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A History of Professional Commitment

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2018 Mid-Year Business Planning

Professional services include:

- Tax Compliance
- Audit & Assurance
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Our mission is to provide our clients with exceptional services by taking initiative to be proactive advisors. We pride ourselves in developing tailored strategies to meet the specific needs of our clients.

We have a diverse commercial and individual accounting, auditing, tax and business consulting practice.

Our partners and staff are available to meet the needs of our clients and offer to meet with owners and management periodically throughout the year to discuss plans and to consult on a broad range of financial and business topics.

Over the past six months, we've digested the many tax law changes brought by the Tax Cuts and Jobs Act (TCJA). From a significantly lower corporate tax rate to a new deduction for qualified business income, the TCJA brings a host of planning opportunities for your business. This letter presents some tax planning ideas under the TCJA for you to think about this summer while there's sufficient time left in 2018 to take tax saving actions.

Maximize Your Qualified Business Income Deduction

You may have heard a lot of talk in the news about a new deduction for "pass-through" income, but it's actually available for qualified business income from a sole proprietorship (including a farm), as well as from pass-through entities such as partnerships, LLCs, and S corporations. Under the TCJA, business owners may deduct up to 20% of their qualified business income; however, the deduction is subject to various rules and limitations.

Although official guidance is lacking on this new deduction, there are some planning strategies that can be considered now. For example, there are ways to adjust your business's W-2 wages to maximize your qualified business income deduction. Also, it may be helpful to convert your independent contractors to employees, assuming the benefit of the deduction outweighs the increased payroll tax burden. Other planning strategies include investing in short-lived depreciable assets, restructuring the business, and leasing or selling property between businesses. We will work with you to determine which strategies produce the best outcome.

Rethink Entity Choice

The TCJA makes major changes to the choice of entity decision. Because C corporations are now taxed at a flat rate of 21% (as opposed to a top rate of 35% under prior law), many business owners wonder whether they should structure or restructure their business operations as a C corporation. Unfortunately, the answer is not simple. For one thing, the top individual tax rate also fell, from 39.6% to 37%. Also, the new qualified business income deduction isn't available for C corporations or their shareholders. There are other factors to consider as well, such as self-employment and state taxes.

It's also important to note that C corporations are subject to double taxation, meaning that corporate income is taxed once at the entity level and again when it's distributed to shareholders as dividends. This can be avoided if the corporation retains all profits to finance growth. However, this opens the door to the accumulated earnings tax (or personal holding company tax) if profits accumulate beyond the reasonable needs of the business.

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Although C corporations are now more attractive thanks to the lower rate, it may make more sense to continue operating as a pass-through entity. This is particularly true if (1) you can claim the full 20% deduction for qualified business income and (2) you plan to exit the business in a relatively short period of time. Generally, it's risky to hold significant assets that are likely to go up in value (like real estate) in a C corporation. If the assets are sold for substantial gains, it may be impossible to get the profits out of the corporation without double taxation.

If you currently operate your business as an S corporation and would benefit from a conversion to a C corporation, we suggest revoking the S corporation election either this year or next year. This is because any income adjustments resulting from required accounting method changes are recognized ratably over a six-year period (as opposed to four years under prior law). This will help ease the sting a bit. To qualify for this, your business (1) must have been an S corporation on 12/21/17 (the day before the TCJA was enacted) and (2) must revoke its S corporation election during the two-year period beginning on 12/22/17. However, the business must have had the same owners on 12/22/17 and the revocation date.

As you can see, the choice of entity decision is complicated, but we're here to help. We would be happy to analyze your circumstances to see if a C corporation is right for you.

Acquire Assets

Thanks to the TCJA, this is a great time to acquire business assets. Your business may be able to take advantage of very generous Section 179 deduction rules. Under these rules, businesses can elect to write off the entire cost of qualifying property rather than recovering it through depreciation. The maximum amount that can be expensed this year is $1 million (up from $510,000 for 2017). This amount is reduced (but not below zero) by the amount by which the cost of qualifying property exceeds $2.5 million (up from $2.03 million for 2017). But, there's more good news. The Section 179 deduction is now available for certain tangible personal property used predominantly to furnish lodging and certain improvements to nonresidential real property (roofs, HVAC, fire protection systems, alarm systems, and security systems).

Note: Watch out if your business is already expected to have a tax loss for the year (or close) before considering any Section 179 deduction. This is because you can't claim a Section 179 write-off that would create or increase an overall business tax loss. Please contact us if you think this might be an issue for your business.

Above and beyond the Section 179 deduction, your business also can claim first-year bonus depreciation. The TCJA establishes a 100% first-year deduction for qualified property acquired and placed in service after 9/27/17 and before 1/1/23 (1/1/24 for certain property with longer production periods). Unlike under prior law, this provision applies to new and used property. The bonus percentage will phase down for years 2023 through 2026. Note that 100% bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business's 2018 tax year. Under the TCJA, the NOL generally can't be carried back to an earlier tax year. However, it can be carried forward indefinitely. Unfortunately, NOLs arising in tax years beginning after 2017 can't reduce taxable income by more than 80%.

Given these generous provisions, your asset acquisition plan is more important than ever. If you're planning on acquiring a business, we suggest you pursue an asset acquisition rather than a stock deal. Also, there may be reasons to elect out of bonus deprecation or use different expensing techniques in individual tax years. We can help with that.

Take Advantage of Minimum Tax Credit Carryovers

Starting in 2018, the TCJA repeals the Alternative Minimum Tax (AMT) for C corporations. If a corporation paid AMT in prior years, it may have generated a Minimum Tax Credit (MTC). Before the TCJA, corporations could use MTCs to offset their regular tax liability in a later year. Any unused credit was nonrefundable and carried forward indefinitely. Thanks to the TCJA, corporations may now use MTCs to offset regular tax for any tax year. Also, corporations may be refunded up to 50% of their MTCs for tax years beginning after 2017 and before 1/1/22. For tax years after 2021, any of the corporation's unused MTC is fully refundable.

Adopt a More Favorable Accounting Method

The cash method of accounting, which allows you to recognize sales when cash is received, is attractive to many small businesses due to its simplicity. For tax years beginning after 2017, the ability to use the cash method is greatly expanded. Any entity (other than a tax shelter) with three-year average annual gross receipts of $25 million or less can use the cash method regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. Likewise, C corporations and partnerships with C corporation partners can use the cash method if they meet the $25 million gross receipts test.

Under pre-TCJA law, if the purchase, production, or sale of merchandise was an income-producing factor, inventories were required to be maintained, and the cash method wasn't allowed unless the taxpayer met a $1 million gross receipts test or a $10 million gross receipts test (which only applied if the taxpayer's principal business activity was an eligible activity). Also, for years beginning before 2018, C corporations and partnerships with a C corporation partner with average annual gross receipts over $5 million couldn't use the cash method.

Now that the rules have changed, your business may be eligible to adopt the cash method of accounting. Since the $25 million gross receipts test is made on a year-by-year basis, we can monitor whether your average annual gross receipts fall below the threshold. If they do, we can discuss the pros and cons of changing your accounting method. Assuming a change would be beneficial, we can file the appropriate paperwork with the IRS to change your method of accounting.

Determine Eligibility for Credit for Employer-paid Family and Medical Leave

The TCJA establishes a new credit for employer-paid family and medical leave. The credit is for tax years beginning in 2018 and 2019 and is equal to 12.5% of the amount of wages paid to qualifying employees on family and medical leave. However, the employer must pay at least 50% of the wages normally paid to the employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percent by which the payment rate exceeds 50%. This could be a valuable incentive for your business, so let's discuss at your earliest convenience.

Watch out for New Business Interest Expense Limit

Regardless of its form, every business will be subject to a net interest expense disallowance. Starting in 2018, net interest expense in excess of 30% of your business's adjusted taxable income will be disallowed. However, your business won't be subject to this rule if its average annual gross receipts for the prior three years is $25 million or less. Also, real property trades or businesses can choose to have the rule not apply if they elect the Alternative Depreciation System (ADS) for real property used in their trade or business. Since ADS is a slower way to depreciate property, real property trades or businesses will need to look at the tradeoff between currently deducting their business interest expense and deferring depreciation expense. If you find yourself in this predicament, we can model out both scenarios to determine the best course of action.

Consider Qualified Equity Grants

The TCJA provides a new tax election for equity-based compensation from private employers. Specifically, the election covers stock received in connection with the exercise of an option or in settlement of a Restricted Stock Unit (RSU). From a tax perspective, many employees struggle with these forms of compensation because they don't have the ability to liquidate their shares to pay their tax bill. This new election provides some relief.

Starting with options exercised or RSUs settled after 2017, qualified employees of eligible private companies may elect to defer income from those instruments for up to five years. To take advantage of this election, various requirements must be met. This includes having a written plan under which at least 80% of full-time employees are granted stock options or RSUs.

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If you're interested in offering qualified equity grants to your employees, we can determine if you're an eligible corporation under this new provision. We can also assist you and your legal counsel in preparing the necessary documentation. Please contact us if you have questions or want more information.

Monitor State Response to Tax Reform

States react differently to changes to federal tax law. For example, some states automatically conform to federal tax law as soon as legislation is passed. Other states require their legislatures to adopt federal tax law as of a fixed date. This generally occurs on an annual basis. There are some states, however, that pick and choose which federal provisions to adopt. Because of this, your state income tax rules may be drastically different than the federal income tax rules. For example, some states may not adopt the new 100% bonus depreciation rules or the NOL rules. We have monitored your state's response to the TCJA and will help you minimize your state income tax bill.

Set up a Qualified Small Business Corporation

As we mentioned earlier, the TCJA establishes a flat 21% federal income tax rate for C corporations, including Qualified Small Business Corporations (QSBCs). A QSBC is generally a domestic C corporation whose assets don't exceed $50 million. In addition, 80% or more of the corporation's assets must be used in the active conduct of a qualified business. There are other requirements as well, but we can fill in the details if you decide a QSBC is right for you.

By far, the biggest benefit of owning QSBC stock is the ability to shelter 100% of the gain from a stock sale. A more-than-five-year holding period requirement must be met to claim this exclusion. Another major benefit of owning QSBC stock is the ability to roll over (defer) the gain on a stock sale to the extent you acquire replacement QSBC stock within 60 days of the original sale. You must have held the QSBC stock for more than six months to take advantage of this break. Once the gain is rolled over, you must reduce the tax basis of the replacement stock by the amount of gain deferred. However, if the replacement stock is QSBC stock when it's sold, the applicable gain exclusion break is available if the more-than-five-year holding period requirement is met.

The 100% gain exclusion and rollover breaks combined with the flat 21% corporate tax rate can make operating a newly formed business as a QSBC more tax-efficient than operating it as a pass-through entity (sole proprietorship, partnership, LLC, or S corporation). That is big news because pass-through entities have traditionally been the first choice for most small and medium-sized businesses. However, not all start-up businesses will qualify for QSBC status.

Conclusion

As we said at the beginning, this letter is to get you thinking about tax planning moves for the rest of the year. This year is unique given the numerous tax law changes brought by the TCJA. Even with uncertainty about some of the TCJA's provisions, there are things you can do to improve your business's situation. Please don't hesitate to contact us if you want more details or would like to schedule a tax planning session.

Best Regards,

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