# Top 8 things small and midsize businesses need to know about tax reform

While some details of the tax code passed last year are still becoming clearer, what we do know is that the changes present both serious implications and potential opportunities for small and midsize businesses. As a business leader, you should not feel you have to become a tax expert. However, you should develop an understanding of how tax changes could impact both yourself and your business, as well as how you can best work with your tax professional to take advantage of some changes or mitigate risk.

Planning for next year needs to happen far in advance to both capitalize on changes that have a positive impact, such as new rules about bonus depreciation, and adjust for potential negative consequences, such as reduced deductions for meals, entertainment and transportation costs. You may decide to restructure your business, or find that you want to make investments that take advantage of new deductions. The income of your spouse has more impact than ever, so you may need to adjust how you keep financial records.

To gain clarity on these issues, we invited tax experts from the Vistage community to identify and answer the top eight questions they hear from CEOs regarding the new tax code. While every CEO should consult with a tax expert to review their own company's circumstances, this research note serves as a starting point for that exploration.

**Click the links below** to find answers to the most frequently asked questions, which are followed by key recommendations at the end of this document:



Webinar on demand: Tax Reform: Key Considerations for SMBs

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# Question 1

## How do you know if your accounting firm or CPA can handle the complexity of the new tax legislation?

Ask them what they're planning to do to calculate your income as a result of the tax act. We get this question from our clients every day. What we do is take their projections for 2017 and show them what their taxable income looks like under the old rules. Then we compare that to what it looks like under the new rules. We go through a waterfall of choices, such as choice of entity, the 20% deduction with qualified business income, depreciation lives and methods, and the accrual method of accounting.

I suggest that business owners read articles that firms publish and educate themselves on some of the touchpoints of the law. Then sit down and have an honest conversation with your accountant. See what they understand and how they plan to maximize benefits and minimize costs for you under the tax act. Ask them to clarify what you've read. If a practitioner is confused about the provisions, that's not a good sign.

This should give you a better sense of whether your CPA knows where they're headed under the new tax law.

*- Robert Tobey, managing director, CBIZ & Mayer Hoffman McCann LLC*



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# Question 2

## What businesses qualify to take advantage of the 20% pass-through income deduction, and how does it work?

The deduction applies to individuals, estates or trusts with qualifying business income. It doesn't matter if you're operating as an S corporation, a multi-member LLC, a partnership or a sole proprietorship. You qualify for this deduction as long as none of the limitations apply to you.

However, this doesn't mean that owners of these kinds of businesses get an automatic 20% reduction of income. It's much more complicated than that.

1. **The 20% deduction only applies to business income.** It doesn't apply to investment income or other types of income. It also doesn't apply to wages you're paying yourself as an employee of an S corporation, or if you're receiving guaranteed payments as a result of a partnership.
2. **The calculation needs to be individually completed for every business activity that you own.** If you own five or six different business activities, you have to repeat this calculation five or six times. You can't combine your businesses for this calculation.

### What is a specified service business?

These are professional or skilled service providers, such as accountants, attorneys and doctors. However, an exception applies to architects and engineers.

### Tip

Review your payroll system if you have more than one business. If, for simplicity purposes, you keep all of your payroll in one company, you may be boxing yourself out of this deduction. Consider shifting payrolls around so you can take advantage of the deduction.

In addition, there are three limitations that will prevent some business owners from taking advantage of the 20% deduction.

1. **Limitation for exceeding taxable income threshold.** If you are married filing jointly, limitations kick in when your taxable income exceeds $315,000. For other taxpayers, it's $157,500. There is a phase-in of this limitation, in which the IRS will only impose the limitation on part of your income if you exceed the limit by a certain amount. For married filing jointly, the threshold is $100,000 (or $415,000 total). For all other taxpayers, the threshold is $50,000 (or $207,500 total).
2. **Limitation for specified service businesses.** If you have a specified service business, once you exceed the taxable income threshold, the limitation of "greater of wages" applies and you will be excluded from taking this deduction. In those instances, you will compare your 20% deduction to the greater of 50% of the wages you've paid, or 25% of the wages you've paid plus 2.5% of your qualifying basis. Qualifying basis is the original cost of the property you purchased, within the first 10 years of having it in service. If the property's useful life extends greater than 10 years, it is included with depreciation factored in.

### Tip

If you're close to the income limitations, look for ways to reduce your income. To bring down your taxable income, accelerate some expenses or make a larger retirement contribution before end of year.

3. **Limitation based on adjusted taxable income.** Take whatever survived these first two limitations and compare it to 20% of adjusted taxable income. Whichever results in the lower amount is your qualified business income deduction. To determine your adjustable taxable income, start with your taxable income and back out any long-term capital gains and qualifying dividends.

*- Leonard Nitti, principal, Wilkin & Guttenplan P.C.*



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# Question 3

## What legal entity would you recommend for a new business? Should a business owner consider changing to another entity type to take advantage of new tax laws?

There are two general structures to consider: pass-through entities such as LLCs, S corporations, partnerships and sole proprietors; and corporations such as C corporations. Each structure has different advantages and disadvantages.

### Pros and cons of pass-through entities

**Pro: Single layer of tax.** You can give equity to new partners or members without having them incur a tax.

**Pro: Tax deduction.** The 20% tax deduction can be very valuable for certain pass-through entities.

**Pro: Tax-free distributions.** In a pass-through entity, you can usually take assets in and out of the entity tax free.

**Con: New loss limitations.** There are new loss limitations that will limit tax-free benefits.

**Pro: Income flows through an LLC or partnership.** If there are capital gains or dividend-type income in the entity, that treatment will flow to the individual and be eligible for a lower tax rate.

**Pro: Step-up in asset basis.** If you're selling the business, purchases of an LLC pass-through entity get a "step-up in asset basis," which is a readjustment of the value of an asset for tax purposes. It's typically valuable for a business.

**Con: Less flexibility in equity interest.** You cannot take assets out of an S corporation tax free. There is no step-up if somebody buys the assets or buys the stock.

### Tip

**Regardless of your entity structure or industry, consider the cash method of accounting.**

Under the new tax law, the cash method of accounting for tax reporting has expanded. Small and midsize businesses whose gross receipts haven't exceeded $25 million in the preceding three years may be able to take advantage of this method — regardless of their entity structure or industry.

– *Brandon Powers, tax partner, Anton Collins Mitchell LLP*

### Pros and cons of corporations

**Pro: Lower tax rate.** The corporate tax rate for C corporations has been reduced to 21%.

**Con: Tax rate may change.** The tax rate may be 21% today, but there is no guarantee it won't increase to 22-24% in the near future. In the past, tax rates have been cut, and then slowly increased over the years.

**Pro: Benefit for qualified small business stock.** Many small businesses may be eligible for a 100% exclusion on the sale of their stock. This can be a very valuable benefit and is something for which startups, in particular, should try to qualify.

**Con: No tax-free liquidation.** Anything that comes out of a corporation will be taxed. There is also a double-tax issue. Any assets that come out of the corporation are taxed to the corporation. Dividends are taxed to shareholders.

**Con: Obscure state tax rules.** States have different rules depending on the type of entity you have and where shareholders or members live.

*- Andrew R. Ben-Ami, partner, Tax Practice Group, Tarter Krinsky & Drogin LLP*



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# Question 4

## What does a business owner need to understand about changes to the meals and entertainment deduction under the new tax law?

Previously, companies could deduct expenses for entertainment or meals that were connected to their business. Entertainment expenses, in particular, were deductible if business was discussed before or after the event. Both expenses were 50% disallowed.

Now, entertainment expenses are 100% disallowed and expenses for meals are 50% disallowed. This is important because, in the past, businesses have lumped meals and entertainment together as one item in their accounting system, as they were both subject to the 50% disallowance.

With the new tax rules, companies need to change their accounting systems to separate meals from entertainment. They also need to educate employees responsible for categorizing these expenses and redesign expense reports so these costs can be correctly documented.

### Changes to rules about meals

The tax bill also created new rules for certain types of meals.

In the past, snacks, drinks and meals provided to employees as part of an overtime allowance were treated as *de minimis fringe benefits*. As a result, they were 100% deductible. Now, they are only 50% deductible.

In addition, meals that are provided to your employees when they're required to be on premises are only 50% deductible. After 2025, they will be 0% deductible.

There are some exceptions. Some meals will remain fully deductible, such as ones you've supplied to your employees at social events.

*- Andrew R. Ben-Ami, partner, Tax Practice Group, Tarter Krinsky & Drogin LLP*

### Q. How do you draw the line between meals and entertainment?

A. This question keeps coming up because there is a lot of gray area surrounding it. For example, what happens if you have meals that are technically called food and beverages? What happens if you have food and beverages at an entertainment event? If you have food at a golf club, on the golf course, at a stadium, or in an arena, is that considered entertainment or food? The IRS hasn't yet drawn the distinction.

*- Andrew R. Ben-Ami*

### Q. How does the tax law impact deductions related to parking and transportation?

A. We're losing the parking deduction. The new law also removes the deductions that businesses can take when providing certain mass transit benefits to their employees.

*- Stacey Hekkert, president and managing partner, Anton Collins Mitchell LLP*



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# Question 5

## How will the new interest expense deduction apply to small and midsize businesses?

Business interest is now limited to 30% of your taxable income, after you add back depreciation and interest expense.

**To understand what this might mean for your firm, try this calculation:**

Take your interest expense and add your taxable income and depreciation. Multiply that number by 30. Then compare that to the interest you've paid and would normally deduct on your tax return. If the number is over 30% of the adjusted taxable income, then it's not deductible interest. The excess can be carried forward indefinitely.

For S corporations and C corporations, the limitation is measured and carryover is applied at the corporation level. For partnerships, the limitation is measured at the partnership level, and then the excess interest is passed up to the partner.

**Exceptions to note for the interest expense deduction:**

**There are some exceptions for businesses** that have more than $25 million in gross receipts starting in 2018. Under the new tax law, the $25 million is measured on a year-by-year basis. So, in some years, the interest expense limitation may apply to you because you have $25 million or more in gross receipts. But if you recalculate the next year, you might not be subject to it.

In addition, **real estate businesses can elect out of the provisions of the interest deduction limitation**. But there is give-back with respect to this. You have to change the depreciation lives and methods. You can only use a straight-line method, and you can't claim bonus depreciation with respect to those assets in the real estate business.

### The impact of rising interest rates

In an environment with rising interest rates, this could really impact a lot more businesses. Before, you were deducting interest. Now, you may have a loss and your interest expense deduction might actually cause you to have taxable income. You would have to pay tax when you don't have an operating income or are generating cash to pay it.

Also, this limitation is measured prior to arriving at a qualified business income when you're calculating the 20% deduction. **So, there is interplay among many of these provisions that you need to consider.** Take each one into consideration when you're measuring your 2018 taxable income.

*- Robert Tobey, managing director, CBIZ & Mayer Hoffman McCann LLC*



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# Question 6

## What other loss limitation has been created or changed by the new tax act?

For background, the IRS has historically placed limits on a taxpayer's ability to deduct expenses and losses under one premise: It doesn't want you to be able to take a loss from one category of income and offset it with income from another category.

Over the years, it's put a lot of limitations in place. These include:

- Capital loss limitations
- Passive activity loss limitations
- Limitations on investment expenses
- Limitations on medical deductions

Now, there is a limitation that **targets business losses**. Specifically, there is a limitation on a taxpayer's ability to deduct net business losses. **The limitation is $500,000 for those married filing jointly and $250,000 for all other taxpayers.**

Any losses that exceed the $500,000 or $250,000 limit become net operating losses (NOLs) that carry forward.

Under previous law, taxpayers were able to either carry these NOLs back up to two tax years and get an immediate refund, or they could carry them forward up to 20 years to offset future taxable income. For NOLs incurred in 2018 or later, **there is no longer a carryback provision in the law**.

The IRS is also limiting your ability to deduct these losses going forward. Under 2017 law, you were able to offset 100% of your income with an NOL. Going forward, it's only 80%.

*- Leonard Nitti, principal, Wilkin & Guttenplan P.C.*

### Example

Here's a hypothetical scenario involving two taxpayers who are married filing jointly: One spouse is an executive who earns $1 million in wages per year. The other spouse is the owner of a business. Because of accelerated depreciation deductions and other one-time items, the business owner incurred a net loss of $1 million this year.

In 2017, under the old tax law, these taxpayers wouldn't pay any tax because their wages would be offset by their losses and they would have a net taxable income of zero. In 2018, under the new tax act, they can only deduct up to $500,000 of those losses.

As a result, the couple is considered to have a net income of $500,000, even though they've had no economic income for the year. They would have to pay tax on $500,000, plus or minus any other income items or itemized deductions.



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# Question 7

## How does the expansion of Section 179 impact businesses for 2018 and beyond?

Section 179 gives taxpayers the opportunity to immediately deduct expenses for fixed asset additions. Qualifying fixed asset additions have included tangible personal property with a class life of 20 years or less, off-the-shelf software, and certain improvements to qualifying non-residential property.

While Section 179 has been around for a long time, the tax act has essentially expanded and increased the availability of deductions. There are two key changes that have taken place:

1. **Increased maximum expense deduction and limitations**

   In 2017, the maximum deduction that businesses could take for fixed asset additions was $510,000. Now, the maximum is $1 million. In addition, the tax bill raised the limitation for this deduction from $2 million to $2.5 million. In other words, when the total cost of your property placed in service during the tax year exceeds $2.5 million, your Section 179 deduction is reduced for each dollar you are now over the limit.

2. **Expanded definition of qualifying real property**

   Qualifying real property that is eligible for a deduction now includes roofs, HVAC systems, fire-protection systems and security systems for non-residential real property.

*- Leonard Nitti, principal, Wilkin & Guttenplan P.C.*

### The state factor

Review your state tax laws for bonus depreciation, so you can understand how that might impact your Section 179 deductions. A number of states have decoupled from both enhanced Section 179 and bonus depreciation. There are some states, however, that allow for one or both.



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# Question 8

## One of the stated goals of the new tax act was to stimulate capital spending by businesses. What fixed asset additions will qualify for the new 100% bonus depreciation?

Fixed asset additions that have a taxed depreciable life of 20 years or less qualify for bonus depreciation. Under the old law, these assets had to be new. Under the new law, they can be used assets, but the used asset has to be new with respect to you.

Examples of fixed asset additions include:

- Land improvements
- Parking lots
- Landscaping
- Souvenir property (e.g., desks used in the business)
- Computers
- Computer software
- Vehicles

You may elect not to have bonus depreciation apply by asset class — meaning, measured by the assets' depreciable life, whether that's three years, five years, seven years or 15 years. You can elect to use a straight-line depreciation over those periods of time. That gives you some flexibility when you're planning to generate income to use your interest expense or get the 20% qualified business income deduction.

### Issues that require attention

With respect to capital asset additions, there is a waterfall that you need to follow to decide how costs are recovered for tax purposes. The first step is to determine if these expenditures qualify as repairs under the tangible property regulations. If they do qualify, then the costs are immediately deductible. If they don't qualify and must be capitalized, then you must determine:

1. Whether the assets are eligible for Section 179 treatment or bonus depreciation;
2. Whether you benefit from electing out of Section 179 or bonus depreciation;
3. Whether you benefit from using the alternative straight-line method and depreciable lives rather than using modified accelerated cost recovery system (MACRS) methods and lives;

What to do with respect to claiming Section 179 and bonus depreciation benefits — along with using different depreciation methods and lives — is dependent on each taxpayer's facts and circumstances.

This is a powerful planning tool for 2018. It can help you with bonus depreciation and using depreciation lives and methods to best manage your taxable income and take advantage of these new rules.

*- Robert Tobey, managing director, CBIZ & Mayer Hoffman McCann LLC*

# Key recommendations

## Think about your long-term plan.

Your accountant can crunch numbers, but they can't predict the future. As a business owner, you need to think beyond 2017 or 2018 taxes. How do you see your business evolving or growing? Will your involvement with the business change over time? Based on that information, your accountant can help you work out the numbers and determine the best path forward. Have a conversation with your tax professional about how you should be planning now to get the best result for your business in the future. They can identify areas that may be problematic for you.

## Run through different scenarios.

Look at the individual provisions in the tax act as pieces of a puzzle that have to be put together. Take the time to work with your CPA or accountant to walk through different scenarios to figure out what's right for your business in the long run.

## Review your financial reporting.

Tax reform has an impact on financial statements and your balance sheets. Balance sheet items have been remeasured, which impacts you and your leadership team. Review your plans for dividend distribution and potentially look at cash roll planning in a different light.

## Review state-specific rules.

State conformity is an issue that's often overlooked. States aren't all the same. Some of the uncertainty relates to whether the state has "static" or "rolling" conformity to the federal tax rules. The states with "static" conformity wait until new state legislation is passed, and the states with "rolling" conformity automatically follow federal changes. The ink is still wet on the tax reform, and we will have to be patient to see how everything comes together holistically.

## Pay attention to the repatriation tax.

Don't be surprised by the foreign repatriation tax and its deadline. Not only does this tax apply to large corporations, but it potentially applies to anyone that had international operations — regardless of size. It's a little bit like foreign bank account report (FBAR) filing. Some small businesses think, "The FBAR filing doesn't apply to us." If you have a foreign account, it applies to you — and it's $10,000 if you miss the filing.

## Anticipate that smaller details may change.

The Treasury and IRS have set a due date of June 30 to issue proposed regulations and updated guidance on a lot of the more complicated and far-reaching provisions of tax reform. Stay close to your CPA as they work through tax planning, financial reporting and transactions to make sure the structures are appropriate in light of some of these new changes. In the meantime, look for notices and guidance from the IRS on rules such as Section 965, which is the repatriation tax or toll charge.

## Consider the costs of disposing of machinery or equipment.

You can no longer exchange tangible personal property on a tax-free basis. So, if you're buying machinery and equipment that will be depreciable, you have to consider how you're going to dispose of the old equipment (e.g., exchange it) and the tax implications of that choice.



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As the leader of the Tax Practice Group at Tarter Krinsky & Drogin LLP, Andrew R. Ben-Ami has extensive experience in tax planning for businesses, individuals and tax-exempt organizations. Andrew advises clients on a broad range of federal, state and local tax matters, and also represents clients in tax examinations and controversies before the Internal Revenue Service and state and local tax authorities.

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As chief research officer for Vistage, Joe Galvin is responsible for providing Vistage members with the most current, compelling and actionable thought leadership on the strategic issues of small and midsize businesses. Joe is an established thought leader and analyst who has researched and presented to business leaders around the world on customer management, world-class sales performance, and CRM and sales force automation technology.

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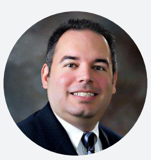
Stacey leads Anton Collins Mitchell LLP ("ACM") as president and managing partner. She has over 25 years of audit and assurance services experience and serves as an advisor to her clients. In addition to managing the overall operations of ACM and ensuring the firm exceeds the standards required of professional service firms, she is instrumental in directing the growth of ACM, which has recently broken into the Top 200 accounting firms in the United States.



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As principal at Wilkin & Guttenplan, Len Nitti's knowledge in Federal and State taxation extends far beyond the compliance aspect and encompasses planning, research and problem solving. Len's major areas of concentration in taxation include real estate, partnership, and state and local tax. His expertise also includes structuring complex transactions, coordinating voluntary disclosure agreements, exit strategies for real estate owners, and identifying tax savings opportunities and other financial incentives for his clients.

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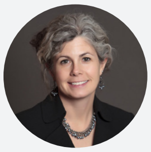

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As director of research, Anne Petrik leads the design, deployment and analysis of member surveys for Vistage, capturing the sentiment and practices of the Vistage CEO community. This analysis, in collaboration with perspectives from experts and partners, helps create insights for SMB CEOs through the thought leadership published by Vistage.

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