Potential tax savings for small business owners in the Tax Cuts and Jobs Act

Legal Matters
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Guest columnist

The Tax Cuts and Jobs Act of 2017 was an unlikely media darling.Although the debate as to the economic impact of the new act continues, there is no doubt that it has made significant changes to the country's tax system.

Chief among those is how businesses and their owners will be taxed.

Winner: Corporations

Most attention has been devoted to the reduction in corporate tax rates. Under prior law, corporations were taxed at graduated rates, ranging from 11 percent to 35 percent. Under the new act, corporations are taxed at a flat rate of 21 percent.

This is a business favorable development, as many of the businesses we are familiar with in our day to day lives are corporations, such as Walmart, Amazon and Apple.

Smaller benefit for small business

But most U.S. businesses are small businesses, many of which are not organized as corporations. They are "pass through entities," such as partnerships, limited liability companies or sole proprietorships.

The main distinction between these pass through entities and corporations is that the income of a pass through entity is not taxed at the entity level. Instead, all items of income, gain, loss and other tax attributes are "passed through" to their owners, who then report them on their individual returns.

The reduction of individual tax rates was nowhere near as great as the reduction in the corporate tax rate. This left the possibility of income from pass through entities being taxed at a much higher rate than corporate income.

To avoid this, the act contains a new deduction for the "qualified business income" of pass through entities. The QBI deduction reduces the entity's income by 20 percent. That reduced amount of income will pass through to each owner, who then reports it on their individual taxes.

Who else benefits?

There are exceptions to this general rule. Many businesses will be able to take full advantage of the deduction. It will only be limited if the business has relatively modest capital assets or pays relatively few wages.

However, certain "service businesses," such as doctors, lawyers, accountants, financial planners or other professions in which the principal asset is the reputation or skill of the owners or employees, may get only limited benefit (or no benefit) from it. If the owner of a service business has income (including income from all sources, not just the business) of less than $315,000, the full QBI deduction can be taken. If their income is between $315,000 and $415,000, the QBI deduction will be reduced. The deduction phases out completely for owners with income of over $415,000.

Nothing good can last forever. Currently, the QBI deduction is scheduled to disappear in 2028 unless Congress extends it. Small business owners should consult with their advisors to determine whether they qualify for this tax relief while it is available.

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