A Practical Approach to Tax Reform: New 20% Pass-Through Deduction

What is the new deduction?

The Tax Cuts and Jobs Act, signed into law on December 22, 2017, created IRC §199A, which allows an individual a deduction for 20% of qualified business income (QBI) from pass-through or rental property income. The deduction starts for the 2018 tax year and expires after 2025. In the simplest of examples, an individual with $100,000 of QBI may be able to receive a $20,000 tax deduction, which at the top 37% tax bracket saves $7,400 in federal taxes. The calculation of the actual deduction is much more complex as it may be limited based on several factors:

1. The taxpayer’s taxable income (TI),
2. The ability of the pass-through income to qualify for the deduction based upon how the income was generated, and
3. The pass-through business having wages and/or property.

What is a pass-through business?

A pass-through business includes a partnership, LLC, S corporation, or a sole proprietorship. Real estate rentals are also included.

What is qualified business income (QBI)?

With certain exceptions, QBI is the net amount of income earned by your pass-through business. QBI does not include investment income (such as dividends, interest, and capital gains); wages paid to S corporation shareholders; or guaranteed payments paid to partners or to LLC members. If the amount of QBI from all businesses for a tax year is less than zero (i.e. a loss), the loss is treated as a loss from qualified businesses in the next year.

What is a specified service trade or business (SSB)?

A qualified trade or business is generally any trade or business other than an SSB. An SSB involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business the principal asset of which is the reputation or skill of one or more of its owners or employees (engineering and architecture are not included in the definition of SSB), or any business that involves the performance of services that consist of investing and investment managing, trading, or dealing in securities, partnership interests, or commodities. There will be continued uncertainty for certain businesses as to whether or not the business is an SSB until the IRS provides additional guidance via Treasury regulations.

How does it work?

- If TI does not exceed a certain threshold amount, whether the pass-through entity income is from an SSB or not is irrelevant; the deduction is the lesser of 20% of taxpayer’s taxable ordinary income or QBI.
• If TI exceeds a certain threshold amount and the pass-through income was generated by an SSB, there is no deduction available.
• If TI exceeds a certain threshold amount and the pass-through income was not generated by an SSB, the deduction is generally the lesser of (1) 20% of QBI or (2) the greater of 50% of W-2 wages paid by the pass-through entity or 25% of the W-2 wages paid by the pass-through entity plus a 2.5% capital element based on qualified property. Furthermore, the deduction is limited to 20% of your taxable ordinary income.
• The threshold amount starts at $315,000 for married individuals filing jointly ($157,500 for everyone else) and is phased out over the next $100,000 for married individuals filing jointly ($50,000 for everyone else).

**Examples**

**Example 1:**
- Filing status is married filing jointly
- QBI = $200,000
- QBI is from legal services
- TI = $300,000, all ordinary income
- Since TI does not exceed the threshold of $315,000, the business income qualifies for the deduction even though it is specified service trade or business income. The W-2 wage limitation and the basis of qualified property limitation are inapplicable.
- The deduction is calculated as follows:
  - TI = $300,000
  - QBI = $200,000
  - 20% of the lesser of QBI or TI = $40,000 deduction

**Example 2:**
Assume the same facts as in example 1 except that TI is $500,000. Since TI exceeds the maximum threshold, and since the business income is specified service trade or business income, the deduction is disallowed.

**Example 3:**
Assume the same facts as in example 1 except that the QBI is from manufacturing. Since manufacturing is not specified service trade or business income, and since TI is below the threshold, the deduction is calculated the same way as in example 1.

**Example 4:**
- Filing status is married filing jointly
- QBI = $200,000
- QBI is from manufacturing
- TI = $500,000, all ordinary income
- W-2 wages paid by the qualified business to arrive at QBI = $130,000
- Basis of qualified property = $100,000
- Since TI exceeds the threshold of $315,000, the 20% deduction is limited to the lesser of 20% of QBI or the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of the basis of qualified property.
• The deduction is calculated as follows:
  Lesser of
  o 20% of QBI ($40,000)
     or
  Greater of
  o 50% of W-2 wages ($65,000)
     or
  o 25% of W-2 wages ($32,500) plus 2.5% of basis of qualified property ($2,500) = $35,000
  o $40,000 deduction

What should you do?

Maximizing this new deduction requires careful planning. Compensation structure, entity structure, and taxable income are all factors that must be considered. Given these complexities, please contact us so that we may assist you in calculating the highest possible deduction.

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