has already gone into effect for 2018, reduces the corporate tax rate, how it generally reduces the rates individuals will pay, and how it eliminates many of the deductions individuals were used to taking. But even if you are a small business owner, what you know about how the act affects small businesses is probably limited to some vague notions about *passthroughs* getting some kind of a break. The news media, even the business news media, have largely ignored this topic because the rules here are hard to understand and do not translate easily into sound bites.

#### **THE PASSTHROUGH DEDUCTION:**

The primary provision affecting most small businesses is called the "Passthrough Deduction" (new Code Section 199A). Put simply, this provision says that some owners of some partnerships, S corporations, sole proprietorships, and certain cooperatives will be able to take a special deduction that can be as much as 20% of the income from that business. But before you start counting your tax savings, you need to understand the limitations.

#### *Limitations:*

First, for taxpayers with incomes above a threshold (covered later), the deduction is not allowed for specified service businesses. These are defined as accounting, actuarial science, athletics, brokerage services, consulting, financial services, health, law, performing arts, investing, investment management, trading, or dealing in securities, commodities or partnership interests, or any business whose principal asset is the reputation or skill of one or more of its employees or owners. This may sound like it covers all services, but specifically excluded from the list are engineering and architectural firms. Presumably businesses such as manufacturing, distributing, construction, real estate, and any other non-service business would qualify.

Second, for taxpayers with incomes above a threshold (covered later), the deduction cannot exceed the greater of

- 50% of wages paid by the business or

- the sum of 25% of wages paid plus 2.5% of the unadjusted basis (i.e., ignoring depreciation) of its depreciable property (that is not older than 10 years and fully depreciated).

Third, the deduction cannot exceed 20% of taxable income excluding capital gains and certain co-op dividends.

#### *Thresholds:*

The first two limitations above do not apply for taxpayers with taxable incomes below a lower limit, and are phased in proportionally for taxpayers with incomes between the lower limit and an upper limit. The lower and upper limits are inflation adjusted and for 2018 are as follows:

- Married taxpayers filing joint returns - \$315,000 - \$415,000
- All others - \$157,500 - \$207,500

#### *Other factors:*

The deduction applies to business income passed through, but not to nonbusiness income passed through on K-1s, such as capital gains, interest or dividends.

The deductible amount is computed separately for each passthrough business, with the first two limitations above applied separately to each. Then those amounts are combined (losses can generate negative deductible amounts which offset positive amounts), and, if the net is positive, the taxable income limitation is applied.

If a net negative amount results, because of losses from qualified businesses, this must be carried over to succeeding years and applied to reduce future deductions.

It is important to note that the deduction does not enter into the computation of Adjusted Gross Income (AGI), so it will not affect how other tax provisions tied to AGI work.

The deduction can also be taken on publicly traded partnership income, dividends from REITs and certain agricultural cooperatives (details not covered herein).

**EXCESS BUSINESS LOSS LIMITATION:**

A negative impact of the new law affecting small business owners, is the new limitation on Excess Business Losses. This provision says that aggregate business losses for noncorporate taxpayers greater than \$500,000 for married taxpayers filing jointly and \$250,000 for all others cannot be taken and must be carried over to succeeding years. This provision will affect taxpayers with excess business losses who may have been counting on those losses to shelter taxable income they have from nonbusiness sources.

**ENTERTAINMENT NOT DEDUCTIBLE:**

Another negative provision is that entertainment expenses, including meals, which were already subject to a 50% deduction limitation, will now be completely nondeductible. This does not apply to meals otherwise subject to the 50% limitation but that are not for entertainment purposes, such as travel meals.

**ACCELERATED DEPRECIATION:**

All trades or businesses acquiring fixed assets can benefit from one or both of the accelerated property write-off provisions.

*Bonus depreciation:*

The bonus depreciation percentage increases from 50% to 100% (for property acquired after September 27, 2017 and phasing out beginning in 2023).

*Section 179 expensing election:*

The Section 179 expensing election dollar limitation is increased from \$510,000 to \$1,000,000 and the investment limitation is increased from \$2,030,000 to \$2,500,000. While this may seem redundant in light of 100% bonus depreciation, some property may not qualify for the bonus depreciation, but will

qualify for the Section 179 election. Also, most states don't accept bonus depreciation.

*Vehicle limits increased:*

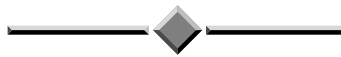
The depreciation allowed on passenger vehicles of 6,000 lbs. or less will increase. The new limits will be \$10,000 in year one, \$16,000 in year two, \$9,600 in year three and \$5,760 thereafter. These limits are roughly triple what they were previously. The additional \$8,000 for bonus depreciation in year one also still applies.

**AVAILABILITY OF CASH METHOD:**

For many taxpayers, the cash method of accounting would be beneficial because it would defer taxation of sales not collected to a greater extent than it would defer deductions for expenses not paid; however, some of those taxpayers have not been allowed to use the cash method because of the size and nature of their business. The new law sets a single \$25 million gross receipts test. Taxpayers below that limit are allowed to use the automatic change procedures to make the accounting change even if the nature of their business would otherwise require use of the accrual method.

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The provisions discussed above only scratch the surface of the new Tax Cuts & Jobs Act. The provisions affecting individuals have only been alluded to. The many provisions affecting businesses with foreign operations have not even been mentioned. The act is one of the most significant changes in tax law in decades and will have many complex effects on economic decisions and the economy. Our firm stands ready to help you navigate this new uncharted territory.



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