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New Tax Act: Save Income Taxes Through Business Restructuring

The Tax Cuts and Jobs Act permanently lowered the tax rate for C Corporations from graduated rates ranging from 15% to 35% to a flat rate of 21%. The Act also included a new 20% deduction for "pass-through" structures. Owners of certain pass-through businesses can now deduct 20% of the income received from the business. Assuming the remaining 80% of the taxpayer's income is taxed at 37%, the effective rate on pass-through income is 29.6%.

The new 21% rate applies to all C Corporations, but the new 20% pass-through deduction is limited. For taxpayers with total income of less than $315,000 (married couple)/$157,500 (single), the deduction is available with no limitations. For taxpayers over that income threshold, there are two limitations: (1) the deduction can't exceed a "wage cap;" and (2) only a proportionate amount of the deduction is available for taxpayers with income between $315,000-$415,000 (married)/$157,500-$207,500 (single). The deduction is additionally limited for "specified service businesses," defined generally as health, law, consulting, financial services, brokerage services, and investing/trading (although it specifically does not include architects and engineers in this definition) in that it is not available for income from specified service businesses for taxpayers with income over $415,000 (married)/$207,500 (single). The impact of these limitations is that the 20% deduction is designed to mainly help only non-service businesses (like companies that sell widgets or manage real estate) and those that have a good-sized payroll or own a capital-intensive company (such as a real estate company or a manufacturing company with a lot of fixed assets).

Planning to achieve maximum income tax savings must be analyzed case-by-case. Even if it appears at first that you don't benefit, be aware that there are planning tools that, if implemented, can create tax savings for you, regardless of your income level or type of business. In addition, be aware that acting by March 15th may allow you to convert to C Corp status retroactive to January 1, 2018.

Taxpayer's Total Income	Income from Specified Service Businesses	Income NOT from Specified Service Businesses
< $157,500 (single)/ $315,000 (married)	Full 20% deduction available	Full 20% deduction available
$157,500 - $207,500 (single) $315,000 - $415,000 (married)	Sliding scale to determine amount of deduction available, then part of deduction subject to wage cap*	Sliding scale to determine amount of deduction available, then part of deduction subject to wage cap*
> $207,500 (single)/ $415,000 (married)	No deduction available	Full 20% deduction available but subject to wage cap*

**Wage cap is the greater of: (i) 50% of W-2 wages, and (ii) 25% of W-2 wages plus 2.5% of unadjusted basis of business assets.*

A Tale of 4 Taxpayers

Compare the after-tax results for these four taxpayers.

Taxpayer Doc is a heart surgeon with pass-through income. With no deduction, tax rate is 37%. After 20 years, Doc liquidates the business and retires. The total of her income throughout the 20 years plus the liquidation is **$85.9M**

Taxpayer Donny is a real estate developer with pass-through income. With the deduction, the effective tax rate is 29.6%. After 20 years, Donny liquidates the business and retires. The total of his income throughout the 20 years plus the liquidation is **$99.7M**

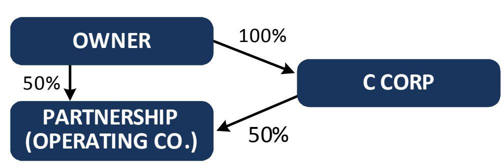
Taxpayer Randy has C Corp income (taxed at 21%). After 20 years, Randy retires and the company pays out the assets as a dividend taxed at 20%. The total of Randy's income throughout the 20 years plus the dividend is **$93.6M**

Taxpayer Bernie has C Corp income (taxed at 21%). After 20 years, Bernie dies. His family gets a step-up in basis for the company stock and dissolves the company. The total of Bernie's income throughout the 20 years plus the distribution after death is **$117.0M**

Assumptions: $5M annual income, 5% rate of return on reinvested assets, 0% dividend rate, 37% individual income tax rate and the 20% pass-through deduction do not sunset in 8 years as scheduled.

Half and Half Might Be Most Beneficial

For some situations, part C Corp and part pass-through might work best. Suppose the owner needs half of the business's profits to live on and will reinvest the rest back into the company. Park only the reinvested half in a C Corp and pass-through the rest. Each year, the operating company distributes half of the profits to the C Corp and passes-through the other half to the owner. The C Corp profits are reinvested.



With the Half and Half structure, when the owner liquidates after 20 years, the total that the owner received over the 20 years is **$213.2M**

If instead had been operated entirely as a C Corp (taxed at 21%), the total received would have been **$192.9M**

If instead had been operated entirely as a pass-through with the 20% pass-through deduction (taxed at effective rate of 29.6%), the total received would have been **$196.9M**

Assumptions: $5M annual income, 20% rate of return on reinvested assets, 37% individual income tax rate and 20% pass-through deduction do not sunset in 8 years as scheduled.