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TAX RATES

QUALIFIED BUSINESS INCOME

DEDUCTIONS AND EXEMPTIONS

By Daniel M. Isard

The New Tax Law, Part 2

Significant tax code changes that apply to business owners when they file personal returns for 2018 income.

In last month's column, I responded to a letter inquiring about the effects of the new tax law on funeral home businesses. Since the present tax code is some 74,600 pages in length, my thoughts on the changes in 2018 need more than the space allotted. Therefore, rather than addressing a new question this month, I will explain the significant changes to the tax code that primarily apply to business owners when they file their personal tax returns for 2018 income.

The biggest change in the business tax code is the creation of a new form of income called qualified business income (QBI for those of us who just learned what ROFL means). QBI is used to calculate a deduction on an amount of qualified income distributed from pass-through businesses such as sole proprietorships, partnerships, Sub S corporations and LLCs. If applied properly, it allows 20% of QBI to avoid being taxed.

Since most funeral home operating entities are pass-through businesses and have real estate owned by pass-through businesses, this is the single largest area of change in 2018 for personal filing as well.

If you operate your business as a C corporation, it's more critical than ever to review whether you should continue as that type of entity. If your real estate is owned in a C corporation, it is imperative to reconsider that as well.

To understand personal tax filing, you must understand the road income travels to be taxed. We start with a definition of total income, as all income is subject to tax. Certain adjustments are added or subtracted to arrive at adjusted gross income. The tax preparer then chooses to deduct the greater of the standard deduction or itemized deductions, as well as exemptions, arriving at taxable income. From taxable income, the tax is computed. The actual tax due may be different as there can be additional tax credits and adjustments that further reduce the tax due.

With the addition of the QBI deduction, I believe the computation on total income will change. No one has seen the 2018 tax form yet, but it is a deduction from income of up to 20% of the QBI, subject to certain qualifications. Since people don't know what their net pass-through income will be, they need a strategy. We recommend two strategies to our accounting clients for all of their business entities:

1. Owners of operating companies should take an "owner's draw" (the owner takes an amount to live on each pay period) and file estimated taxes each month. The accounting team can square this up at year's end. At that time, they will balance the total business pass-through, reasonable compensation and QBI deduction to arrive at an amount for compensation and pass-through.

2. Real estate companies should do the same thing. The accountant should first estimate the operating cash flow of the real estate enterprise, then complete the owner's draw and square things up at the end of the year, as with the operating company.

Deductions from adjusted gross income have changed as well. In the past, we had two ways to take deductions: the standard deduction for anyone not itemizing their deductions, and itemized deductions. Most people filing the standard deduction fall within the two extremes of age – those who are young and starting out and those who are retired. The standard deduction for 2018 has increased from $6,350 to $12,000 for single filers and from $12,700 to $24,000 for married couples filing jointly. This means the first $24,000 in income of a married taxpayer filing jointly is sheltered from tax.

The exemptions have also changed. In the past, you took a deduction from income for the number of people in your household covered by your personal tax return. For example, a married couple with two children residing under their care would get four exemptions. The 2017 amount was $4,050, but this exemption deduction is eliminated under the 2018 tax law.

If you add the exemptions and standard deduction together, for a married couple with two children in 2017, that would equal $28,900, but the 2018 amount is just $24,000. Part of this difference is made up in the child tax credit. Remember, as stated above, tax credits are applied to the amount of tax due. Tax credits are $2,000 per child if your income is under $400,000 for married couples and under $200,000 for single taxpayers. Tax credits for two children, if applicable, are $4,000, which, for most people in a 30% tax bracket, are the same as a $12,000 deduction!

And yes, it's just as confusing as we go from talking about deductions to credits.

Homeowners itemizing their mortgage interest are in for a surprise. Home mortgage interest is deductible up to a limited amount. Presently, that number is on a cumulative mortgage amount for qualifying residences (not more than two) up to $1 million. This does not include a home equity line of credit. For mortgages entered into after December 15, 2017, the new limit is $750,000.

State income taxes and real estate taxes are also changing. During the past hundred years of our income tax code, the income taxes paid to your state of domicile were deductible from the federal income tax you paid. Real estate taxes were also deductible. However, state income, sales and real estate taxes are now deductible only up to a total for all state and local taxes of $10,000. This will particularly hurt business owners filing itemized deductions on their returns in states with high income and real estate taxes.

There are other small changes to areas of deductions. Theft and casualty losses are not deductible now unless there is a federal declaration of disaster. Medical expenses above 10% of adjusted gross income (AGI) were deductible, meaning that if you had $100,000 of adjusted gross income and $12,500 in medical expenses, the amount of medical expenses above $10,000, in this example $2,500, would be deductible. The new threshold for both 2017 and 2018 is 7.5% of AGI but is reverting to 10% for 2019 and beyond.

The last major change affecting business owners' personal tax returns is the tax rates themselves. By overview, the number of tax rates is the same in 2018 as in 2017, with seven income categories, but the income ranges have changed:

- *For single tax filers:* $0-$500,000 in 2018 ($0-$418,000 in 2017)
- *For married filing joint:* $0-$600,000 in 2018 ($0-$471,000 in 2017).

The maximum tax rate for 2017 was 39.6%. For 2018, the maximum is 37%. Therefore, the amount of tax owed for each segment of income will decrease. Even maximum-income filers will pay less under the new law. If you couple this with the QBI deduction, most business owners will pay less in taxes in 2018 than they did in 2017, presuming the same amount of income.

There you have it – our new simplified tax laws. Yes, that was indeed sarcasm since our tax code, if printed out and placed on the floor, would climb 25 feet into the air!

If you wait until the end of 2018 to understand the new law, you will be penalized and not get the full deduction for QBI. If your accountant doesn't understand funeral service, you will overpay on your taxes by so much that a sign will be posted on the highway reading, "The next mile of highway paved by XYZ Funeral Home." And that donation will bring you even fewer calls than donating handheld fans to a church in August.

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2017 TAX RATE	SINGLE FILERS	MARRIED FILING JOINTLY
10%	$0 – $9,325	$0 – $18,650
15%	$9,326 – $37,950	$18,651 – $75,900
25%	$37,951 – $91,900	$75,901 – $153,100
28%	$91,901 – $191,650	$153,101 – $233,350
33%	$191,651 – $416,700	$233,351 – $416,700
35%	$416,701 – $418,400	$416,701 – $470,700
39.6%	Over $418,400	Over $470,700

2018 TAX RATE	SINGLE FILERS	MARRIED FILING JOINTLY
10%	$0 – $9,525	$0 – $198,050
12%	$9,526 – $38,700	$19,051 – $77,400
22%	$38,701 – $82,500	$77,401 – $165,000
24%	$82,501 – $157,500	$165,001 – $315,000
32%	$157,501 – $200,000	$315,001 – $400,000
35%	$200,001 – $500,000	$400,001 – $600,000
37%	Over $500,000	Over $600,000