Tax Cuts and Jobs Act

Questions and Answers for Small Businesses

February, 2018

This is a summary of items that are subject to variations and exceptions. It is not to be relied upon as tax advice. For tax or legal advice, contact your accountant or attorney.

General Business Tax Questions

1. New Section 199A "Passthrough" Deduction

a. What is Section 199A?

The *Tax Cuts and Jobs Act* created a new section 199A in the Internal Revenue Code. Small businesses which are organized as passthroughs may deduct 20% of qualified business income from a partnership, S corporation, or sole proprietorship. Importantly, this deduction is *in addition* to reductions in individual rates detailed later in this document, and is also in addition to the deductions generally available to individual taxpayers. A taxpayer who earns passthrough income eligible for the 20% deduction does not have to itemize his or her deductions to claim the deduction, and may simultaneously claim this deduction and the standard deduction.

b. What is "qualified business income?"

Qualified business income generally refers to taxable income from a qualified passthrough business (see Question 1(c) for an explanation of which businesses qualify), meaning the net amount of qualified items of income, gain, deduction, and loss with respect to the trade or business of the taxpayer.

Qualified business income is determined for each qualified trade or business of the taxpayer. Qualified business income does not include any amount paid by an S corporation or a partnership that is treated as reasonable compensation for the taxpayer.

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are connected with the conduct of a trade or business within the United States.

c. Who is eligible for the 20% deduction under section 199A?

Under section 199A, owners of all businesses, regardless of industry, are eligible for the full 20% deduction on their share of a passthrough business's income, until they earn up to $157,500 individual / $315,000 joint in qualified taxable income.

Two important rules apply when the owner has taxable income greater than this initial threshold.

First, an exclusion for certain "specified service" trades or businesses phases-in for a small business owner with taxable income in excess of the $157,500 / $315,000 initial threshold amounts. For owners of such specified service trades or businesses, including certain professional service corporations, the deduction is fully phased-out at a cutoff threshold of $207,500 individual / $415,000 joint.[1] If an owner's taxable income is greater than the initial threshold (*i.e.*, $157,500 or $315,000), but not the cutoff threshold (*i.e.*, $207,500 or $415,000), a reduced deduction is available for the owner's income from any specified service business.

Note that this phased-out exclusion for income from a specified service business applies on a business-by-business basis. If a business owner, for example, has taxable income greater than the applicable cutoff threshold and owns two businesses, only one of which is a "specified service" business, the deduction is phased-out only for this business (and not for the other business).

Importantly, all of these thresholds are indexed for inflation to ensure that the passthrough deduction's value is not eroded over time.

Second, for a business owner with taxable income above the cutoff threshold (*i.e.*, $207,500 or $415,000), the deduction for qualified business income cannot be greater than either the taxpayer's share of 50% of W-2 wages paid by the business, or if the taxpayer elects in the alternative, the taxpayer's share of 25% of such wages plus 2.5% of the unadjusted "tax basis" in the business's assets. For a business owner with taxable income above the initial threshold, but less than the cutoff threshold, this "cap" on the deduction is

[1] These businesses are a modified list of Internal Revenue Code Section 1202(e)(3)(A) professional service corporations, "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 of business where the principal asset of such a trade or business is the reputation or skill of 1 or more of its employees." Further guidance and/or regulatory clarification is expected.

greater (based upon a pro-rata formula). Owners with taxable incomes less than the initial threshold are not subject to the deduction cap.

2. How does the new federal tax law affect small business expensing?

The new federal tax law increases the amount of property eligible for section 179 expensing from $510,000 of business property in 2017 to $1 million of property beginning in 2018. It also increases the phase-out threshold from $2.03 million in 2017 to $2.5 million in 2018. These increased amounts are indexed for inflation.

Section 179 eligibility is also expanded to include furnishings for lodgings,[2] new roofs, HVAC systems, and fire and security alarms for commercial buildings.

3. Are there additional expensing / depreciation components of the new law?

In addition to increasing section 179 expensing, the law also includes a temporary (through 2022) increase of "bonus depreciation" under section 168(k). This allows 100% cost expensing for acquisitions of depreciable business property, *regardless* of the amount of property. Unless this general cost expensing is extended, the amount of allowable bonus depreciation will be subject to an annual 20% decrease beginning in 2023, resulting in a complete phase-out of bonus depreciation at the end of 2026.

4. Does the new federal tax law expand cash accounting?

Yes. The new federal tax law expanded the use of cash accounting to all businesses (including C corporations) with average annual gross receipts under $25 million for the three prior taxable years. This expansion is a significant improvement from the prior threshold of $5 million. As with prior law, passthrough businesses are generally not subject to this income-based limitation on using the cash accounting method.

The provision also expands the universe of farming C corporations (and farming partnerships with a C corporation partner) that may use the cash method to include any farming C corporation (or farming partnership with a C corporation partner) that meets the $25 million gross receipts test.

[2] As defined in section 50(b)(2). Property used predominantly to furnish lodging or in connection with furnishing lodging generally includes, e.g., beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let. See Treas. Reg. sec. 1.48-1(h).

5. Is business interest deductible for small businesses?

Generally, yes. New limitations on interest deductibility only apply to businesses with average annual gross receipts of more than $25 million (on a three-year look-back basis). Businesses with average annual gross receipts below the $25 million threshold are not subject to the cap on interest expenses described in the following paragraph.

For businesses with gross receipts above the $25 million threshold, interest deductibility is limited to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) for four years (*i.e.*, through 2021), and thereafter is limited to 30% of earnings before interest and taxes (EBIT).

Thus, even many business owners with more than $25 million of gross receipts will continue to be able to deduct all of their interest expenses (*i.e.*, to the extent their interest expenses as a percentage of adjusted taxable income are below the cap). Moreover, to the extent a business is limited from deducting interest, the excess interest has an indefinite carryforward. Accordingly, unless the business perpetually will be over the $25 million gross receipts threshold and in a position where it is subject to disallowance, the interest will eventually be deducted (and the difference is just a timing change, albeit one that the taxpayer would not prefer).

6. How does the new federal tax law change the tax treatment of state and local taxes (SALT) for businesses?

While the law includes a $10,000 cap for individuals on the amount of state and local income, property, and sales taxes that are deductible, most business-related state and local taxes are still fully deductible. Under prior (and current) tax law, a distinction exists for those taxes imposed upon a business (e.g., franchise taxes, a tax upon real property used in a business) and those imposed upon individuals (e.g., state income taxes on an individual's share of income earned by a business).

The new federal law fully allows a deduction for state and local taxes imposed upon a business (even where the deduction for such taxes flows through to the business's owner). By contrast, the law restricts state and local taxes imposed upon the owner of a business.

For example, with respect to state, local, and foreign property and sales taxes imposed upon a business (the deductions for which flow through to the business's owner and are currently reported on Schedule C, Schedule E, or Schedule F), these taxes are still fully deductible and not subject to the $10,000 cap. In contrast, state, local, and foreign income taxes imposed upon the owner's share of the income of the business (which are currently reported on an individual's Schedule A) are subject to the $10,000 per year cap.

As a further example, in the case of property taxes, an individual may deduct such items if these taxes were imposed on business assets (such as residential rental property on Schedule E).

Additionally, taxes imposed at the entity level, such as a business operation tax imposed on passthrough entities, and that flow through the business and are reflected in an owner's tax return (e.g., as an item reported to a partner on a Schedule K-1, or similar form), will continue to reduce such partner's or owner's taxable income.

State and local taxes for C corporations are also still fully deductible.

7. **How does the new federal tax law change the Alternative Minimum Tax (AMT) for corporations?**

   The corporate AMT is repealed. For businesses organized as passthroughs, see Question 3 in the **General Individual Tax Questions** section below.

8. **How does the new federal tax law change corporate (C corporation) tax rates?**

   The new federal tax law consolidates the graduated corporate tax rates into one rate. Beginning in 2018, the rate for all C corporations is 21%.

9. **Do small businesses lose the deduction for business meals?**

   No. The new federal tax law does not eliminate the business meals deduction. It does align the in-office meals deduction with the general business meals deduction, which limits the deduction to 50% of meals.

   Taxpayers may still generally deduct 50% of the food and beverage expenses associated with operating their trade or business (for example, meals consumed by employees on work travel).

   The provision also applies this 50% limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer. After 2025, expenses incurred for such an eating facility are no longer deductible.

10. Do small businesses lose the home office deduction?

No. The home office deduction was not repealed for small business owners. Rather, the new federal tax law repealed the employee itemized deduction for unreimbursed miscellaneous expenses, like home office expenses.

The deduction for home office expenses of a small business owner remains unaffected by any changes in the bill.

11. Was the deduction for entertainment expenses curtailed?

Yes. The new federal tax law essentially eliminates the deduction for entertainment expenses.

The new federal tax law provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items. Thus, the provision repeals the present-law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50% limit to such deductions).

The membership dues paid to any club organized for business, pleasure, recreation, or other social purposes refers to entities like country clubs; it does not refer to membership fees to organizations like NFIB or trade associations.

General Individual Tax Questions

Unless otherwise specified, tax changes for individuals under the *Tax Cuts and Jobs Act* are scheduled to expire at the end of 2025. Without an extension of these changes, the rules in 2026 would revert to those that existed prior to enactment of the *Tax Cuts and Jobs Act*.

1. How will my individual income tax rates change?

The figures below detail income tax rate (not including payroll taxes or surtaxes on upper-income taxpayers) and bracket changes for individuals and couples filing jointly. The thresholds are indexed for inflation.

2017 (old law)

- 10% up to $9,325 individual / $18,650 joint
- 15% up to $37,950 individual / $75,900 joint
- 25% up to $91,900 individual / $153,100 joint
- 28% up to $191,650 individual / $233,350 joint
- 33% up to $416,700 individual / $416,700 joint
- 35% up to $418,400 individual / $470,700 joint
- 39.6% over $418,400 individual / $470,700 joint

2018 (new law)

- 10% up to $9,525 individual / $19,050 joint
- 12% up to $38,700 individual / $77,400 joint
- 22% up to $82,500 individual / $165,000 joint
- 24% up to $157,500 individual / $315,000 joint
- 32% up to $200,000 individual / $400,000 joint
- 35% up to $500,000 individual / $600,000 joint
- 37% over $500,000 individual / $600,000 joint

2. What is the increase in the standard deduction?

The standard deduction is *roughly doubled* to $12,000 for individuals and $24,000 for married couples filing jointly. Importantly, these amounts are also indexed for inflation.

3. How did the Alternative Minimum Tax (AMT) for individuals change?

The income level that triggers phase-out of the AMT exemption has been increased dramatically, from $120,700 to $500,000 (individual filers) and from $160,900 to $1 million (married filers). The exemption itself has risen by roughly one-third, from $54,300 to $70,300 (individual filers) and $84,500 to $109,400 (married filers). These figures are also indexed for inflation.

As a practical matter, based upon the additional changes to individual taxation made by the *Tax Cuts and Jobs Act* (e.g., eliminating or curtailing many itemized deductions) plus the increased exemption amount and phase-out, the vast majority of taxpayers will no longer owe individual AMT.

4. **How did the tax treatment of state and local taxes (SALT) change for individuals?**

   For individuals, the deduction for state and local income, property, and sales taxes is capped at $10,000. The $10,000 cap applies to aggregate income and property taxes, or sales taxes.

5. **How does the new federal tax law affect healthcare?**

   The financial penalty stemming from failure to meet the individual mandate requirement under the Affordable Care Act is permanently repealed, effective January 1, 2019. The individual mandate penalties still apply for 2017 and 2018.

   Separately, the new federal tax law lowered the medical expense deduction threshold from 10% of adjusted gross income to 7.5% of adjusted gross income for 2018 and 2019.

6. **How is the estate tax affected?**

   The amount of an estate's value that is excluded from the federal tax is *roughly doubled*, to $11 million for individuals and to $22 million for married couples. These figures are also indexed.

7. **Does the new federal tax law change the tax treatment of charitable deductions?**

   The new federal tax law slightly adjusted the tax treatment of charitable deductions by increasing the limit on cash contributions to qualified organizations from 50% to 60% of taxable income and denying the deduction for purchases of college athletic seating rights.

8. **Does the new federal tax law change the tax treatment of the home mortgage interest deduction?**

   The new federal tax law generally did not alter the tax treatment of existing home mortgages, but it did cap the deduction on home mortgage interest for new mortgages (entered into after 12/15/17) at $750,000. Deductions continue to be allowed for second homes, as long as the aggregate total is below the $750,000 threshold.

   The law repeals the deduction for interest paid on "home equity" debt that is not used to acquire, construct, or substantially improve a qualified residence, including for existing home equity loans.

9. Did the new federal tax law change the tax treatment of capital gains?

The basic capital gains tax treatment did not change (including the imposition of the “net investment income tax” on certain upper-income taxpayers). The new federal tax law generally retains maximum rates on net capital gains and qualified dividends. Long-term capital gains did not change. Short-term capital gains are treated as ordinary income, so if your marginal tax rate decreases, your taxes paid on short-term capital gains will also decrease.

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