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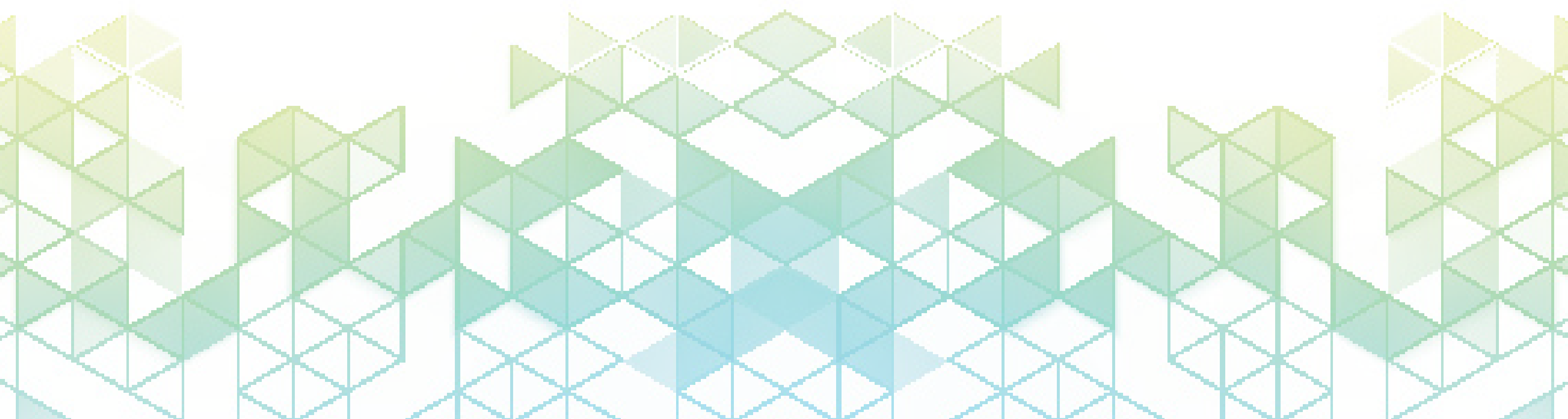
What You Need to Know About the 20% Pass-Through Business Deduction



As a business owner, you are probably focused on building your business, and cash flow is the best means to do just that. Unfortunately, the government often wants a cut of the pie, too. You need to take every deduction you possibly can because maximizing your deductions lowers your overall tax bill, leaving money you can use to help your company grow. That's why it's important that you understand the new 20 percent pass-through business deduction. Here's what you need to know.

What is the 20% pass-through business deduction?

In 2017, Congress amended the IRS tax code via The Tax Cuts and Jobs Act (TCJA). As the name suggests, the main goal of the TCJA is to provide tax relief to certain businesses and individuals. It is also expected to boost employment rates over the next several years. The 20 percent pass-through deduction is a small part of the TCJA. With this new regulation, certain businesses are able to deduct up to 20 percent of their net income, reducing their federal tax bill significantly. However, as with many tax laws, the pass-through business deduction is complicated, leaving many business owners scratching their heads in confusion. It has several limitations, and many calculations are necessary to determine if you qualify for the deduction or not.

Who does the new deduction benefit?

There are a few qualifications you must meet to take advantage of the 20 percent deduction.

Pass-Through Businesses

First of all, you must be considered a "pass-through" business. That means your company must be set up so that it does not pay taxes as an entity. Instead, those taxes are paid by the owner (or owners) of the company as personal income taxes. Pass-through businesses are so-named because their income essentially just "passes through" the business. Many owners opt for a pass-through business entity because it helps avoid double taxation since the money is only taxed on your personal return.

The following business structures are considered pass-through entities:

- Sole proprietorship (if you've never registered as another type of company and you are the sole owner of the business, you are probably considered a sole proprietorship by default)
- Partnership
- S-corporation
- LLC (Limited Liability Corporation)
- LLP (Limited Liability Partnership)

If your company is registered as any of these entities, then you meet the first criteria to qualify for the deduction. Unfortunately, C-corporations do not qualify for the deduction.

Qualified Business Income

You must also have qualified business income (QBI). This should equal your net profit for the year. To calculate your QBI, take your gross income and subtract all of your other qualified business deductions. This income should include rental income (as long as your rental activity is considered business-related). It should not, however, include:

- Capital gains or losses
- Income you earned in other countries (outside the U.S.)
- Dividend or interest income
- Wages to your shareholders if your company is an S-corporation
- Guaranteed payments to partners if your company is a partnership or an LLC

If you own multiple businesses, you should calculate QBI for each company separately, then add the totals together to determine your QBI. If the resulting total is a negative number, then you had a loss for the year and are not eligible for the pass-through deduction.

Taxable Income

You must also have taxable income to qualify for the deduction. While this may seem obvious, many business owners are surprised to find that they do not owe any income tax once they fill out their 1040 for the year. Before you bother with the more complicated calculations, you should first determine whether you fall into this category or not. To do this, you'll need to subtract your personal deductions from your income (including business income, investment income, and any income you received from working).
Also, you should note that the deduction is limited to 20 percent of your taxable income. That means if your QBI for the year was $100,000 but your personal taxable income is only $20,000, you qualify for a $4,000 deduction instead of a $20,000 one (20% of $20,000=$4,000).

Specified Service Provider

In addition to the requirements above, there are different limitations for certain businesses which fall under the classification of a "specified service provider." This classification includes businesses in the following categories:

- Healthcare (including doctors, dentists, etc.)
- Law
- Accounting
- Consulting
- Athletics
- Financial services
- Brokerage services
- Investing and investment management
- Trading and dealing in securities or commodities

The law also states that other service businesses may be included if their sole assets include the reputation or skill of one or more employees or owners. However, engineering and architectural services are specifically excluded from the list.

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How does the pass-through deduction work?

If you meet the qualifications above, it's time to move on to the details of the new law. At this point, you should already have your QBI and taxable income amounts calculated, and you'll need those numbers to determine your total pass-through deduction amount.

Taxable Income Below $157,500 for Singles ($315,000 filing jointly)

First, if you are single and your total taxable income is $157,500 or less, then you are eligible for the full 20 percent deduction. If you're filing jointly, then you can claim the full deduction if your taxable income is $315,000 or less. There are no other calculations or limitations for this income range. (Remember that the deduction is 20 percent of your QBI.)

Service Providers With Taxable Income Above $207,500 ($415,000 filing jointly)

Unfortunately, if your business is considered a specified service provider, you're filing single, and your total taxable income is $207,500 or more, then you are not eligible for the deduction at all. That's also true if you're filing jointly and your taxable income is $415,000 or more. If you own any other kind of pass-through business, you may be able to claim a portion of the deduction, but the amount will depend on certain factors, such as the wages you paid for the year and the assets you own. See below.

Non-Service Providers With Taxable Income Above $207,500 ($415,000 filing jointly)

If your income is above the $207,500 threshold and you aren't a specified service provider, you have a bit more math to do to determine your eligibility. Your maximum deduction is limited to 20 percent of your QBI. However, there are additional limitations at this income level.

You will need to know:

1. Your total W-2 employee wages (paid by the business to employees)

2. The acquisition cost of your depreciable property (not inventory; only equipment or real property)

You are eligible to take the greater of:

1. 50 percent of your total W-2 employee wages, or

2. 25 percent of your total W-2 employee wages plus 2.5 percent of the acquisition cost of your depreciable property

If you don't have any wage expenses (or employees) and you don't have any depreciable property, then you can't claim the deduction at all. If you have depreciable property but no employees, you will need to use the second calculation as your basis.

Taxable Income Between $157,500 and $207,500 ($315,000 and $415,000 filing jointly)

If your taxable income falls between the two thresholds above, then you may qualify for a prorated portion of the deduction. However, the calculations for this threshold are complicated because there is a phase-out. At the lower end of the range, you are eligible for the full 20 percent deduction, based on your QBI. However, past that point, you need to convert to the wage/depreciable property listed above.

When your income is in this range, it's likely that part of your income will be subject to the additional wage/depreciable assets limitation, while the remaining portion can take the full 20 percent deduction. The total range is $100,000 for joint filers, so your income will be subject to the phase-out limitations based on a percentage. For example, if your income is $400,000 (and you're filing jointly), you are at 85 percent of the cap (using the calculation $400,000-$315,000)/($415,000-$315,000).

Conclusion

The 20 percent pass-through deduction is certainly one of the more complicated tax regulations, but it can save many business owners a significant portion of their tax bill. Unfortunately, because the TCJA was enacted to boost job growth, higher income service providers and companies without employees or depreciable property likely won't see much of a tax break from this specific deduction.

While this guide offers a breakdown of many aspects of the law, if you find yourself struggling with the calculations or intricate tax law wording, it may be worth contacting a professional for assistance.

About Olsen Thielen

Olsen Thielen is a full service accounting and consulting firm, and a "Top 25" firm in Minneapolis and St. Paul, Minnesota. We focus on providing top quality solutions for our clients through our traditional accounting and tax services, as well as non-traditional services like valuations, business succession planning, employee benefits and human resources consulting, back-office cloud accounting solutions, estate, gift and financial planning, and fraud and forensic accounting.

Olsen Thielen was founded on the belief that personal attention, trust, and quality service were the key elements to helping our clients succeed. Over 95 years later, that commitment remains. Our longevity and growth can be attributed to building strong relationships with our clients and continuing to earn their trust.

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