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Tax

What the New Tax Law Means for Small Businesses

By Lisa Morris Josefak on January 31, 2018

The new tax law became both the beauty and the beast for companies of all sizes across the country when 2018 officially opened for business.

As accountants, attorneys and business owners continue to comb through this tax overhaul, financial experts caution that before businesses celebrate or criticize aspects of the new law, they need to take a step back and look at the big picture.

Small Corporations Beware

With the passing of the new tax law, the corporate tax rate has been reduced from a top rate of 35 percent to 21 percent.

While this is good news for businesses across the board, some smaller companies may actually see a tax hike, warns Diane Giordano, a tax partner at Marcum LLP, a national accounting and advisory firm with offices in major business markets throughout the U.S., as well as Grand Cayman, China and Ireland.

"Prior to this law passing, there was a graduated corporate rate schedule that taxed businesses with taxable income under $50,000 at 15 percent," Giordano said. "So, for those C Corporation businesses with income below $50,000, they will experience an increase in rates. However, for most other larger companies, they will see a big reduction."

Shift of Focus

Most of the focus has been on the big business blue-chip Fortune 500 companies, said Russell Stern, a partner in the law firm of Ruskin Moscou Faltischek PC in Uniondale, NY.

"These represent a very small percentage of all of the businesses in the United States," Stern noted. "It is your smaller businesses — your mom and pop shops with maybe less than 100 employees — that people haven't been focusing on. It is unclear as to what this new tax law does for them. Lowering the corporate tax rate to a flat 21 percent rate is good. However, many small business owners are concerned about the cost associated with restructuring their businesses."

Flow-Through Complexities

For owners, partners and shareholders of S Corporations, LLCs and partnerships — who pay their portion of the business' taxes through their individual tax returns (known as "flow-through entities") — the new tax regulations can be very complicated and still need to be defined, said Vic Hausmaninger, founding partner of HBLA Certified Public Accountants, Inc. in Irvine, Calif.

“Basically, they get a deduction on taxable income for a portion — up to 20 percent — of the income that comes from those entities, which basically means 20 percent is not going to be subject to taxes," he said. "There are some exceptions, some limitations and the formula for doing so is quite complex.”

Giordano agrees that it is not all cut and dry for these businesses.

“It is complex because the 20 percent generally applies if the company has W2 wages,” she noted. “So, in order to get the 20 percent reduction, the company must have wages. There are other limits relating to wages. Additionally, some small businesses like law firms, accounting firms and other professional service companies aren’t entitled to this 20 percent deduction at all or have other limitations on its availability.”

Small Businesses: Restructure — or Not?

A lot of the small businesses out there have spent years structuring themselves to minimize their taxes and many of them opted to use a “flow-through” entity to operate their businesses through.

“Now you have a situation where the corporate tax rate has dropped to 21 percent, which is lower than anyone of their individual rates that these small business owners are going to pay, and they are sitting there scratching their heads wondering, ‘Should I decide to become a regular corporation as opposed to a flow-through entity or should I leave everything in place?,’” Stern explained.

“And if you start over-reacting to that — the not so publicized pieces of the tax bill is — come 2025 all of the items being promoted as positive for individuals go away,” Stern added. “You are suddenly back to the idea of, ‘Wait a second, I just jumped back to the old tax brackets?’”

The real takeaway to this is the individual side is really in limbo, he said.

Opportunities to Grow

Even as small business owners are still studying the new tax law, many plan to capitalize on certain aspects of the new tax code.

“As the tax percentage drops in 2018, this will allow me to take the difference and invest it to grow my company,” said Matthew Morris, owner of JAMO Property Services, a full-service maintenance company in Brooklyn, NY.

“Growing my company allows me to obtain more accounts,” said Morris, who employs four and works with independent contractors and sub-contractors. “Obtaining more accounts means creating more jobs. This is beneficial for my company and the economy.”

Pushing Wages Up?

Robert McMeekin is president and CEO of Interbrands LLC, an accessories company headquartered in Plainview, NY, with offices in California and North Carolina, selling brand names to big box stores across the country. For the past decade, he has experienced a major price compression due to stagnant wages across the country.

 ”It has forced many companies like us to run leaner and more efficient, and leaner doesn’t always equate to being more efficient — unfortunately leaner is the priority because of that formula," said McMeekin, who employs 35 people.

But with corporate rates going down, he believes this will trigger better wages and higher incomes.

"If wages go up then prices will start to go up, which means profits will go up,"McMeekin said. "We, in turn, will be able to hire more people and ease the current stress on our employees.”

Companies Must Step Up

This tax plan will help companies significantly, as it will put more money in their pockets, Morris explained.

“This allows companies to invest and grow their company and create more jobs,” he said. “Although, it is up the owner to do these things and put more jobs in the economy. This tax law will give them the option and opportunity to create more jobs but it takes two to make this possible — the government and a company’s owner.”

Banks Feel Initial Pain

Empire National Bank Chief Executive Officer Doug Manditch said the new law includes a couple of prominent tax breaks for his Islandia, NY-based bank, which has five New York branches and a total of 80 employees. However, the bank will experience an initial sting.

“Obviously, the most advantageous part of the new law is the drop in the federal tax rate from 35 percent to 21 percent,” Manditch said. “That will be a great deal of help to us. However, there is a little pain because of deferred tax credits."

He explained one drawback of the new law was that the bank would take a loss on the "bad debt" in its loan portfolio (technically knows as the allowance for loan and lease losses). Since the bank can't take the tax credit until it actually loses the money, the reduced tax rate will cost Empire National Bank about $2 million based on already assumed risk. “That will be basically made up in about a year, or maybe 15 months, by the lowered income tax rate," Manditch said.

Changes to capital improvements will also be advantageous for Empire National Bank. “Capital improvements can be written off,” he noted. “I don’t know if that is permanent or for a period of time, but that is obviously good.”

Shifts for Law Firms

A small, two-person law firm will not likely feel much of an impact of the new tax law.

“They are likely going to continue to be taxed as a partnership,” Stern said. “If it is a very financially successful law firm, we are talking about high earners who will still be in the top tax brackets on the individual level even though the high end bracket was reduced from 39.6 percent to 37 percent — they will most likely change their tax structures (switch to traditional C Corporation from a flow through entity) to take advantage of the new lower 21 percent corporate rate.”

For medium- to large-sized law firms, this bill will absolutely be a factor as they move forward, he noted. “I don’t think you are going to see anyone rush to change their form overnight — meaning from a partnership/single layer of tax to a corporation — but, I certainly think this new law could lead to a major shift in the way large personal service firms are currently structured.”

That’s Entertainment

All businesses should be aware that the new law basically eliminated entertainment as a deduction.

“If someone takes a client out to play golf or to a football game, it used to be that a company could write it all up — meals and entertainment — and they’d get a 50 percent deduction,” Hausmaninger said.

Under the new law, the only “entertainment” deduction allowed is business meals, he noted. “So, you might be able to write up a hotdog at the football game, but you are not going to be able to write off the football ticket — or the golf fees.”

This will affect the bottom line, but when you look at percentage of meals and entertainment in relation to the total expenses of a business, it’s not going to make a huge impact, Hausmaninger noted.

Raises/Benefits

“We saw on the news that certain employers were giving their employees bonuses and that’s nice — they got good publicity out of that — but I wouldn’t hold my breath that companies are going to start increasing everybody’s salary,” Hausmaninger said. “I don’t think we will see a carte blanche increases in compensation. That is just not going to happen, in my opinion.”

However, with the corporate rate coming down to 21 percent that allows a lot more cash to be retained in the companies and that may indirectly benefit a lot of people.

“When you have more profitable corporations, the values of stocks go up so therefore values of retirement plans that people are investing in increases, as they have been the last year in anticipation of all this happening," he said. "In addition, companies can retain more cash to pay down debt, invest in new properties and hire more people.”

National Economy

Many business leaders will have to wait to gage how the new law affects businesses and the economy as a whole.

“It may not be completely visible in one year, but I don’t think this new law will hurt business,” Manditch said. “And, frankly the millions of dollars they think they will be able to bring back from overseas because the tax rate has been lowered to below the 21 percent — with a special tax — bringing back those dollars for investment into this country like new plants, creating new jobs as long as the economy holds out — I cannot see how that could be a bad thing.”

Stern also believes it is too early to tell, with respect to businesses, who are the real winners and losers under this new tax law. “However,” he said, “It is definitely structured to favor big business, especially those that operate globally.”

Hausmaninger had a more immediate reaction: “This will result in more money to spend by individuals and businesses and therefore stimulate growth — the GDP forecast is now over 3 percent.”

The 2017 Christmas season was promising. “This has been the highest spending for Christmas in many years with the percentage increase about 5 percent," he said. "This is almost back to 2011 levels and is an indication people are more optimistic and are planning on having a little more cash available.”

The Big Picture

When viewing the new tax law, people should not be razor-focused on a particular item, advises Hausmaninger.

“Many of the comments are focused on certain geographic areas or income brackets, but we have a large nation with many, many people," he said. " When you look at the nation as a whole, the big picture is that the large majority of people will significantly benefit from the changes in the tax act.”

McMeekin noted: “The positive for us is the ripple effect of consumer confidence equating to increased consumer spending, which equates to better retail sells. As long as the economy continues to grow in 2018 the future looks bright.”