Anchin Alert

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The Pass-Through Provisions of the TCJA: The Devil is in the Details

The Tax Cuts and Jobs Act (TCJA) has been touted for cutting the corporate tax rate, but the law also contains some valuable changes for smaller businesses that operate as pass-through entities, including partnerships, limited liability companies, S corporations and sole proprietorships. These businesses stand to see their tax liabilities fall significantly, but determining just how much they will benefit can be complicated.

Pass-Through Tax Cuts

The owners and shareholders of pass-through entities pay taxes on their net income at individual ordinary income tax rates, which had reached as high as 39.6% under prior law. The TCJA reduced individual tax rates, with the highest rate now at 37%.

Moreover, the TCJA added a generous new business deduction for pass-through businesses that will slash taxable income. The qualified business income (QBI) deduction generally allows taxpayers to deduct as much as 20% of QBI received. QBI is the net amount of income, gains, deductions and losses, exclusive of reasonable compensation, certain investment items and payments to partners for services rendered. The calculation is performed for each qualified trade or business and aggregated.

Once taxable income — not QBI — exceeds $157,500 for single filers or $315,000 for married couples filing jointly, a wage limit begins to phase in, under which taxpayers can deduct only the lesser of 20% of QBI or 50% of their allocable share of W-2 wages paid by the business. The wage limit is intended to deter high-income taxpayers from converting wages or other compensation for personal services to QBI that qualifies for the deduction.

Alternatively, taxpayers can deduct the lesser of 20% of QBI or 25% of wages plus 2.5% of their allocable share of the unadjusted basis of qualified business property (QBP) — essentially, the purchase price of tangible depreciable property held at the end of the tax year. This option makes it easier for capital-intensive firms with relatively low wages (for example, real estate, construction or manufacturing businesses) to take advantage of the deduction.

The wage limit phases in completely when taxable income exceeds $207,500 for single filers and $415,000 for joint filers. When it applies but isn't yet fully phased in, the gross (without any wage limit) deduction is reduced by the same ratio of the difference between the amount of the gross deduction and the fully wage-limited deduction as the ratio of 1) the amount by which the taxable income exceeds the threshold to 2) $50,000 for single filers or $100,000 for married couples filing jointly.

The amount of the deduction may not exceed 20% of the taxable income less any net capital gains. So, for example, if the QBI for a married couple is $400,000 and their taxable income is $300,000, the deduction is limited to 20% of $300,000, or $60,000.

The QBI deduction is further limited for specified service trades or businesses (SSTBs). SSTBs include businesses involving law, financial, health care, brokerage and consulting services firms, as well as any business where the principal asset is the reputation or skill of one or more of its employees. The QBI deduction for SSTBs begins to phase out at $157,500 in taxable income for single filers and $315,000 for joint filers, phasing out completely at $207,500 and $415,000, respectively (the same thresholds by which the wage limit phases in).

The QBI deduction applies to taxable income and doesn't come into play when computing adjusted gross income (AGI). It's available to both itemizing and non-itemizing taxpayers.

Anchin has developed some examples that are housed on our website – if you'd like to explore some of these scenarios, click here.

Impact

How will this impact you? Speak with your Anchin Relationship Partner about how this specifically impacts you and your tax picture.

If you have questions, contact your Anchin Relationship Partner or Clarence Kehoe, Leader of Anchin's Tax Department for more insight around these changes.