FINANCE
101

NEW INCOME CATEGORY

C CORP FLAT TAX RATE

DEPRECIATION

By Daniel M. Isard

The New Tax Law, Part 1

Examining the biggest changes in the business part of the Tax Cuts and Jobs Act. Coming next month: personal application of the law.

Dear Dan,
I am not Jewish, but after trying to decipher the new tax law, I find myself just walking around muttering "oy vey!" Can you help me understand the new tax law or do I need to wait for April 2019, when my accountant files my 2018 taxes?
Almost Jewish in Jonesboro

Dear Almost Cousin,
I will not even try to fit an understanding of the Tax Cuts and Jobs Act, let alone how the new law needs to be applied to your business, in the 1,500 words my publisher allows me. What I can do, however, is focus on the business part of the law this month and address personal application in April.

The biggest single change is a new category of income that has been created. Prior to this, business was taxed as income. If the profit was from a pass-through business entity (sole proprietor, partner, LLC or Sub S Corporation), it was taxed at individual tax rates. If the business was a C Corporation, it was taxed at corporate tax rates. You were able to choose two things as a business owner: what type of business entity you wanted to operate and whether to be taxed under the accrual or cash method of taxation.

Now, we have a third category of income – get ready to exclaim your first "oy vey!" – called qualified business income or QBI. QBI is not income so much as it is a deduction from income (yeah, another "oy vey!" here). QBI is the income that comes from your pass-through business. In the past, all of this was taxable. In 2018, it's possible that only 80% is going to be taxable. The 20% that is not taxable, for federal tax computation, is a good thing. However, it is not automatic (yes, "oy vey!"). Let's assume this entire article is subject to a three "oy vey!" maximum per paragraph.

How will you know if any or all of your pass-through income is subject to the QBI 20% deduction? Good question. QBI is a formula. The amount of the deduction is calculated as the lesser of 20% of the pass-through income or 50% of the total W-2 wages paid by the business.

As an example, assume that a business generates $200,000 of income. Assume that the owner takes a salary of $100,000 and has total wages to all employees of $500,000. The QBI deduction is *the lesser of*:

- 20% of the pass-through income (e.g., $200,000 X 20% = $40,000)
- 50% of total wages paid by the business (e.g., $500,000 X 50% = $250,000).

In this example, the lesser amount is $40,000. The business owner would therefore recognize income of his or her salary ($100,000), plus the QBI of $160,000 ($200,000 less 20%).

Now, you might think you want salary to be as little as possible so you can get more via QBI. Well, think again. Congress has set a standard so that you must be paid a reasonable compensation. This is set as the amount a third party would have to pay you to do the same tasks and responsibilities.

It is ironic that in my 43 years of teaching or following the US Tax Code, the IRS would audit business owners for "unreasonable compensation," which is taking too much out of their company and deducting it from taxable corporate income. Now the IRS will audit you for "unreasonable compensation" if you take too little out. The method of audit will be the same, looking at national sources for this information, such as the compensation study done by NFDA and others.

You will want to take a reasonable salary to keep benefits such as Social Security and retirement plan contributions to their maximum. However, since the amount of company "pass through" of profits won't be known until year end, what can you do?

We recommend that our accounting clients take an "owner's draw": The owner will take an amount to live on each pay period and will then pay estimated taxes each quarter. At year end, we can balance the salary versus pass-through income to maximize the best allocation for QBI.

I said earlier that business owners got to make two decisions. The second is the method of taxation on which they pay taxes. We have long recommended the cash basis method for income tax filing for our clients. The cash basis has been available for funeral homes since the early part of this century. However, it was limited to the amount of revenue a business generates.

This limit has risen – from $3 million, then to $10 million and now to $25 million. Therefore, almost every privately owned funeral business in America will qualify under this new law. Management reviews and pricing analysis are still done on the accrual basis, but we want to recognize as little revenue as possible for tax filing purposes, and the cash basis will usually provide for that.

Of course, this discussion is limited to federal tax issues. Your state may have a state income tax. It is too soon to tell if states will recognize the QBI deduction for their income tax calculation. It's a matter of state income tax conformity to the federal income tax.

Conformity is more the rule than the exception for states. However, this tax law is interesting because on the personal filing, the deduction for state income taxes and real estate taxes, which had been the norm, is now limited. I would not be surprised if there's a backlash by states and they assert their state's right to govern within their own border, including the right to collect taxes. Time will tell.

If you own your funeral home real estate in a Sub S Corporation, LLC, partnership or outright, you previously just took the net earnings of the enterprise on your tax return. To qualify for QBI, you might want to take some salary from this enterprise. This may give you the opportunity for a QBI deduction on some of the earnings. Again, we would recommend taking an owner's draw, filing quarterly estimated taxes and reconciling at year end to get the best computation.

Keep in mind that you can have QBI from every qualifying enterprise. The more, the merrier, I say.

The next big change to the corporate aspect of the law is for C Corporations, which were the standard type of corporate entity prior to 1984, when Congress changed the tax law to start promoting Sub Chapter S Corporations. This was done as a move to promote a single tax level for small, closely held businesses, and it liberalized many of the restrictions by which Sub S Corporations were limited.

The C Corp tax was a progressive tax that taxed income by formula. For most funeral home businesses, the chart that would apply is as follows:

If in 2017 you earned $50,000, your corporate tax is $7,500.

INCOME	TAX RATE
$0 – $50,000	15%, plus
$50,001 – $75,000	25%, plus
$75,001 – $100,000	34%, plus
$100,001 – $335,000	39%, plus

If you earned $100,000 that tax is $22,250. The new tax law has imposed a tax rate of a flat 21% on C Corporation income.

Of course, if you ever took the earnings out of your corporation, you would be taxed again either as a dividend, capital gain or ordinary income, depending on the amount of historical retained earnings and your basis. The second tax, when previous earnings are distributed to the owners, is still applicable but at the new 2018 ordinary income tax rates. I'll cover this in the next issue.

The last of the big changes for businesses is depreciation. Depreciation applies to the ability of a business to deduct those capital assets in which it invests to help promote the business. Previously, different classes of assets were limited in their write-down. The code section that promoted larger write-offs was Section 179. Section 179 was depreciation on steroids so that you could write off more in one year than just the individual class of assets. That amount has increased to $1 million!

QBI is the income that comes from your pass-through business. In the past, all of this was taxable. In 2018, it's possible that only 80% is going to be taxable.

And if this is not enough for you, there is bonus depreciation, the additional amount of depreciation deduction above and beyond what would usually be available. There are still limits on the use of Section 179 and bonus depreciation for some types of assets, such as automobiles and real estate. Luxury auto write-off is capped at $10,000 in year one, $16,000 in year two, $9,600 in year three and $5,400 thereafter.

Therefore, Almost Jewish in Jonesboro, there are many things you must look at this year, and the sooner you start categorizing your income properly, the better the outcome will be in this first year of the new tax law.

Editor's note: Isard will address the personal application of the new Tax Cuts and Jobs Act in the April issue of *The Director.*

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