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New Pass-Through Entity Rules

One of the most important – and complicated – changes in the new tax reform act is to 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.

Because 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, that 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.

Members: American Institute of Certified Public Accountants, Minnesota Society of Certified Public Accountants

Willmar Office
331 Third St SW, Ste 2
PO Box 570
Willmar, MN 56201
P (320) 235-3311
T (888) 388-1040

Benson Office
1209 Pacific Ave, Ste 3
Benson, MN 56215
P (320) 843-2302

Morris Office
401 Atlantic Ave
Morris, MN 56267
P (320) 589-2602

Litchfield Office
820 Sibley Ave N
Litchfield, MN 55355
P (320) 693-7975

St. Cloud-Sartell Office
Ste 110
2351 Connecticut Ave
Sartell, MN 56377
P (320) 252-7565
T (800) 862-1337

www.cdscpa.com

How to Figure Out Your Deduction – Easy Cases

First, make a rough calculation of your expected qualified business income (QBI), which is generally your net income other than income in the way of compensation. This figure excludes business losses, as well as factoring in amortization and capitalized expenditures. QBI is figured separately for each business activity, not on a per-taxpayer basis.

Easy Case 1: If your QBI 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 QBI 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 **any** of the deduction.

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: Small business owners with QBI of more than \$157,500 as individual filers (\$315,000 for married filing jointly) but less than the phaseout of \$207,500 as an individual filer (\$415,000 married filing jointly).

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

After your QBI passes the threshold amount PLUS the phaseout amount, which is \$207,500 as an individual filer, or \$415,000 as a married couple filing jointly, the wage and capital 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 capital 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 qualified property acquired by your business during the year.

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

REMINDER: If you're familiar with the wage and capital 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.

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.

If you own a pass-through business, you will need help navigating the choppy waters of tax reform. When the storm of the recent passage subsides and the details are clarified, reach out to schedule a consultation to chart a course for your business in 2018.

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

Q&A

You likely have more questions about the new 20 percent income deduction rule than anyone can possibly answer right now. Clarification from the IRS is coming in the following months. Until then, here are answers to some common questions businesses are asking.

Q. Why is there a wage and service business limit calculation in the deduction?

A. Lawmakers were concerned that the owners of service businesses would change how they pay themselves in order to reduce their tax burden. They said they intended to “deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20-percent deduction.”

Source: U.S. Congress Conference Report, page 37.

Q. I’ve heard that rental property owners could possibly get this deduction. Is this correct?

A. Yes, in all likelihood Schedule E filers will also be eligible for the deduction. While most of these entities do not have wages, the capital portion of the calculation may result in a deduction for these businesses.

Q. What about losses? Do they affect my ability to get the deduction?

A. Yes, losses will lower your eligible income. Excess losses will carry over to future years, limiting your ability to take the deduction in the future.

Q. How is qualified property calculated? How does bonus depreciation and Section 179 expensing affect the 2.5 percent property calculation?

A. These answers can get pretty complicated and will require clarification from the IRS. While we wait for that, here is a short explanation based on what we know now: Qualified property must be tangible property subject to depreciation and available for use in a qualified trade or business.

The calculation for businesses subject to limitation will be based on 2.5 percent of the property value. The value of the property appears to be its basis after it is placed into service, and it must be actively used as of the end of the year. There will be provisions to account for the leveling out of different recovery period calculations and the prior use of accelerated depreciation methods. But stay tuned; this area could be full of further clarifications and guidance.

Q. Where is the deduction taken on Form 1040?

A. The deduction probably will be taken on page 2 of Form 1040, following the calculation of adjusted gross income.

Q. What about my hobby activity, does it get this deduction?

A. Probably not. It's likely that you would need to pass the threshold rules relating to hobby versus business activity. But this area too, could use some help with clarification.

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 at (888) 388-1040 if you have questions regarding your particular situation. Feel free to share this memo with those you think may benefit from it.