Does your business qualify for this notable tax deduction?

Pass-through entities now have a more level planning field with businesses that benefitted from the 2017 corporate tax reduction.

You might recall that the Tax Cuts and Jobs Act, enacted in December 2017, reduced corporate tax rates from 35% to 21%. Given this notable boost to corporations, a coinciding change was made for pass-through entities (which pay income taxes at the individual owners' level, not the corporate level) to help level the playing field.

So, what's the change for pass-through businesses? Through 2025, noncorporate owners of pass-through businesses in the U.S. are allowed a deduction equal to the lesser of:

- 20% of the owner's combined qualified business income (QBI), or
- 20% of the excess of the owner's taxable income excluding net capital gains

Although the overall concept of this deduction is straightforward, the specific provisions are quite complicated. The IRS has issued guidance for interpreting and applying these rules, hopefully enabling taxpayers to benefit from the deductions as the law intended.

Let's walk through these complex provisions.

Who's eligible?

Eligibility for the new deduction is limited to qualified trades or businesses (QTOB)in the U.S. that produce income. A QTOB is any trade or business that is *not* a specified service trade or business (SSTB).

Eligible for the deduction:

- QTOBs: Any pass-through trade or business that is *not* an SSTB (see section below)
- Rental real estate owners who devote at least 250 hours a year to their business and maintain records
    - Note: This excludes properties used as a residence by the taxpayer at any time during the year as well as any properties subject to a triple net lease
- Architects and engineers, as they are specifically excluded from the SSTB category

- Relevant pass-through entities (RPEs), which include:
    - S corporations
    - Partnerships (including general, limited, and limited liability partnerships)
    - LLCs (treated as partnerships for federal income tax purposes)
    - Some Schedule E real estate investors
    - Sole proprietorships (i.e., Schedule C filers)
    - Non-grantor trusts and estate with an interest in a pass-through entity (this excludes REITs and PTPs)

Ineligible for the deduction:

- SSTBs, where the principal asset of the business is the reputation or skill of one or more employees. These businesses include:
    - Accounting
    - Actuarial science
    - Athletics
    - Brokerage services
    - Consulting
    - Financial services
    - Health
    - Investing
    - Investment management
    - Law
    - Performing arts
- Taxpayers whose trade or business is being an employee

Exception: Some SSTBs are still eligible

There’s a significant exception to the rule that SSTBs are *not* QTOBs and thereby ineligible for the deduction, and the exception is based on the taxpayer’s taxable income.
An SSTB may still qualify for the deduction if:

- The owner’s taxable income is below or equal to a lower threshold. The applicable threshold depends on the taxpayer’s filing status and is indexed for inflation. If this condition is met, the business qualifies for the full deduction. There are lower thresholds for 2022:
    - $340,100 for married filing jointly and surviving spouse
    - $170,050 for single filers and head of household
    - $170,050 for married filing separate, trusts and estates

  Calculating QBI: for those entities that qualify for the deduction, the next step is calculating QBI.

  QBI is generally the net amount of the business’s qualified income, gain, deduction, and loss. However, the following adjustments may be needed.
- Apply initial adjustments.
    - Exclude any non-U.S. portion

    - Exclude qualified REIT dividends and qualified PTP income (however, see Step 3 below)
    - Exclude investment income earned by the trade or business
    - QBI losses are carried forward to the next tax year, thus reducing next year's QBI
- For non-SSTBs, apply deduction limitation based on wages paid. The deduction is limited to the lesser of:
    - 50% of QBI, or
    - The greater of the following:
        - 50% of W-2 wages
        - 25% of W-2 wages, plus 2.5% of the unadjusted basis of qualified property used in the trade or business

Increase deduction by 20% of REIT dividends and PTP Income. 20% of ordinary REIT dividends and PTP income are now added back to the QBI component to reach the combined QBI amount.

Reaching the deduction amount

Compare 20% of the combined QBI amount to 20% of adjustable taxable income. The lesser of these two figures is the deduction. Keep in mind the overall deduction limit if the taxpayer's taxable income exceeds the lower threshold.

Note that the pass-through entities do not take the deduction themselves – instead, they provide the owners with relevant information so the owners can compute their individually available deduction. The deduction does not affect the calculation of self-employment tax or AMT and is available whether the taxpayer itemizes deductions.

While the IRS's guidance should prove helpful, the computations involved in the QBI deduction include a significant amount of complexity and technicalities. Your tax advisor can help provide further details.

Sources: "Getting the 411 on IRC 199A: Just the Facts Ma'am" (Melissa J. Williams, Heckerling Institute on Estate Planning, January 2019); "The 20% Deduction For Business Income From Pass-Through Entities" (U.S. Trust, Oct. 2018)

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