The business income deduction: Time to rethink your choice of entity?

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Time to Rethink Your Choice of Entity?

Are you a sole proprietor or the owner of a pass-through business (for example, an S corporation, partnership or limited liability company), and do you hire employees and use buildings and equipment to manufacture, sell and/or distribute your product? If so, you will very likely see a 20 percent drop in the tax you pay on your business income starting this year. That's thanks to the Tax Cuts and Jobs Act of 2017, or theTCJA, which added Section 199A to the tax code. This means a big savings for a lot of business owners, many of them owners of small businesses.

That's the good news. The-less-than-good news is there are many limitations on the 20 percent pass-through business income deduction. Certain types of businesses, known as "specified service trades or businesses," orSSTBs, do not get the deduction over certain income limits, and there are limitations based on the size of your payroll or the amount of property used in the business that apply to all types of businesses. It can get complicated, but there are tax savings for many pass-through business owners under Section 199A, at least until 2026, so it pays to take the time to find out whether your business income qualifies for the deduction and if there are steps you can take to increase the size of your deduction. (See the post entitled **"Do You Qualify for the 20% Tax Break on Your Business Income?"** for more on the limitations.)

Some business owners may get a greater benefit from the business income deduction if they change the type of business entity used. It has always been important to consider what type of business entity best serves your type of business and your particular business strategy. The tax treatment of the entity is a big factor in that decision. When the TCJA reduced the tax rate on C corporations to 21 percent, many commentators suggested pass-through businesses would want to switch to being C corporations. Maybe. When all the relevant factors are considered, it turns out the advantages of being a pass-through entity continue to outweigh the advantage of the 21 percent tax rate in a great many cases. There is no universal answer, so run the numbers on your business and think about your succession plan or other exit strategy before deciding whether or not to go to a C corporation.

Even if you decide to keep you pass-through entity, it turns out the type of pass-through entity used can make a difference. This is a bit surprising because the purpose of the business income deduction was to give pass-through business owners a deduction similar to the deduction given to C corporations. But there can be differences, so business owners should run the numbers and consider if there is an advantage to operating as a different kind of pass-through entity.

Some astute analysts have run the numbers to show Section 199A, as written, can produce a different deduction amount depending on whether the business is operating as an S corporation, partnership, or sole proprietorship. Some commentators thought this might be an oversight in the drafting of the statute that would be corrected when the IRS issues regulations. But that has not turned out to be the case. The IRS issued extensive proposed regulations in August of 2018 on the pass-through deduction, and it chose not to address this disparity.

As a result, the amount of the deduction can still vary, sometimes significantly, depending on whether you operate as an S corporation, a partnership, or a sole proprietorship. Take the case of a married engineer who operates her engineering firm as a sole proprietor, making $300,000 in 2018 from her practice after all expenses have been paid. Assume she has no employees, uses no depreciable property in her practice, and her taxable income is also $300,000. Her practice is not an SSTB and her income is below the phase-in threshold that applies to joint filers ($315,000 in 2018), so it looks like all $300,000 in qualified business income. That is a $60,000 deduction (20 percent of $300,000).

If she had incorporated her practice as an S corporation, she would need to pay herself a reasonable amount of salary, thereby reducing the amount of her business income deduction because W-2 earnings are not treated as business income eligible for the pass-through deduction. Her salary would be taxed as compensation subject to ordinary income rates and applicable employment taxes. The amount of her business income deduction would be reduced because her qualified business income would be reduced by the amount of the salary. On these facts, therefore, she is better off, from a tax perspective, as a sole proprietor. (Could an LLC be the better choice here?)

Staying with that example, if her business income from the engineering practice exceeded the phase-in range ($315,000-$415,000 in 2018) for the limitations based on W-2 wages and property, then she would be subject to the wage and property limitations that apply to potentially limit the business income deduction. Those limitations are not described further in this article, but suffice it to say if a business does not pay any W-2 employees, it will not qualify for the business income deduction. If the engineer operates her practice as an S-corporation, she will have some W-2 income, so she will be able to deduct 20 percent of her business income, but not more than 50 percent of the W-2 income. If she continued to operate as a sole proprietor at that income level, she would receive no business income deduction because the threshold would be exceeded and the business did not pay any W-2 wages. On these facts, therefore, she is better off from a tax perspective as an S corporation shareholder.

This is just one example of how there can be a different outcome, depending on the type of pass-through entity and the type of business involved. We encourage all owners of businesses to review their choice of entity to determine whether they qualify to deduct the full 20 percent of all business income, and, if not, whether that outcome can be improved by changing the type of pass-through entity used or making other adjustments to increase the availability of the deduction.
Thanks for reading this. Please be aware it does not describe all the rules that may apply to your situation. The circumstances of your particular business need to be separately

analyzed to determine, in light of all the available guidance, whether and to what extent you may be able to deduct a portion of your business income or make adjustments to increase the amount of your deduction. Consult with a tax professional. In many cases, the savings will be well worth the effort.

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I have extensive experience helping business owners and executives negotiate compensation and ownership agreements and develop retirement and estate plans. I understand that they do not want problems; they want it done.

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