The Tax Cuts and Jobs Act

Implications for Small Businesses

BUSINESSES FOR RESPONSIBLE
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The views expressed in this commentary are solely those of the authors.

About Businesses for Responsible Tax Reform

Businesses for Responsible Tax Reform is a coalition of business leaders calling for tax reform that truly benefits America's small business owners. We are dedicated to ensuring tax reform is fiscally responsible, creates a level playing field for all businesses, grows the economy and works for our nation's 30 million small business owners. Learn more about us on our website and follow us on Twitter and Facebook.

Summary

The Tax Cuts and Jobs Act includes two key changes that will affect small businesses: (1) the introduction of the 20 percent deduction on qualified business income and (2) the move toward a territorial system of taxation through the global intangible low-taxed income (GILTI), in which the profits of a foreign subsidiary of a U.S. company that meets certain conditions will not be subject to U.S. taxes.[1] The international taxation of business income under the new tax law will likely push businesses to save money by moving offshore.

The majority of small businesses are pass-through entities, meaning business income generated is passed through to the owner(s)/shareholder(s) and taxed at the personal level. The GILTI provision is structured in favor of C corporations and puts small businesses at a competitive disadvantage. The new tax law introduces a number of changes and repeals to business deductions and credits, such as the 20 percent deduction on qualified business income (QBI). However, for many small businesses, the expense of navigating through the new tax code via the expertise of tax professionals is going to be burdensome and costly.

Key Findings

(1) The 20 percent deduction on QBI is unlikely to generate enough tax savings for small businesses to hire new employees and/or make significant operational improvements or capital investments. In addition, the QBI deduction applies to service oriented small businesses differently than other small businesses. Small businesses that are primarily providers of a "specialized service" are subject to greater limitations on the QBI deduction.

(2) The new tax law may not translate into significant savings for small businesses, many of which will require the outside expertise and incur the additional cost of accountants and tax lawyers in order to understand and satisfy their tax obligations.

(3) The territorial system of taxation adds complexity to the tax code for small businesses operating internationally. On average, the international taxation of business income under the Tax Cuts and Jobs Act gives C corporations a relatively larger tax break and, as a result, puts small businesses at a competitive disadvantage.

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[1] Marr, Chuck, Brendan Duke, and Chye-Ching Huang. "New Tax Law Is Fundamentally Flawed and Will Require Basic Restructuring." Center on Budget and Policy Priorities, April 9, 2018.

Introduction

The Tax Cuts and Jobs Act, signed into law on December 22, 2017, represents the largest tax overhaul since 1986. In addition to changes in tax rates and brackets, the new tax law modifies the taxation of international business income and introduces a 20 percent deduction on QBI. These changes are especially important to small business owners as they begin to grapple with the implications of the new tax legislation and what it means for the future of their businesses.

This issue brief takes a deeper look at how the Tax Cuts and Jobs Act will affect small businesses. Our analysis shows how the new law adds complexity to the tax code, treats different types of pass-through businesses differently, and indirectly imposes an additional cost to small businesses vis-a-vis the cost of hiring a tax professional; tilting any potential tax savings toward businesses with greater financial resources and in-house accountants and tax lawyers. Those business owners who cannot afford tax professionals will likely find it harder to minimize their tax obligations than those who can afford to search out loopholes and reorganize into advantageous business structures. Indeed, the Joint Committee on Taxation released new data showing that 44 percent of the new 20 percent pass-through deduction—$17.4 billion—benefits roughly 200,000 individuals making $1 million or more.[2] By 2024, millionaires will be receiving over half of that tax relief. There are 30 million small businesses in the United States, the vast majority of which are pass-through entities.[3]

The following section reviews the main legal forms of organization (LFO), the treatment of business income for different legal entities, and a breakdown of U.S. small businesses by LFO. The two sections following the review of LFO address the 20 percent deduction on QBI and changes made to the taxation of international business income.

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[2] Allen, John. "Special Trump Tax Provision Gives $17 Billion Break to Millionaires, Government Report Finds." *NBC News*, April 23, 2018.

[3] Ibid.

Legal Form of Organization

The 2017 Tax Cuts and Jobs Act introduces a number of changes to the federal taxation of businesses and individuals based on their LFO. Sole-proprietorships, partnerships, and corporations are the three main LFOs that businesses assume. As shown in Table 1, the majority of businesses are organized as sole proprietorships (72 percent). Corporations and partnerships comprise a much smaller share of small businesses, representing 17.6 percent and 10.4 percent respectively.

Table 1. Business Tax Returns by Legal Form of Organization, 2014

Legal Form of Organization	No. of Business Tax Returns (1,000)	Percent of Business Tax Returns
C Corporations	1,391	5.4
S Corporations	3,913	15.0
Partnerships	2,761	10.6
Sole Proprietors	10,692	41.1

Source: Prisinzano et al. (2016) and author's calculations.[4] Table does not include all LFOs.

The simplest and most common LFO is a sole proprietorship. Sole proprietorships represent 41.5 percent of small businesses (Table 2) and are owned and managed by one individual (maximum of two owners for married couples). Sole proprietors are pass-through businesses, meaning they report all of their business profits and losses on their personal tax returns.[5]

Partnerships make up 10.4 percent of small businesses as shown in Table 2. Partnerships have a minimum of one general partner who assumes all of the business' legal liability in addition to one or more limited partners who are not involved in the firm's regular operation. In partnerships, all business profits and losses are treated as pass-through income and flow straight

[4] Prisinzano, Richard, Jason DeBacker, John Kitchen, Matthew Knittel, Susan Nelson, and James Pearce. "Methodology for Identifying Small Businesses and Their Owners." Office of Tax Analysis, Technical Paper 4 (Update), U.S. Department of the Treasury, Table 2014-1, 2016.

[5] Cole, Rebel A. "How Do Firms Choose Legal Form of Organization?" SBA Office of Advocacy, 2011.

to the partners per the partnership agreement. While partnerships are slightly more complex LFO relative to sole proprietorships, they have the advantage of being able to raise capital equity.[6]

Table 2. Small Business Tax Filings by Legal Form of Organization, 2014

Legal Form of Organization	No. of Small Business Returns (1,000)[7]	Percent of Small Business Returns
Sole Proprietors	10,688	41.5
Partnerships	2,669	10.4
S Corporations	3,806	14.8
C Corporations	1,320	5.1

Source: Prisinzano et al. (2016) and author's calculations.[8] Table does not include all LFOs.

The most complex LFO is a corporation. A corporation is treated legally as an individual person and is fully separate from the owner(s). C corporations and S corporations are the two main types of U.S. corporations. C corporations are required to pay federal and state corporate income tax, and their shareholders must also pay personal income tax on the dividends distributed to them.[9] Unlike C corporations, S corporations are given a special tax status which lets them bypass the federal corporate income tax. Income generated by an S corporation is pass-through income and taxed once as personal income to the shareholders. Small businesses that are organized as corporations are often eligible for S corporation status and tend to file accordingly. As shown in Table 2, 5.1 percent of small businesses are C corporations while 14.8 percent are S corporations.

It is important to note that a limited liability company (LLC) can structure as a sole proprietor, partnership, or corporation. As an LLC, a business has limited liability (similar to corporations)

[6] Cole, Rebel A. "How Do Firms Choose Legal Form of Organization?" SBA Office of Advocacy, 2011.

[7] Small businesses are identified from Form 1040 Schedules C, E, and F, Forms 1065, 1120 and 1120S filings. Tests based on income and deductions group filers into businesses and non-businesses of which small businesses are identified using a threshold of $10 million of income or deductions (Prisinzano et al. 2016).

[8] Prisinzano, Richard, Jason DeBacker, John Kitchen, Matthew Knittel, Susan Nelson, and James Pearce. "Methodology for Identifying Small Businesses and Their Owners." Office of Tax Analysis, Technical Paper 4 (Update), U.S. Department of the Treasury, Table 2014-1, 2016.

[9] Cole, Rebel A. "How Do Firms Choose Legal Form of Organization?" SBA Office of Advocacy, 2011.

and qualifies for the same tax benefits awarded to partnerships.[10] For federal tax purposes, a domestic LLC with at least two members is treated as a partnership or can opt to be treated as a corporation. LLCs with only one member are treated as "an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it...elects to be treated as a corporation."[11]

Evaluating the tax benefits of electing one LFO over another plays an important role in determining how a business structures itself and operates. The Tax Cuts and Jobs Act created and removed a number of different deductions, exemptions, credits, etc. This will likely affect the organization of small business entities and their tax liabilities moving forward. The following sections provide a detailed review of some of these changes and their expected consequences.

Qualified Business Income Deduction for Pass-Through Businesses

Section 199 of the Tax Cuts and Jobs Act includes a 20 percent deduction on domestic qualified business income (QBI) for pass-through entities. In effect, Section 199 provides a huge incentive for businesses subject to additional eligibility requirements and limitations on the QBI deduction to restructure, or split, into a business structure that enables them to take full advantage of the deduction. However, not only is there uncertainty as to how much small businesses will benefit from this deduction, but the provision itself is not a permanent piece of the new tax law (set to expire in December 2025).

The 20 percent deduction on QBI applies to a qualified trade or business differently than a specified service trade or business (Table 3) if taxable income exceeds $157,500 for single filers or $315,000 for joint filers.[12] A specified trade or business is defined as "(1) a trade or business, involving the performance of services in the fields of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services, or brokerages services and (2) any trade or business where the principle asset is the reputation or skill of one or more of its employees or owners."[13]

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[10] Legal Information Institute. "Limited Liability Company (LLC)," Cornell Law School, accessed April 3, 2018.

[11] Internal Revenue Service. "Limited Liability Company (LLC)," Small Business and Self-Employed, Internal Revenue Service, last modified December 13, 2017.

[12] Cordasco & Company, P.C. "Tax Cuts & Jobs Act 2017 Law, Explanation & Analysis." December 2017.

[13] Davis Polk & Wardell LLP. "Impact on Businesses Owned by U.S. Individuals." Client Memorandum, December 20, 2017.

Table 3. Deduction on QBI for a Single Filer Qualified Trade or Business

	Taxable Income Thresholds		
	≤ $157,500	*> $157,500 ≤ $207,500*	*> $207,500*
Taxable income	$60,000	$160,000	$207,500
Threshold	$157,500	$157,500	$157,500
Taxable income > threshold	n/a	$2,500	$100,000
Phase-in range	n/a	2.5%	100%
QBI	$60,000	$60,000	$60,000
20% deduction on QBI	$12,000	$12,000	$12,000
50% W-2 wages	n/a	$10,000	$10,000
25% wages plus 2.5% property	n/a	$10,500	$10,500
20% deduction less wages/property limitation	n/a	$1,500	$1,500
Phase in of limitation	n/a	$37.50	$1,500
Tentative deduction	**$12,000**	**$11,962.50**	**$10,500**

Source: Britton (2018) and author's calculations.[14]

Take the example of a pediatrician, Jane, who owns and operates her own practice. She has a taxable income of $100,000, including $60,000 in QBI and $20,000 in W-2 wages. Under the new law, her allowable deduction is $12,000 (Table 4), but due to the added complexity of the tax code, she now has to pay a CPA to help file her taxes, effectively reducing her tax savings.

For joint filers with a taxable income between $315,000 and $415,000 (between $157,500 and $207,500 for single filers), the allowable deduction on QBI is gradually reduced. To illustrate, let's assume that Jane is now married and filing a joint return with a taxable income of $340,000, including $60,000 in QBI and $20,000 in W-2 wages.

[14] Britton, Liz. "§199A Qualified Business Income Deduction." DHG Tax, February 22, 2018.

As the owner of a specified service trade or business with a taxable income above $315,000, Jane can only claim a deduction on a percentage of her QBI (Table 4). Her deduction will be limited by the larger of either (1) 50 percent of W-2 wages or (2) 25 percent of W-2 wages plus 2.5 percent of qualified business property. In addition, only 75 percent of Jane's taxable income can be included in calculating her final allowable deduction because her taxable income is 25 percent through the phase out range ((340,000 - 315,000)÷(415,000 - 315,000)).

After the phase-out range adjustments are applied, 20 percent of Jane's QBI is equal to $9,000. To make things simple, assume that 50 percent of W-2 wages, or $7,500, is larger than 25 percent of W-2 wages plus 2.5 percent of qualified business property. Jane's final allowable deduction is then calculated subtracting 25 percent of the difference between the initial deduction and 50 percent of W-2 wages from the original deduction amount ($9,000). Jane's final allowable deduction would be $8,625.

Table 4. Deduction on Qualified Business Income for Joint Filers

	Service Trade or Business			Qualified Trade or Business		
	≤ $315,000	*> $315,00 ≤ $415,000*	*> $415,000*	*≤ $315,000*	*> $315,00 ≤ $415,000*	*> $415,000*
Joint Taxable Income	$100,000	$340,000	$420,000	$100,000	$340,000	$420,000
QBI (before limit)	$60,000	$60,000	$60,000	$60,000	$60,000	$60,000
Subject QBI Limit?	No	Partial	Yes	No	No	No
QBI (after limit)	$60,000	$45,000	$0	$60,000	$60,000	$60,000
W-2 Wages	$20,000	$20,000	$20,000	$20,000	$20,000	$20,000
Wage/Property Limit?	No	Partial	No	No	Partial	Yes
Allowable Deduction	**$12,000**	**$8,625**	**$0**	**$12,000**	**$11,500**	**$10,000**

Source: Krupkin and Gleckman (2018) and authors' calculations.[15]

Despite more than a threefold increase in taxable income as a joint filer, Jane's allowable deduction on QBI only decreased by a little over $3,000. Moreover, the tax savings generated from the deduction on QBI does not take into account the costs of hiring the requisite tax

[15] Krupkin, Aaron and Howard Gleckman. "Navigating the TCJA's Pass-Through Deduction." *TaxVox*, Tax Policy Center, February 1, 2018.

professionals and/or CPAs need for businesses to file correctly and meet their tax obligations while maximizing their eligibility for business deductions and credits.

Ultimately, the deduction on QBI does not represent an amount large enough for a business to hire additional full-time employees and will likely not be enough for make small businesses to make significant capital investments. However, some tax experts expect the 20 percent deduction on QBI will be an important factor in determining business organization.[16] For example, some economists and tax professionals expect an increase in the number of businesses reorganizing into business structures that include an LLC branch in order to maximize their eligibility for business deductions under the new law.[17] Because LLCs are eligible for the QBI deduction, businesses that do not qualify for the deduction in their current form will find the LLC structure extremely cost effective.[18] For example, consider an individual who does not qualify for the 20 percent deduction on QBI because their taxable income exceeds the allowable limit, and/or their business is a specified service trade or business.

However, several economists predict many businesses will use different strategies such as "cracking" and "packing" to split and restructure their businesses in order to qualify and maximize their deduction eligibility. [19] "Cracking" a business entails breaking apart revenue from a service partnership in order to reclassify business income into a category that qualifies for the deduction.[20] The second strategy is to "pack" businesses that qualify for the deduction into a

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[16] Simon, Ruth and Richard Rubin. "Crack and Pack: How Companies are Mastering the New Tax Code; Businesses Seeking to Lower their 2018 Bills are Splitting in Two, Changing their Legal Status and Reclassifying Workers." *Wall Street Journal*, April 3, 2018.

[17] David Kamin, David Gamage, Ari Glogower, Rebecca Kysar, Darien Shanske, Reuven Avi-Yonah, Lily Batchelder, J. Clifton Fleming, Daniel Hemel, Mitchell Kane, David Miller, Daniel Shaviro, Manoj Viswanathan. "The Games They Will Play: An Update on the Conference Committee Tax Bill," December 18, 2017.

[18] Mercado, Darla. "The 20 Percent Tax Break for Small Businesses Is No Free-For-All. How to Navigate." *CNN*, January 9, 2018.

Ballard Spahr Tax Group. "Analysis of Key Provisions of the Tax Cuts and Jobs Act," *Tax Truths* 3, no. 1, 2018..

[19] Simon, Ruth and Richard Rubin. "Crack and Pack: How Companies Are Mastering the New Tax Code; Businesses Seeking to Lower Their 2018 Bills Are Splitting in Two, Changing Their Legal Status and Reclassifying Workers." *Wall Street Journal*, April 3, 2018.

[20] David Kamin, David Gamage, Ari Glogower, Rebecca Kysar, Darien Shanske, Reuven Avi-Yonah, Lily Batchelder, J. Clifton Fleming, Daniel Hemel, Mitchell Kane, David Miller, Daniel Shaviro, Manoj Viswanathan. "The Games They Will Play: An Update on the Conference Committee Tax Bill," December 18, 2017.

service partnership in order to transform the business into an entity that is not considered a specialized service trade or business.[21] Douglas Holtz-Eakin, an economist who heads the American Action Forum recently told the Senate Finance Committee on April 24, 2018 the pass-through provision drew "haphazard lines in the sand" that "are the exact kind of lines that tax lawyers and experts will attempt to try to game."[22]

While these strategies may increase a business' tax savings, this type of restructuring is usually done with the assistance of a tax professional at an additional cost to the firm. As a result, larger businesses with in-house tax professionals will be in a better position to maximize their tax savings, giving big business an added competitive advantage.[23] In short, the 20 percent deduction on QBI may not translate into significant tax relief for many small businesses.

International Taxation of Business Income

The Tax Cuts and Jobs Act's introduction of the global intangible low-taxed income (GILTI) moves the United States from a worldwide system of taxation to a territorial system. GILTI treats C corporations and non-C corporations differently. U.S. shareholders of controlled foreign corporation C corporations can claim a 50 percent deduction on business income that effectively reduce the corporate income tax rate to 10.5 percent. In addition, C corporations that have paid foreign taxes are eligible for a foreign tax credit of up to 80 percent, which, in some cases, completely eliminates their U.S. corporate income tax liability.[24]

While these deductions and credits represent huge savings for controlled foreign corporation (CFC) C corporations, non-C corporations are left with relatively few tax breaks to offset their tax liability. This is partly due to the fact that deductions under GILTI are designed around corporate tax rate targets and used, without modification, to calculate the tax liability for non-C corporation businesses under Section 965.[25] Non-C corporation CFC U.S. shareholders are not entitled to reduce their GILTI by 50 percent, are generally ineligible for foreign tax credits, and are subject to a maximum federal personal income tax rate of 37 percent, versus the corporate

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[21] Ibid.

[22] Becker, Amanda. "U.S. Republican Tax Law's Pass-Through Deduction Open to Gaming Experts." *Reuters*, April 24, 2018.

[23] Nitti, Tony. "The Republican Tax Plan's Break for Small Business Yields Huge Benefits...For Big Business." *Forbes*, April 24, 2018.

[24] McGill, Sandra, Gary Karch, Kevin Feeley, Susan O'Banion, Justin Crouse. "GILTI Rules Particularly Onerous for Non-C Corporation CFC Shareholders." McDermott Will & Emery, January 30, 2018.

[25] Davis Polk & Wardell LLP. "The New 'Not Quite Territorial' International Tax Regime." Client Memorandum, December 20, 2017.

income tax rate of 21 percent.[26] As a result, CFC U.S. shareholders of non-C corporations are subject to significantly higher effective tax rates than their C corporation counterparts.[27]

To illustrate the difference in tax liability between U.S. shareholders of CFC non-C corporations and C corporations, assume a CFC with an income of $1,000 with a foreign income tax of 10 percent ($100). The CFC has two United States shareholders who hold equal shares in the firm, a C corporation, *YCorp*, and a U.S. individual, *Individual Z*. *YCorp* is able to claim a 50 percent deduction on their business income ($500) from which their federal corporate income tax liability of $52.50 is calculated using the federal corporate income tax rate of 21 percent of their GILTI ($250). *YCorp* is also entitled to a $40 foreign tax credit, or 80 percent of the corporation's foreign taxes, making their federal tax liability, after the 50 percent deduction and foreign tax credit, $12.50.

Unlike *YCorp*, *Individual Z* is not entitled to a 50 percent deduction on business income and, absent making a Section 962 election, cannot claim the foreign tax credit. *Individual Z* is required to claim their share of the CFC's income ($450) as part of their gross income which is subject to the federal personal income tax rate of 37 percent. As a result, *Individual Z*'s final income tax liability would be $166.50.

If *Individual Z* wants to decrease their tax liability, one option is electing Section 962 treatment. After making an election under Section 962, *Individual Z* is subject to the 21 percent corporate income tax rate (500×0.2) and can claim the foreign tax credit (50×0.8), making their final tax liability $65.

Alternatively, *Individual Z* could elect to be treated as a pass-through entity. In pass-through form, *Individual Z* would be subject to the 37 percent federal personal income tax rate but would be able to claim a foreign tax credit equal to 100 percent of foreign taxes paid. Therefore, their final tax liability as a pass-through entity would be $116.50.

Considering the substantial differential in the tax liability of C corporations and non-C corporations, some businesses will find it cost effective to offshore their accounts all together in order to minimize the potentially massive tax obligations many non-C corporations will soon be facing.[28] Particularly, for businesses with smaller returns that are subject to taxes on a large share of their CFC income, offshoring may be the most viable option. Varma and Kelly (2018) argue, "this may be the case not only where the value of a CFC's business is primarily intangibles (as no return is given for intangible assets), but also where a CFC has limited tangible assets (as may

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[26] Davis Polk & Wardell LLP. "Impact on Businesses Owned by U.S. Individuals." Client Memorandum, December 20, 2017.

[27] McGill, Sandra, Gary Karch, Kevin Feeley, Susan O'Banion, Justin Crouse. "GILTI Rules Particularly Onerous for Non-C Corporation CFC Shareholders." McDermott Will & Emery, January 30, 2018.

[28] Zimmerman, Anne. "Mom, Pop -- You're the Losers in this Tax Plan." *CNN Wire Service,* Dec 14, 2017.

be the case in a primarily services business), or where a CFC has tangible assets that are largely depreciated."[29]

In cases where GILTI can be included as part of the United States shareholder's income, the foreign tax credit can help offset some of the GILTI tax. However, the foreign tax credit is limited to 80 percent of the CFC's foreign taxes. Consequently, in order to eliminate the residual tax, the minimum foreign tax rate would have to be 13.125 percent.[30]

There is a lot of uncertainty as to whether or not the territorial system will benefit businesses, especially small businesses. Larger C corporations are more likely to benefit than small businesses under the new tax law's international taxation of business income. Small businesses are less likely to have the dedicated legal and accounting expertise required to navigate a piece of legislation as complicated and unprecedented as the new tax bill. As a result, many small businesses will be poorly equipped to take full advantage of the deductions, credits, exemptions, etc. while minimizing their tax liability.

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[29] Varma, Amanda and Brigid Kelly. "The New US international Tax Rules: What You Need to Know About GILTI, FDII, BEAT Etc." *Multinational Tax and Transfer Pricing News*, January 22, 2018.

[30] Ibid.

Conclusion

The Tax Cuts and Jobs Act introduces a new tax structure that favors big businesses and, ultimately, puts small businesses at a competitive disadvantage. The new tax law introduces additional complexity to the tax code and will likely force many small business owners to consult the expertise of tax professionals. Indeed, a recent survey by the National Small Business Association found that only 10 percent of small businesses say filing taxes will be easier under the law.[31] Ultimately, any savings for small businesses generated under the new tax law is likely to be spent on the expertise of accountants and lawyers needed to navigate the tax code.

Some small businesses may respond to the new tax bill by reorganizing into different legal forms, splitting their business to include a pass-through entity, and/or move their business accounts offshore. The optimal decision for businesses will depend on the cost incurred by them because of the changes introduced by the Tax Cuts and Jobs Act, the feasibility of employing different coping strategies, and the payoff of each. Moving forward, small businesses should continue to engage lawmakers on legislative issues regarding the new tax law and the steps needed to address and resolve provisions in the bill that impose excessive burdens on small businesses.

Disclaimer: This paper represents the opinions of the authors. It is not meant to represent the position or opinions of any other governmental or nongovernmental institution or organization.

[31] National Small Business Association. "NSBA 2018 Small Business Taxation Survey." NSBA, 2018.