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Pass-Through Entities and the 20 Percent Tax Break

In the past few weeks, we have received many calls from business clients with questions about the recent tax law change regarding pass-through entities and the 20 percent tax break. The most asked question has been, “Should we be changing to a C corporation?” The short answer has to be “maybe, but maybe not”.

The tax law is much more complicated than it appears on the surface. Let’s explore it in a little more depth.

A pass-through entity can be a partnership, S corporation, limited liability company or partnership, or sole proprietorship — basically, most of the country's small to mid-sized businesses. Owners of these entities are taxed on earnings based on individual, not corporate, tax rates. Effectively, company earnings, losses and deductions pass through to the individual's personal tax rates, which, in the past, were typically lower than corporate rates, making for a nice tax break.

But things have changed with the new tax law.

In 2017, the top U.S. corporate tax rate was 35 percent, one of the highest in the industrialized world. The new bill slices that rate to a flat 21 percent, which is lower than the top individual tax rate of 37 percent. At first glance, it would appear that individual earners who fall into a higher tax tier would no longer want to claim a pass-through deduction, as their individual rate is now higher than the corporate rate. This has prompted the question of changing the entities to C corporations.

However, to even things out, lawmakers have allowed pass-through owners to deduct 20 percent of their qualified business income (QBI) from their personal income taxes. Unlike the corporate tax cut, which is permanent, this pass-through deduction lasts only through 2025, unless Congress extends it.

A 20 percent pass-through deduction can be significant for the taxpayer. For example, if you have $100,000 in pass-through income and are in the 24 percent tax bracket, you can reduce your income taxes by $4,800.

However, we must emphasize the new law surrounding pass-through entities and the 20% tax break is not cut and dried. On the surface, it may appear that certain changes or choices are obvious to a business owner. They are not.

We have found that each situation requires a deeper understanding of the new law, the definitions and the details to determine the impact for a client.

Understanding Qualified Business Income (QBI)

QBI is, essentially, the profit a pass-through business makes during a year.

QBI includes (but is not limited to):

- Rental income from a rental business.
- Income from publicly traded partnerships.
- Real estate investments trusts.
- Qualified cooperatives.

QBI does not include:

- Dividend income.
- Interest income.
- S corporation shareholder wages.
- Business income earned outside the United States.
- Guaranteed payments to LLC members or partnership partners.
- Capital gain or loss.
- Income from service or consulting businesses above certain amounts.

In order to take advantage of the pass-through deduction, you must have net taxable income from your businesses. Of course, if there is no profit, there is no deduction.

The QBI from each business is calculated separately. If you have several businesses, and one or more loses money in a given year, you will deduct that loss from the QBI from the profitable businesses.

More Considerations and Limitations

- **Service Businesses**

  If your business performs certain specified services, such as doctor, lawyer, or consultant, where the principal asset is the reputation or skill of one or more employees or owners, the deduction phases out at certain income levels. These 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.

  For instance, if your taxable income falls below $315,000 (married filing jointly) or $157,500 (filing single), you can take full advantage of the pass-through deduction. However, if your taxable income is more than $415,000 (filing jointly) or $207,500 (filing single), the deduction is lost. If your income falls somewhere between $315,000/$157,500 and $415,000/$207,500, the deduction is calculated on a sliding scale.

  There are still many questions about the details and definition of service business income, and we are looking forward to reviewing future clarifications.

- **Non-Services Businesses**

  For non-services businesses with owners whose taxable income is higher than the thresholds listed above ($415,000 filing jointly or $207,500 filing single), a deduction is still allowed equal to the lesser of the following:

  A. 20% of qualified business income, or
  B. The greater of:
     1. 50% of W-2 wages paid, or
     2. 25% of W-2 wages paid plus 2.5% of the cost of business property

  Under this limitation, the business owner cannot just take 20% of QBI, if the second calculation in B. is less. There are additional guidelines for determining eligible business property referenced above in B. 2.

Some takeaways from this legislation

- **An S Corporation election might be beneficial for sole proprietors or owners of single member limited liability companies, especially those with no employees.**

  A sole owner of a company may benefit from a combination of the 20 percent deduction and possible reduction in overall employment taxes. Such planning is complex, and requires an analysis of a number of factors before taking such action.

- **A sole proprietor may also benefit by converting an independent contractor to employee status, providing W-2 wages that may give rise to the deduction**

- **Rental activities can also give rise to the 20 percent deduction, due to the inclusion of the 2.5 percent of property cost factor mentioned above**

Obviously, the complexities surrounding this substantial new deduction can be formidable, especially if your taxable income exceeds the thresholds discussed above. The new pass-through deduction may turn out to be a good tax break for those who qualify. However, we caution against any knee jerk decisions, as each company and taxpayer situation can be different. We urge you to give us a call, to explore your options. We want to help you to make the most of the new tax laws.