TAX REFORM FOR THE SMALL BUSINESS OWNER: APPROACH WITH CAUTION

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There has been a great deal of discussion and debate over the impact of tax reform on small businesses and their owners. Congress enacted the Tax Cuts and Jobs Act in late-2017, and, in doing so, created a number of business incentives. Many of these incentives will benefit small businesses and their owners. In many cases, the benefits will depend on the overall tax posture of the owner and his or her family.

The impact of tax reform on small business owners and their families will be significant. Individual tax rates are lower, and the standard deduction has been increased. To pay for these benefits, personal and dependency exemptions have been eliminated, and Congress reduced the deductibility of mortgage interest. Specifically, interest is no longer deductible for mortgage amounts over $750,000, and the deductions for home equity debt and lines of credit have been eliminated, unless used to buy, build or substantially improve the taxpayer’s home.

One area of tax reform that received the immediate attention of practitioners and a great deal of media attention was the state and local tax deduction. Congress changed the deductibility of state and local taxes by limiting the deduction to $10,000. Congress also eliminated most other itemized deductions.

Finally, in a bit of a surprise, Congress retained the alternative minimum tax (AMT), but made it easier to avoid the tax by increasing the exemption that is available to taxpayers.

So who will benefit? Taxpayers with itemized deductions that are less than with new standard deduction will benefit. Taxpayers who currently pay the AMT tax are now more likely to avoid that tax. Taxpayers who operate small businesses through pass-through entities will likely be able to take advantage of a new 20% deduction, which will reduce personal taxable income.

On the other hand, taxpayers with larger families and/or larger amounts of itemized deductions could experience an increase in taxable income, resulting in a higher tax bracket, due to the elimination of personal and dependency exemptions, as well as a number of itemized deductions.

What does all this mean to the small business owner? To answer this question, let’s turn to corporate taxation. Under the new law, Congress made changes to corporate tax rates, specifically reducing the “C corporation” tax rate to a flat 21%. Should small business taxpayers change from the pass-through format to the corporate format? Not so fast. While small business owners who are taxed at overall higher personal rates might be tempted, the analysis will require some number-crunching. Militating against such a change: the new 20% deduction available to owners of most pass-through businesses, and the double-tax environment of corporate taxation.

The new law will present challenges; small business owners should be prepared to proactively address these matters with their tax representatives.

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