Sizing Up New Deduction for Pass-through Entities

Complicated new rules for business owners

The new Tax Cuts and Jobs Act (TCJA) creates a brand-new deduction for pass-through entities, designed to provide a balance to corporations benefiting from tax rate cuts. But the deduction is not nearly as simple as the new flat 21% rate for corporations authorized by the TCJA. Although many tax experts are still grappling with the rules, here are the basics of what we know so far.

The deduction, which takes effect in 2018, is available to pass-through entities such as partnerships, S corporations and limited liability companies (LLCs), as well as sole proprietors. It can be as high as 20% of business income received.

However, deductions are reduced or eliminated for certain taxpayers, depending on the amount of qualified business income (QBI) and the nature of the business activity and, in some cases, wages paid to employees, and business property. QBI is generally defined as your net income from the business without including amounts in the nature of compensation.

For starters, pass-through entities are divided between those that provide personal services and those that do not. The personal service group includes attorneys, physicians, consultants, athletes, financial advisers, accountants, stockbrokers and others who typically offer services to the public; however, engineers and architects are specifically excluded. Then, the following rules apply:

♦ If you have income lower than $157,500 as a single filer or $315,000 as a joint filer, you are entitled to the full 20% deduction of QBI—no questions asked. It does not matter whether you are a personal service owner.

♦ If your income exceeds $207,500 as a single filer or $415,000 as a joint filer, you receive no deduction if you are a personal service owner. For other owners above these thresholds, your deduction is limited and possibly eliminated.

♦ If your income falls between the thresholds stated above, your deduction is reduced, regardless of whether you are a personal service owner.

For instance, assuming you are a personal service owner who files a joint return, the amount of your QBI is phased out on a pro rata basis until it disappears completely when total taxable income exceeds $415,000. For other pass-through owners above the upper threshold, the deduction is limited by the greater of either (1) 50% of the wages the business pays its employees or (2) 25% of wages plus 2.5% of the basis of the qualified property owned by the business. After

Inside

Roth Recharacterizations: Back to the Future

New Law Revives Six Key Tax Breaks

Child Tax Credit Grows Up

Five Prime Issues for Business Startups

Facts and Figures

comparing this limited deduction to the maximum 20% deduction of QBI, you are entitled to deduct the smaller of the two.

Suffice it to say, calculations involving the new deduction for pass-through entities will often be exceedingly complex. As of this writing, the IRS has not yet weighed in on the issue, although it is expected to provide some much-needed guidance before the end of the year.

Should business owners shift to a pass-through entity form to benefit from this new deduction? This is a decision that involves an analysis of many factors in addition to this tax break. Obtain expert advice for your particular situation before you proceed further.

Give Us A Call!

Do you have any questions or comments about this newsletter or your individual situation? Please do not hesitate to contact our office. We would be glad to serve you in any way we can.

Roth Recharacterizations: Back to the Future

How to undo a conversion to a Roth

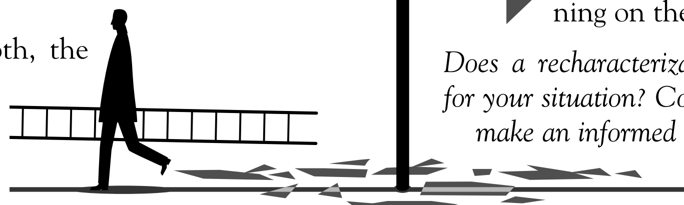
When it comes to taxes and finance, there is usually no going back in time. However, a notable exception may apply if you converted a traditional IRA into a Roth last year. In effect, you can undo a conversion as if it never happened.

This "recharacterization" technique has been repealed by the Tax Cuts and Jobs Act (TCJA), beginning in 2018. But the IRS has indicated that it is still available for 2017 conversions. Thus, you have until the extended deadline for filing your 2017 tax return—October 15, 2018—for a recharacterization.

Background: The annual contribution limit for traditional and Roth IRAs is the same. For 2018, the limit is $5,500 per person, or $6,500 if you are age 50 or older. (This is also the limit for any combination of traditional and Roth contributions for the year.) Although traditional IRA contributions may be partially or wholly tax-deductible, distributions are generally taxed at ordinary income tax rates.

Conversely, you can never deduct contributions to a Roth, but qualified distributions, such as those made after age 59½, are completely tax-free five years after setting up the account. Plus, you don't have to take mandatory lifetime distributions after age 70½ as you do with a traditional IRA.

When you convert to a Roth, the value of the funds transferred to your new account is taxed just like a regular distribution from a traditional IRA. Therefore, if you convert some funds this year, the tax will be due on your 2018 return, but you are in line for future tax-free benefits (assuming no further legislative changes).



Why would you want to recharacterize a Roth conversion? Here are a few possibilities.

♦ The value of the funds has declined since the conversion, so you have effectively overpaid the tax liability.

♦ The amount of the conversion tax caught you by surprise, and you cannot afford to pay the IRS.

♦ You simply decide that the Roth conversion is not the best approach for your situation.

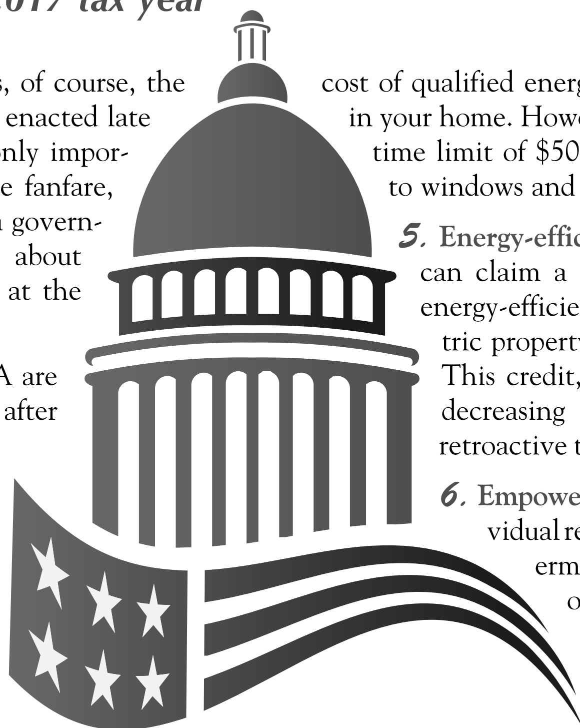
If any of these is true for a 2017 conversion, there is still an opportunity to recharacterize the Roth back into a traditional IRA by the extended tax return due date of October 15, 2018. But this deadline is fast approaching.

Note that you can convert back to a Roth, if that suits your needs, after some time has passed. The earliest date allowed for a reconversion is the later of the beginning of the tax year following the tax year of the conversion and the end of the 30-day period beginning on the day of the recharacterization.

Does a recharacterization or reconversion make sense for your situation? Consult your professional advisers to make an informed decision.

New Law Revives Six Key Tax Breaks

Extensions retroactive to 2017 tax year



The biggest news in tax circles is, of course, the Tax Cuts and Jobs Act (TCJA) enacted late last year. But the TCJA isn't the only important new tax legislation. With little fanfare, the Bipartisan Budget Act (BBA), a government spending measure, extended about 30 tax provisions that had expired at the end of 2016.

Generally, the extenders in the BBA are retroactive to 2017 but expire again after just one year. Although many provisions are industry-specific, here are six items that may have broad appeal.

1. Tuition and fees deduction: This above-the-line deduction may be claimed in lieu of a higher-education credit, such as the American Opportunity Tax Credit (AOTC). However, the deduction is limited to either $4,000 or $2,000 before being phased out, based on your modified adjusted gross income (MAGI) for the year. The phaseout is complete at $80,000 of MAGI for single filers and $160,000 of MAGI for joint filers.

Note: Depending on your situation, a higher-education credit may still be preferable.

However, the credits are also subject to income phaseouts. For instance, the AOTC, which has a maximum credit of $2,500 per student, is completely phased out at $90,000 of MAGI for single filers and $180,000 of MAGI for joint filers.

2. Mortgage debt forgiveness: Under this provision, forgiveness of a mortgage debt is excluded from tax, up to a maximum of $2 million. This tax break is only available for debt forgiveness on a mortgage for a principal residence.

3. Mortgage insurance premiums: If you pay mortgage insurance, you can deduct the cost of the premiums, subject to a phaseout beginning at $100,000 of adjusted gross income (AGI). The phaseout is complete at $110,000 of AGI. Unlike mortgage debt forgiveness, this tax break is available for a principal residence and one other home (e.g., a vacation home).

4. Residential energy credit: The latest version of the residential energy credit may be claimed for 10% of the cost of qualified energy-saving improvements installed in your home. However, the credit is capped at a lifetime limit of $500. (Separate limits of $200 apply to windows and skylights.)

5. Energy-efficient property: If you qualify, you can claim a tax credit for certain residential energy-efficient property, such as solar electric property or solar water-heating property. This credit, which is based on a percentage decreasing from 30% to 22%, is extended retroactive to 2017 and then through to 2021.

6. Empowerment zones: Businesses and individual residents within designated empowerment zones are eligible for various tax incentives. This includes a 20% wage credit, special Section 179 expensing, tax-exempt bond financing and deferral of capital gains tax on the sale and replacement of qualified assets.

If you did not elect to benefit from these tax breaks on the 2017 tax return you initially filed earlier this year, you must file an amended return to capture the retroactive tax benefits. Consult your professional tax adviser.

Child Tax Credit Grows Up

The Child Tax Credit (CTC) gets a boost from the Tax Cuts and Jobs Act (TCJA). Under the TCJA, the credit is doubled from $1,000 to $2,000, of which $1,400 is refundable, subject to a phaseout based on modified adjusted gross income (MAGI).

Also, the new law creates a $500 nonrefundable credit for non-children dependents, subject to the same MAGI phaseout.

The CTC changes take effect in 2018 and sunset after 2025. Contact your tax adviser concerning your personal situation.

Five Prime Issues for Business Startups

Items for new owners to resolve

Are you starting a new business venture or investing in potential opportunities in the marketplace? Before you make any commitments, be aware that there are numerous practical considerations from a business, tax and legal perspective. In other words, there is much more involved than just fronting the cash.

Although the "to-do list" is too long to enumerate and explain here, the following are five primary issues that may deserve your immediate attention.

1. Form of ownership: One of the first decisions is the form of business ownership. Typically, you must choose between operating the company as a C corporation, S corporation, partnership, limited liability company (LLC) or, if you are on your own, a sole proprietorship.

Notably, C corporations, S corporations and LLCs provide protection against liability from creditors. In addition, taxes may be a major factor, especially in light of the new tax law changes involving lower corporate tax rates and deductions for certain pass-through entities (see page 1). Obtain expert tax advice for your situation.

2. Place of incorporation: You may choose to incorporate your company in the state of your main location or in a state such as Delaware, which promotes favorable rules for businesses. Consider all the costs and tax ramifications of being incorporated in Delaware versus the main place of your business.

3. Structure of ownership: For most corporations, the simplest ownership structure requires you to issue fully vested shares of stock for a designated price. But this approach is not always preferred if you are seeking financing from outside sources. In that case, you might impose vesting restrictions. Discuss alternatives with your legal adviser.

4. Intellectual property: Does your company have a "secret sauce" or other recipe for business success that will set it apart from the competition? Protecting your brand is vital to the growth of the company. There are various legal means of protecting intellectual property, including use of patents, copyrights, trademarks and domain names. Furthermore, have employees sign agreements concerning trade secrets of your company.

5. Recordkeeping: As you might imagine, keeping good records is essential to avoiding legal battles and winning the ones you are forced to fight. Resist the temptation to do things informally as your business gets off the ground. The time spent documenting actions and business relationships, including contracts and other agreements establishing responsibilities and obligations, is time well spent.

Do not overlook these five important issues and related matters. If you do things right from the start, you may avoid problems later on.

Facts and Figures

Timely points of particular interest

➡**Estate-tax Exemption**—The IRS recently announced that the indexed federal estate-tax exemption amount for 2018 is $11.18 million, not $11.2 million as originally assumed by many. The update reflects a revised method of calculating inflation adjustments required by the Tax Cuts and Jobs Act (TCJA). This TCJA change will generally result in smaller inflation increases than would have occurred under the prior method.

➡**Tardy Again?**—Employees who are habitually late can slow down the productivity of everyone else. Generally, managers should address tardiness problems, but in a sensitive way. For instance, speak to the employee privately without making a scene. During your meeting, ask the employee to suggest ways to avoid further occurrences. If matters do not improve, disciplinary action may be required.

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