THE NEW TAX LAW AND YOUR COMPANY

Tax reform passed in the closing days of last year can have profound effects on your business and may provide big benefits — if you have a basic understanding of the changes.

"Peculiar." That's how Steven Rosenthal, senior fellow at the Urban-Brookings Tax Policy Center in Washington, D.C., describes last year's tax reform bill, the Tax Cuts and Jobs Act of 2017. He says the bill is unlike typical tax code and understanding its implications requires a somewhat different approach. On top of that, passage of the bill was rushed and there's much yet to be worked out; situations will doubtless arise for which there is no specific answer and not even general guidance in the bill as it was finalized.

One major effect of the new act is on pass-through entities. These include S corporations, sole proprietorships, partnerships and some limited liability companies. A high percentage of owners of wheel loaders operate as one of these.
A pass-through entity is a business where the tax liability "passes through" to the business principals and other investors. Whereas a C corporation pays its own taxes, pass-throughs pass the tax liability to individuals.

There are different tax obligations for businesses that are not a "specified business firm;" mainly, they don't qualify for the 20 percent deduction detailed below. The definition of a specified business firm is essentially any pass-through business for which the principal asset is the reputation or skill of one or more of its employees.

There are lists of specified trades and businesses and most businesses on the list are what you'd expect: law and medical firms, consultancies, performing artists. (Section 1202(e)(3)(A) of the tax code.) Could your business be considered a "specified trade or business"? Maybe. If your marketing focuses on your experience and expertise, the IRS could make that argument. *See the sidebar for more information.*

Threshold for 20 percent

Every pass-through business investor is potentially able to take advantage of the section 199A deduction of 20 percent of income. This is just what it sounds like, the ability to deduct 20 percent of your qualified business income (QBI) from a pass-through business. If you had $100,000 in QBI, you pay taxes on only $80,000.

The math is easier if income is below $157,500 for single tax filers and $315,000 for joint filers. Above that there are a couple of what Rosenthal refers to as "guardrails" that constrain what a tax filer can do. Both set upper limits on the dollar amount of the deduction.

The first is that the deduction cannot exceed 50 percent of the total payroll. The second is that the deduction cannot exceed 25 percent of wages plus 2.5 percent of the unadjusted basis of depreciable property. Why two methods? The first accommodates businesses that have a high percentage of business costs in payroll. The second helps businesses that have a lower percent of payroll expense but high value holdings in depreciable assets. Lawmakers were thinking of real estate holding companies when they came up with this alternative, but any contractor with a fleet of expensive equipment may also benefit. The filer can use whichever deduction is greater.

It's not quite this simple. There is a graduated conversion of applicable math between $157,500 and $207,500 for single filers and between $315,000 and $415,000 for joint filers, spreads of $50,000 and $100,000, respectively. Explaining this phase-in is beyond the intent of this article; we just want our readers to know it exists.

"The real challenge will be to manage tax liabilities under these constraints," Rosenthal says. "There may be work-arounds required, such as joint ventures or other arrangements with other business firms."

You need a tax professional

This article is not intended to give tax advice but rather an overview of the 2017 tax reform bill so that our readers can speak from a position of knowledge with their tax professional. And you do need a tax professional. It helps if you understand the concepts of tax liability, but your main contribution to the discussion will be knowledge of your business and your accounting information.

25 million changes

While the 20 percent deduction has been basking in the spotlight, the Act has a lot of other significant changes, says Matthew Turkstra, director of tax, fiscal affairs and accounting, Associated General Contractors of America. One of those is the increase from $10 million to $25 million for a number of tax situations. The $10 million threshold was set in 1986 and was not adjusted for inflation. The new $25 million threshold will be adjusted for inflation.

One item dictated by this threshold is the required accounting method. Below the cutoff (using a running average of the current tax year and the past two tax years), companies can choose to use the completed contract method of accounting, and taxes are due for the year in which a project is completed. Above the cutoff, companies are required to use percent of completion accounting; tax liability for a year is equivalent to the percent of completion of a project. If a multi-year project were 50 percent complete at the end of the year, 50 percent of the taxes would be due.

Is mine a 'specified trade or business'?

Ostensibly, construction contractors, scrap-waste-recycling firms, landscapers and other wheel loader customers are not considered specified trades or businesses. But if you've promoted your business based primarily on your experience or expertise, the argument could be made that your business is such a firm. This is one of those situations for which no guidance is given in the bill as it was finalized and may not be decided until there's a court case on the matter.

Depending on payment terms they set up with their customers, companies could find themselves with cash flow trouble. The same procedures are in place except at the much higher threshold.

The $25 million threshold also applies to uniform capitalization, which deals with the production of real or tangible personal property and the acquisition of real and tangible property for resale. For our readers, this is most likely to affect dealers and distributors of parts and equipment. Below $25 million, companies can use cash accounting and they can use cash accounting even if they have inventory. It used to be that if you had inventory it precluded you from using cash accounting.

The cap on interest deductions also changes at $25 million earnings (again, a three-year running average). Below that threshold there is no limit on the interest deduction. At or above $25 million, the limit is 30 percent of earnings before interest, taxes, depreciation and amortization through the 2021 tax year. Starting in 2022 the cap is 30 percent of earnings before interest and taxes.

NOL backwards and forward

There are also important changes to the way net operating losses can be used. Under the old law, NOLs could be carried back two years and carried forward 20 years. The carry-back provision has been eliminated and the carry-forward period has been changed from 20 years to indefinitely. In addition, the amount of NOL that can be used in a tax year is limited to 80 percent of earnings.

These changes affect NOLs in tax years beginning after Dec. 31, 2017, so businesses should track 2018 and later NOLs separately from those of 2017.

There are other considerations and it's not clear how NOLs from tax years before and after the Dec. 31, 2017, cutoff can be allocated to offset future earnings.

These rules apply to non-farm income, and there are other considerations. For example, one-year NOL carryback is allowed under certain disaster situations.

By and large these changes should make life easier for most pass-through businesses, Turkstra says. "The threshold increase from $10 million to $25 million is a huge relief to small- and mid-size contractors. The other provisions also come with benefits. The key is to be aware of the changes, discuss them with your tax professional and be sure to keep accurate, complete records."

Check your dates

If you do an online search on this topic, note that the bill was rushed through Congress and the results you find online may not have the language of the final bill, even if those results are from the weeks and days immediately preceding passage. For example, architecture and engineering were on the initial list of specified trades and businesses and therefore ineligible for the 20 percent deduction, but they were stripped out of the final version. This is one more reason to rely on your tax professional, who should have all the latest information.