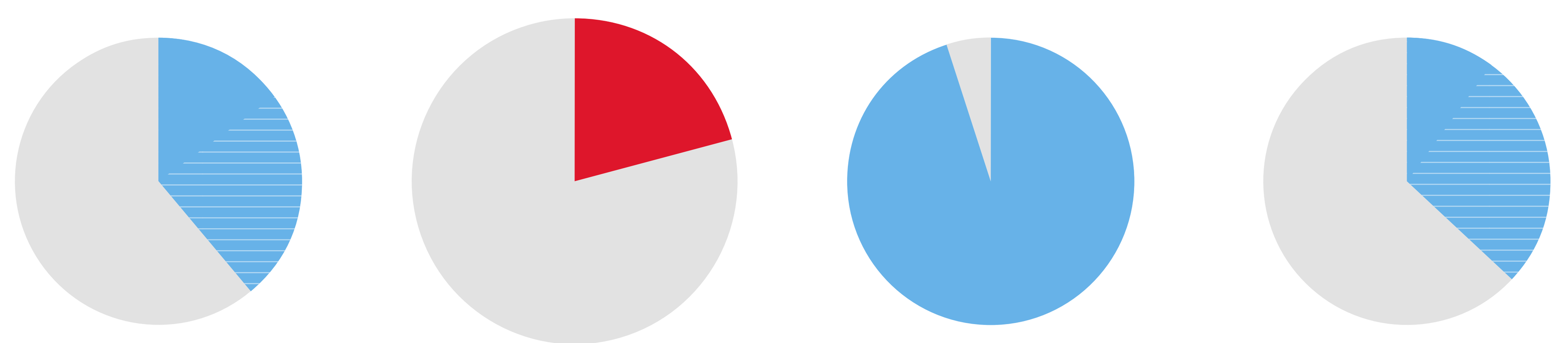
Does tax reform mean you should restructure?

Tax reform created new rules for both corporations and pass-through entities. Understanding the rules can help you decide whether restructuring might reduce your tax bill.[1]

The Tax Cuts and Jobs Act went into effect in January 2018, and as the changes to the tax code kick in, many small business owners are reconsidering how their businesses are structured. Primarily, companies that are currently structured as pass-throughs are wondering if it would benefit them to restructure as a C corporation.

Here's a few things you should know:



15-39%
Prior to tax reform, the U.S. corporate income tax rate was progressive, and ranged from 15-39%.

21%
Going forward, corporate income tax will be a flat rate: 21%.

95%
95% of U.S. businesses are structured as "pass-throughs" and do not pay the corporate tax rate.

10-37%
Personal income tax still ranges from 10-37% but the income brackets are different.

Bottom line:

A shift in the corporate income tax to a flat rate, while personal income taxes remain progressive, means many pass-through companies might have a bigger tax liability post reform. To prevent this, the Tax Cut and Jobs Act created a 20 percent deduction for all pass-through businesses, known as 199-A.

83% of small business owners don't fully understand how tax reform will impact their businesses.
Source: National Association for the Self-Employed.

How the pass-through deduction works:

Joe owns a jukebox repair company. As a sole proprietor, he reports his business income on his personal tax returns (Form 1040).

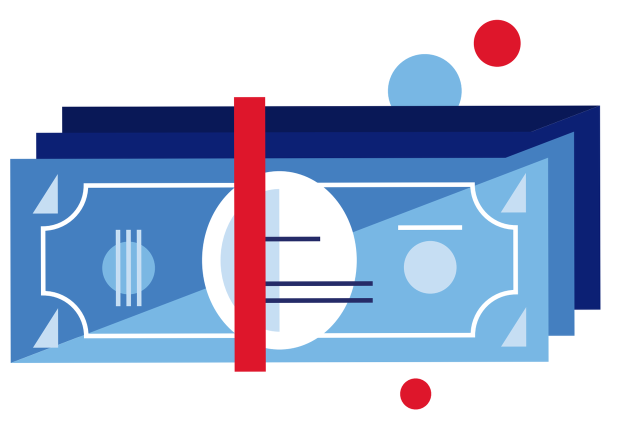
Let's say his business earned a $100,000 profit in 2018, placing him in the 24% tax bracket.

After the 20% deduction

Joe would pay taxes on just $80,000 of that income, placing him in the 22% tax bracket.

Which business structures qualify as pass throughs?

- Sole proprietors
- Partnerships (LP & LLP)
- S corporations
- Limited Liability Corporations (LLCs) with multiple owners



QBI: Qualified business income

Qualified business income is a key phrase for anyone filing taxes related to business income. All tax rates are based on your QBI, which is essentially the net income or profit of your business, excluding any salary paid to the owners.

What's the fine print?

- You only claim the deduction up to a certain amount of income (known as an income threshold). If your QBI is **greater than $157,500 for individuals or $315,000 for married filing jointly,** your deduction phases out.
- Some types of businesses and trades don't qualify at all if income is above a certain amount.

Read a full list of the exceptions on the IRS website.

How the income threshold works:

Maria is a partner in a widget business. Let's say her QBI is $200,000 for 2018. Here's how she might calculate her deduction:

$200,000 – $157,500 = $42,500 over the income threshold.

$42,500 ÷ $157,500 = by 27%

So, Maria likely qualifies for the 199A deduction up to 73%.

$200,000 X .73 = $146,000 X .20 = $29,200

Maria can likely deduct $29,200 from her QBI using the 199-A pass-through deduction, making her taxable income **$170,800.**

Should you restructure to a C corp?

It's a good idea to consult with a tax professional if you're thinking of restructuring. These questions can help you have that conversation.

Do you work in a trade or business that is exempt from the pass-through deduction?

- If so, you might pay less tax as a C corp.

What is your 10-year plan for your business?

- The pass-through deduction is set to expire in 2026 (though it could be extended), whereas the corporate tax cut is permanent.

Will you be reinvesting your profits or distributing them?

- Owners pay tax on any profit distributed by a C corp. However, if you plan to reinvest profits, this might not be an issue.

Is there a chance you'll lose money?

- If your business posts a loss, you cannot claim a pass-through deduction and must carry the loss to the next tax year.

[1]U.S. Bank representatives do not provide tax or legal advice. Your tax and financial situation is unique. You should consult your tax and/or legal advisor for advice and information concerning your particular situation.