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New Pass-Through Entity Rules

One of the most important – and complicated – changes in the new tax reform act is the tax rules affecting small businesses that are treated as "pass-through entities."

The good news is that if you own one of these businesses you may get as much as a 20 percent reduction to the taxation of business net income under the new rules. However, calculating the actual deduction can become very complex. It depends upon several factors, including your level of income, your profession, the amount your business spends on wages and property acquired during the year.

Tax reform background

Most small businesses in the U.S. use pass-through business structures, which pass their profits on to their individual owners. Owners pay tax on those profits at their individual tax rates, in conjunction with other income. The new tax rates range from 10 percent to 37 percent in the 2018 tax year. Pass-through business structures include S corporations, partnerships and LLCs. Sole proprietorships handle business income in a similar way using Form 1040 Schedule C and are also covered by the new rules.

The Tax Cuts and Jobs Act signed in late December 2017 changed the corporate tax rate structure to a flat 21 percent rate from a progressive scale with a top rate of 35 percent. This meant many pass-through business structures would pay more than regular C corporations. To offset this, Congress gave pass-through owners the new 20 percent business income deduction.

But Congress also put in place special rules limiting the ability of "specified service trades" to take the full deduction. The list includes health, law, consulting, athletics, financial services, brokerage services, accounting firms, "or any trade or business where the principal asset … is the reputation or skill of one or more of its employees or owners." An earlier version of the bill included the engineering and architectural

professions, but those were later taken off the list, so they are considered exempt from the limits.

How to figure out your deduction – easy cases

First, make a rough calculation of your expected ”Qualified Business Income (QBI)”. Your QBI from a partnership, S corporation, or sole proprietorship is defined as the net amount of items of income, gain, deduction, and loss with respect to your trade or business. Generally, the amount will be line 1 of your Schedule K-1 from each entity. The business must be conducted within the U.S. to qualify, and specified investment-related items are not included, e.g., capital gains or losses, dividends, and interest income (unless the interest is properly allocable to the business). The trade or business of being an employee does not qualify. Also, QBI does not include reasonable compensation received from an S corporation, or a guaranteed payment received from a partnership for services provided to a partnership's business. Once you arrive at the QBI of the entity, the related deduction is 20% of the QBI. QBI is figured separately for each business activity of each taxpayer and spouse and then combined.

The deduction is taken “below the line,” i.e., it reduces your taxable income but not your adjusted gross income. But it is available regardless of whether you itemize deductions or take the standard deduction. In general, the deduction cannot exceed 20% of the excess of your taxable income over net capital gain. If QBI is less than zero it is treated as a loss from a qualified business in the following year.

Rules are in place to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the deduction.

Easy Case 1: If your taxable income is ***less than*** $157,500 as an individual filer, or $315,000 as a married couple filing jointly – you can take the ***full*** 20 percent deduction.

Easy Case 2: If your taxable income is ***greater than*** $207,500 as an individual filer, or $415,000 as a married couple filing jointly, ***AND*** you are in one of the specified service professions (health, law, consulting, athletics, financial services, accounting, brokerage services, etc.) – you can’t take the deduction for the business associated with that profession.

How to figure out your deduction – hard cases

If you don’t fall into either of the easy cases, figuring out your pass-through deduction gets much more difficult.

Who is affected: Individuals with taxable income of more than $157,500 as individual filers ($315,000 for married filing jointly) but less than the phase-out of $207,500 as an individual filer ($415,000 for married filing jointly).

After your taxable income passes the threshold amount of $157,500 as an individual filer, or $315,000 as a married couple filing jointly, special wage and/or depreciable property limits that reduce your deduction start to apply.

After your taxable income passes the threshold amount PLUS the phase-out amount, which is $207,500 as an individual filer, or $415,000 as a married couple filing jointly, the wage and depreciable property limits are applied fully to reduce your deduction. You'll still get a reduced deduction (unless you are in one of those specified service professions – then your deduction is eliminated completely).

The formula for calculating the wage and depreciable property limits is based on the greater of 50 percent of the W-2 wages paid by your business, OR 25 percent of the W-2 wages, plus 2.5 percent of the unadjusted basis of all tangible depreciable property used by your business during the year.

Sound confusing? In most cases the calculation will be straightforward – but not for everyone.

The rules are in flux

Every tax reform bill is subject to technical amendments that clarify and adjust what is confusing or not working as lawmakers intended. The Tax Cuts and Jobs Act will likely be no different. The pass-through rules are among the most complicated parts of the act, so many of the moving parts will change over the coming months. We will know more as 2017 taxes are completed and the focus turns to the 2018 rules.

Obviously, the complexities surrounding this substantial new deduction can be formidable, especially if your taxable income exceeds the thresholds discussed above. If you wish to work through the mechanics of the deduction with us, with particular attention to the impact it can have on your specific situation, please give us a call.

Note: The threshold amounts cited in this memo are for tax year 2018 and are indexed to inflation in subsequent years.

REMINDER: If you're familiar with the wage and depreciable property limits calculation, it may be because your small business used the Domestic Production Activities Deduction (DPAD) in the past, which uses a somewhat similar calculation. The DPAD was repealed in the Tax Cuts and Jobs Act for 2018 and subsequent tax years, so keep that in mind as you chart your business plans.

This brief summary of the pass-through rules in the tax reform act is provided for your information. Any major financial decisions or tax-planning activities in light of this new legislation should be considered with the advice of a tax professional. Call us you have questions regarding your particular situation. Feel free to share this memo with those you think may benefit from it.