Taxing business income: The impact of the TCAJCA of 2017

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ABSTRACT

The Tax Cuts and Job Creation Act of 2017 made significant changes in the taxation of business income. The primary change was a reduction in the maximum corporate tax rate from 35% to a flat rate of 21% on all income. For large corporations this significant reduction in tax rates makes it easier to compete in global markets. One concern raised with the reduction in the corporate tax rates was that smaller business operating as a proprietorship might choose to incorporate as the maximum individual tax rate was only reduced from 39.6% to 37%. Reducing the tax benefits of proprietorships would make the limited liability feature of corporations more beneficial for some businesses who could make the change. To address this issue the new law created the qualified business income deductions for businesses other than corporations. This deduction allows many businesses to claim a deduction of 20% of their business income effectively reducing the maximum rate from 37% to 29.6%. This paper examines the taxation of business income from $100,000 to $500,000. The results indicate that the new law maintains the tax benefit of proprietorships when comparing income taxes paid as well as all taxes paid on all income. However, the benefit decreases as income levels increase which is expected as more of the income is taxed at the higher individual rates. For income levels above $500,000 the benefit would be even smaller and could be eliminated completely with significant increases in income.

Keywords: tax cuts business income job creation

INTRODUCTION

When operating a business one of the most important decisions made by owners is the selection of the type of business organization. The most common forms are a proprietorship, a corporation, a partnership, a S corporation, or a limited liability company. The selection of the type of business organization primarily impacts how the income of the business will be taxed as well as the liability faced by owners for business debts. The income of a corporation is subject to double taxation where the corporation pays taxes on the income earned and then the owners pay taxes on the amount distributed from the corporation to the owners. All other business organizations face single taxation where the tax on the income is paid as part of the owners' individual tax return and no income taxes are paid when money is distributed from the business to the owner. Owners of proprietorships and partnerships face unlimited liability where they can lose both business and personal assets to settle business debts. Owners of corporations, a limited liability company, or a S corporation have limited liability where they can lose business assets but their personal assets can not be taken to settle business debts.

The 2017 Tax Cuts and Job Creation Act was passed to make U.S. corporations more competitive in the global marketplace. One major component of the new law reduced the maximum corporate income tax rate from 35% to 21%, close to the rate of most other nations. While individual rates were also decreased the maximum rate only decreased from 39.6% to 37%. This decrease in corporate income tax rates potentially limits the tax benefits of the other forms of business organizations which could lead to more owners choosing to incorporate their businesses. To reduce this impact the new law also added Section 199A the qualified business income deduction. The qualified business income deduction allows businesses other than corporations to claim a deduction of 20% of business income, reducing the maximum tax rate on this income from 37% to 29.6%. The purpose of this paper is to examine the impact of the new tax law on the taxation of business income across different income levels for the different types of business organizations.

THE QUALIFIED BUSINESS INCOME DEDUCTION

The Tax Cuts and Job Creation Act of 2017 added Section 199A the Qualified Business Income Deduction which was allowed for individuals operating a qualified trade or business in the United States. The deduction is available for shareholders of a S corporation, members of a limited liability company, partners in a partnership, and owners of a proprietorship. The deduction was enacted to provide tax relief for businesses other than corporations that do not benefit from the significant reduction in corporate tax rates (Witteman, 2019). The deduction is 20% of the income from the trade or business subject to limitations based on the type of business, the total taxable income of the owner, and the W2 wages paid to business employees and the original basis of depreciable assets owned by the business. The deduction is initially measured as the lower of 20% of the qualified business income or 20% of the individual's taxable income less their net capital gain and qualified dividends. The qualified business income is reduced by half the self-employment tax, the cost of the owners' health insurance, and any pension contributions to a plan established in the business which are allowed as deductions for adjusted gross income instead of being deducted on Schedule C in determining business income (Husbands & Berrelli, 2019).

Section 199A limits the deduction for specified service trades or businesses. These are businesses where most of the income for the business are earned based on skills of the owners. The deduction is limited for the fields of medicine, law, accounting, actuarial science, performing arts, consulting, athletics, and brokerage services. The income for these firms is essentially considered as wages for the owners so the deduction is limited. The law explicitly states that businesses in the fields of engineering and architecture are not included as specified service trades or businesses. For the others, the 20% QBI deduction is only allowed if the owners taxable income is $160,700 or less if the filing status is single or head of household or $321,400 if the owners filing status is married filing joint. The exception is phased out as the taxable income increases from $160,700 to $210,700 ($321,400 to $421,400) and is completely disallowed once the income is above the upper income amounts. For all businesses not classified as a specified service trade or business the deduction is 20% of business income if the income is below the thresholds set for the specified service trades or businesses. Once the income exceeds these thresholds the 20% deductions is still allowed but is limited to 50% of the W2 wages paid to business employees or 2.5% of the initial basis (cost) of depreciable assets owned by the business (Witteman, 2019).

TAXATION OF BUSINESS ORGANIZATIONS

Since all organizations except corporations face single taxation this paper will focus on the taxation of proprietorships and corporations. If a business is a proprietorship the business itself does not file a tax return. Business activities are reported on Schedule C of the individual income tax return and the business income is taxed at the individual tax rates which range from 10% to 37% using a progressive tax system. The amount of income taxed at each rate is based on the filing status of the individual. The owner must also pay the self-employment taxes on the business income to earn credit towards Social Security and Medicare. The self-employment taxes are based on 92.35% of the business income and are 7.65% on amounts up to $132,900 and 1.45% on amounts above $132,900 for 2019. They must also pay the additional Medicare tax of .9% on the business income above $200,000 if filing as single and on business income above $250,000 if filing as married filing joint.

If the business is organized as a corporation the business must file a corporate income tax return. The business income will be taxed at the corporate tax rate which is 21% on all income. Double taxation applies when the corporate earnings after taxes are distributed to the owners. If the earnings are distributed as a dividend the income will be taxed as qualified dividends on the owner's tax return and will be taxed at the capital gains tax rate. The capital gains rates are 0%, 15%, or 20% depending on the owner's taxable income. The dividend income could also be subject to the 3.8% additional Medicare tax if the owner's adjusted gross income is greater than $200,00 if filing under the single status and $250,000 if married filing joint. If the distributions are paid as wages the wages will reduce the corporation's taxable income reducing the corporation's income tax liability. The corporation will have to pay the payroll taxes on the wages matching the FICA taxes as well as state and federal unemployment taxes. The owner will have to pay individual income taxes as well as FICA taxes on the wages received.

CASE ANALYSIS

To analyze the taxes paid on business income the following assumptions will be made. The business will either be a proprietorship or a corporation with one owner. It is also assumed that the business income is the only income earned by the owner. If the business is a proprietorship the only deductions will be for half the self-employment tax (SEP) , the standard deduction, and the qualified business income deduction. For the qualified business income deduction it is assumed that the business is not a specified service trade or business and pays enough in wages that the income limits do not limit the deduction. If the business is a corporation the only deductions will be if the distributions to the owner are made as wages and the corporation can deduct the wages and related payroll taxes. The analysis will be conducted for incomes of $100,000, $300,000, and $500,000 before accounting for distributions to the owners. For the corporate form it will be assumed that all the income is distributed as dividends, all distributed as wages, or half wages and half dividends. The data will be analyzed for taxpayers filing as single as well as married filing joint.

The initial analysis will focus on the taxation of a proprietorship. Table 1 illustrates the tax calculations for the different income levels and the filing status of the owner (See Appendix 1). The lower taxes for taxpayers filing married filing joint results from the higher standard deduction and using the married filing joint tax table where higher levels of income are taxed at lower tax rates.

The second analysis presents the calculations for the taxes paid when the organization is a corporation and all income after paying corporate income taxes are distributed to the owner as a dividend. The owner will have to pay individual income taxes on the dividend income taxed at the capital gains rates and may have to pay the additional 3.8% Medicare tax. Table 2 presents the calculations across the three income levels for each filing status (See Appendix 1).

The individual taxes owed were calculated using the capital gains worksheet. The total taxes paid include the corporate income tax, the individual income tax, and the additional Medicare tax.

The third analysis presents the calculations of the taxes paid when the business is organized as a corporation and all the income is used to pay wages to the owner as well as the related payroll taxes on the wages. For the $100,000 income level the wages are assumed to be $92,000 with $8,000 used to pay payroll taxes. For the $300,000 income level the wages are $287,000 and the payroll taxes are $13,000. For the $500,000 income level the wages are $484,000 and the payroll taxes are $16,000. In this analysis the corporation will have no income so there are no corporate income taxes. The taxes paid by the owner will be the corporate payroll taxes, the individual income taxes, and the individual FICA taxes. Table 3 presents the tax calculations for this analysis (See Appendix 1).

As with a proprietorship, the taxes are lower for a taxpayer filing jointly because of the higher standard deduction as well as the use of the married filing joint tax table where higher levels of income are taxed at lower rates.

The fourth analysis presents the tax calculations for a business organized as a corporation with half the income used to pay wages and the related payroll taxes and the rest used to pay corporate income taxes and then distributed as dividends. For the $100,000 income level the wages are $46,000 with payroll taxes of $4,000. The wages are $139,600 with $10,400 in payroll taxes for the $300,000 income level. With $500,000 in income the wages are $238,000 with $12,000 in payroll taxes. In this analysis the owner will pay corporate income taxes, corporate payroll taxes, individual income and FICA taxes and potentially the additional Medicare taxes. Table 4 presents the tax calculations for this analysis (See Appendix 1).

The individual income taxes owed were calculated using the capital gains tax worksheet as the dividend income is taxed at the capital gains rates and the wages are taxed using the ordinary tax rates.

Comparing Taxes Paid Across Forms of Business Organizations

The initial analysis will focus on the income taxes paid on business income comparing proprietorships to corporations under the different assumptions for distributions to owners. Table 5 presents the results for each filing status across the different income levels, with the data presented as the percentage of business income used to pay income taxes (See Appendix 1).

In examining the income taxes paid the corporate form with just dividend distributions results in significantly higher taxes paid than the other options. There is little variability in the tax liability across income levels as the corporate income is taxed at a flat rate as well as most of the dividend income. The proprietorship form provides the lowest income tax liability with the corporate form paying wages being the next best option for taxpayers. The difference in these two categories primarily results from the business income being eligible for the qualified business income deduction while wages are not. As the income increases the difference increases as more income is taxed at higher individual tax rates without the deduction. At the $500,000 income level single taxpayers would do better with half in wages and half in dividends as opposed to all in wages.

The above analysis just focuses on the income taxes paid by the business owner. It is also important to examine additional taxes that must be paid on business income. For a proprietorship the owner will also have to pay the self-employment taxes which will earn credit towards social security benefits. If the business is a corporation and all income is distributed as a dividend the owner could potentially have to pay the additional Medicare tax. One problem in this case is that the owner is not earning any credit towards social security benefits. If the business is a corporation with all income paid as wages the owner will also pay corporate payroll taxes and individual FICA taxes. If half of corporate income is paid as waged and the rest is used to cover corporate income taxes, the owner will be responsible for corporate payroll taxes and individual FICA taxes. In this case the owner could also potentially be responsible for the additional Medicare tax. Table 6 presents the results for total taxes paid for each filing status across the different income levels, with the data presented as s the taxes paid as a percentage of income (See Appendix 1).

As with income taxes proprietorships pay lower total taxes across all income levels for each filing status. A corporation paying all wages is the worst option at the $100,000 income level but the next best option for the higher income levels for taxpayers filing joint returns. For taxpayers using the single filing status is the next best option across all income levels, tied with half wages and half dividends at the $100,000 income levels. However, the differences are small across the corporate options and paying all dividends does not earn any credit towards social security benefits. In many cases, especially for owners filing as single, the increase in taxes as income increases is higher for proprietorships than corporations as more income is taxed at the higher individual tax rates. This trend will continue as business income rises above the $500,000 level and would eventually reach a point where proprietorships would not provide the lowest tax liability. However, the larger the business becomes the importance of limited liability usually increases.

Limitations and Conclusion

This paper has examined the taxation of business income for different forms of business organizations for income ranging from $100,000 to $500,000 accounting for the changes enacted in the Tax Cuts and Job Creation Act of 2017. The primary changes were reducing the maximum corporate income tax rate from 35% to 21% and adding the qualified business income deduction of 20% of business income for all businesses not operating as a corporation. These changes reduce the benefits provided by single taxation of all businesses except corporations. Analysts were concerned that business could choose to incorporate as the tax benefits of proprietorships would not be worth the risk of unlimited liability. The results indicate that the proprietorship form of business still has tax advantages as compared to corporations. However, the tax advantages decrease as income increases and could be eliminated if income significantly exceeds the $500,000 level.

The results of the analysis are limited by the assumptions that were made in calculating the taxes owed. If taxpayers have significant income from other sources the advantage of proprietorships will decrease as more income will be taxed at higher individual income tax rates. Also, if the business is a specified service trade or business as defined in Section 199A the qualified business income deduction is disallowed for business income above set amounts that will increase the income taxes paid by proprietorships. Taxpayers with personal deductions beyond those assumed in the analysis will have additional benefits for proprietorships as the amount taxed at the higher rates will be decreased. This paper has provided a framework for examining the taxation of business income across different income levels. Business owners would have to adjust the analysis for their personal circumstances in making the best selection for their business.

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Appendix 1

Table 1
Taxation of Proprietorships

Single			
Gross Income	$100,000	$300,000	$500,000
Half SEP Tax	$7,065	$12,854	$16,114
Adjusted Gross Income	$92,935	$287,146	$483,886
Standard Deduction	$12,200	$12,200	$12,200
Qualified Business Income Deduction	$16,147	$54,989	$94,337
Taxable Income	$64,588	$219,957	$377,349
Income Taxes Owed	$10.068	$52,178	$107,266
SEP Taxes Owed	$14,130	$25,707	$32,227
Total Taxes Paid	$24,198	$77,885	$139,493

Married Filing Joint			
Gross Income	$100,000	$300,000	$500,000
Half SEP Tax	$7,065	$12,381	$15,888
Adjusted Gross Income	$92,945	$287,619	$484,112
Standard Deduction	$24,400	$24,400	$24,400
Qualified Business Income Deduction	$13,707	$52,644	$91,942
Taxable Income	$54,828	$210,575	$367,770
Income Taxes Owed	$6,191	$38,887	$80,319
SEP Taxes Owed	$14,130	$24,762	$31,777
Total Taxes Paid	$20,321	$63,649	$112,096

Table 2
Corporation – Income Distributed as Dividends

Corporate Taxable Income	$100,000	$300,000	$500,000
Corporate Income Taxes Paid	$21,000	$63,000	$105,000
Corporate Net Income	$79,000	$237,000	$395,000

Single			
Gross Income	$79,000	$237,000	$395,000
Half SEP Tax	0	0	0
Adjusted Gross Income	$79,000	$237,000	$395,000
Standard Deduction	$12,200	$12,200	$12,200
Qualified Business Income Deduction	0	0	0
Taxable Income	$66,800	$224,800	$382,800
Income Taxes Owed	$6,060	$29,760	$51,630
Additional Medicare Tax	0	$1,406	$7,410
Total Taxes Paid	$27,060	$94,166	$164,040
Married Filing Joint			
Gross Income	$79,000	$237,000	$395,000
Half SEP Tax	0	0	0
Adjusted Gross Income	$79,000	$237,000	$395,000
Standard Deduction	$24,400	$24,400	$24,400
Qualified Business Income Deduction	0	0	0
Taxable Income	$54,600	$212,600	$370,600
Income Taxes Owed	$720	$23,970	$44,010
Additional Medicare Tax	0	0	5,510
Total Taxes Paid	$21,720	$86,970	$154,520

Table 3
Corporation – Income Distributed as Wages

Single			
Gross Income	$92,000	$287,000	$484,000
Half SEP Tax	0	0	0

Adjusted Gross Income	$92,000	$287,000	$484,000
Standard Deduction	$12,200	$12,200	$12,200
Qualified Business Income Deduction	0	0	0
Taxable Income	$79,800	$274,800	$471,800
Income Taxes Owed	$13,415	$71,374	$140,324
FICA Taxes Owed	$7,038	$13,185	$17,814
Corporate Payroll Taxes	$8,000	$13,000	$16,000
Total Taxes Paid	$28,453	$97,559	$174,138

Married Filing Joint

Gross Income	$92,000	$287,000	$484,000
Half SEP Tax	0	0	0
Adjusted Gross Income	$92,000	$287,000	$484,000
Standard Deduction	$24,400	$24,400	$24,400
Qualified Business Income Deduction	0	0	0
Taxable Income	$67,600	$262,600	$459,600
Income Taxes Owed	$7,724	$51,373	$111,247
FICA Taxes Owed	$7,038	$12,735	$17,364
Corporate Payroll Taxes	$8,000	$13,000	$16,000
Total Taxes Paid	$22,762	$77,108	$144,611

Table 4
Corporation – Income Distributed as Half Wages and Half Dividends

Corporate Gross Income	$100,000	$300,000	$500,000
Wages Paid	$46,000	$139,600	$238,000
Payroll Taxes	$4,000	$10,400	$12,000
Taxable Income	$50,000	$150,000	$250,000
Taxes Paid	$10,500	$31,500	$52,500
Dividends Paid	$39,500	$118,500	$197,500

Single

Gross Income	$85,500	$258,100	$435,500
Half SEP Tax	0	0	0
Adjusted Gross Income	$85,500	$258,100	$435,500
Standard Deduction	$12,200	$12,200	$12,200
Qualified Business Income Deduction	0	0	0
Taxable Income	$73,300	$245,900	$423,300
Income Taxes Owed	$13,415	$42,526	$83,489
FICA Taxes Owed	$3,519	$10,264	$12,033
Additional Medicare Tax	0	$2,208	$7505
Corporate Income Tax	$10,500	$31,500	$52,500
Corporate Payroll Taxes	$4,000	$10,400	$12,000
Total Taxes Paid	$27,086	$96,898	$167,527

Married Filing Joint

Gross Income	$85,500	$258,100	$435,500
Half SEP Tax	0	0	0
Adjusted Gross Income	$85,500	$258,100	$435,500
Standard Deduction	$24,400	$24,400	$24,400
Qualified Business Income Deduction	0	0	0
Taxable Income	$61,100	$233,700	$411,100
Income Taxes Owed	$3,404	34,836	$69,238
FICA Taxes Owed	$3,519	$10,264	$11,691
Additional Medicare Tax	0	$308	$7,049
Corporate Income Tax	$10,500	$31,500	$52,500
Corporate Payroll Taxes	$4,000	$10,400	$12,000
Total Taxes Paid	$21,423	$87,308	$152,478

Table 5
Recap of Income Taxes Paid

Single			
Income Level	$100,000	$300,000	$500,000
Proprietorship	10.1%	17.4%	21.5%
Corporation – Dividends	27.1%	30.9%	31.3%
Corporation – Wages	13.4%	23.8%	28.1%
Corporation – Wages & Dividends	19.6%	24.7%	27.2%
Married Filing Joint			
Income Level	$100,000	$300,000	$500,000
Proprietorship	6.2%	13.0%	16.1%
Corporation – Dividends	21.7%	29.0%	29.8%
Corporation – Wages	7.7%	17.1%	22.2%
Corporation – Wages & Dividends	13.9%	22.1%	24.3%

Table 6
Recap of Total Taxes Paid

Single			
Income Level	$100,000	$300,000	$500,000
Proprietorship	24.2%	26.0%	27.9%
Corporation – Dividends	27.1%	31.4%	32.9%
Corporation – Wages	28.5%	32.5%	34.8%
Corporation – Wages & Dividends	27.1%	32.3%	33.5%
Married Filing Joint			
Income Level	$100,000	$300,000	$500,000
Proprietorship	20.3%	21.2%	22.4%
Corporation – Dividends	21.7%	29.0%	30.9%
Corporation – Wages	22.8%	25.7%	28.9%
Corporation – Wages & Dividends	21.4%	29.1%	30.5%