How the Tax Cuts and Jobs Act is changing tax strategies

The changes brought by the Tax Cuts and Jobs Act and the U.S. Supreme Court's decision in *South Dakota v. Wayfair Inc.* are prompting businesses to reassess their tax strategies.

New corporate and personal tax rates are making certain legal structures look more appealing, and after *Wayfair*, more businesses than ever will be required to collect sales tax and possibly pay additional state and local taxes.

To find out where businesses should look to change their tax planning and where they should leave well enough alone, Crain's Custom turned to accounting and advisory firm Marks Paneth LLP. We spoke with Mordecai Lerer, CPA, partner.

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Q *Crain's:* Given the changes brought about by the Tax Cuts and Jobs Act, what year-end tax planning strategies remain viable and effective for businesses?

A *Lerer:* Two provisions of the TCJA make the year-end purchasing of property and equipment even more beneficial than before. First, the immediate write-off has been increased to $1 million from $500,000, and the maximum threshold for total property placed in service has been increased to $2.5 million. Second, under bonus depreciation, 100 percent of your qualified property acquired can be expensed immediately, up from 50 percent.

Also, qualified property only needs to be new in the hands of the taxpayer, meaning businesses can expense their purchases of used property. A business that acquired real property this year can realize a major tax break by allocating a portion of the purchase price to tangible personal property. For example, suppose a taxpayer purchased a hotel for $100 million. If a cost-segregation study identified tangible personal property of $30 million, the taxpayer could deduct the full $30 million in the year acquired.

Under the new tax act, taxpayers with annual gross receipts below a certain threshold can elect to recognize their taxable income under the cash method, opt out of Section 263a and use the completed contract method of accounting. In many cases these changes should result in lower taxable income.

Q *Crain's:* Now that C corporations enjoy a tax rate that's been reduced from 35 percent to 21 percent, should non-C corporations consider changing the form of their business entity?

A *Lerer:* When taxpayers compare the new corporate rate to the new personal tax rate of 37 percent, switching to a C corporation seems pretty compelling. In many instances, this may be a mistake. First, unlike pass-throughs, C corporations have a second layer of tax at the individual level when dividends are paid to its shareholders. If the dividend is taxed at the highest rate of 23.8 percent, that may raise the effective federal rate above 37 percent.

Also, a 199a deduction can bring the highest personal rate down to 29.6 percent. Furthermore, the corporate rate is not graduated; the very first dollar is taxed at 21 percent. The rate on pass-through income is taxed at the graduated personal rates.

Q *Crain's:* For businesses that operate as pass-through entities, what are some year-end planning strategies to consider that will help maximize the Section 199a deduction?

A *Lerer:* Basically, 199a provides for a tax deduction of up to 20 percent of qualified business income from a domestic pass-through business. The mechanics are somewhat complex. The main items that will limit the deduction are the type of business that will generate the QBI, the wages paid and the business's unadjusted basis in qualified property. For taxpayers that are below certain thresholds these limitations will not apply.

As a result, it is important to maximize QBI by limiting the wages or guaranteed payments paid to the owners. In an S corp, the shareholder must be paid at least a reasonable salary; in a partnership, guaranteed payments can be eliminated and replaced with special allocations.

A sole proprietorship or partnership limited by a percentage of wages paid may find it useful to incorporate and elect to be taxed as an S corp. Then it can pay wages to its shareholders. Of course, wages paid effectively reduce QBI, so modeling is required. It has been suggested that the sweet spot for W-2 wages paid is 28.57 percent of overall business income.

Another strategy would be to use qualified pension plan deductions to reduce the thresholds below the limitation levels or to consider married filing separately.

Q *Crain's:* What do business owners need to understand about the effect of this year's Supreme Court decision in *South Dakota v. Wayfair Inc.* on their tax planning?

A *Lerer:* The court's decision in *Wayfair* overturned many years of precedent, which had held that a business must have a physical presence in a state to be required to charge, collect and remit its sales tax. Going forward, all that is required is that the business have "substantial nexus" with the state. The court did not define substantial nexus, but it did find that South Dakota's economic nexus thresholds of $100,000 or more in gross sales into the state or 200 or more separate transactions with customers in the state during the previous or current year "clearly" constituted "substantial" nexus. Following *Wayfair*, many states have enacted their own economic nexus laws.

It's important to note that this development doesn't just affect retailers, nor does it only apply to sales taxes. For instance, wholesalers and distributors who sell into other states may have a responsibility to at least register to collect sales taxes in those states where they exceed the economic nexus threshold. Companies conducting interstate businesses also must worry about income, franchise, and other state and local business-activity taxes. While federal law might still protect companies that sell tangible personal property from state income taxes, they may nevertheless have to file state income tax returns to affirmatively claim immunity. Many states and their political subdivisions impose minimum or non-income-based taxes, which are not afforded federal protection. ■