The New Deduction for Pass-Through Income (or How Congress Failed at Tax Simplification)

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One of the more significant changes in the recently enacted Tax Cuts and Jobs Act is new Internal Revenue Code Section 199A, Qualified Business Income. Although touted as providing tax simplification, the Tax Cuts and Jobs Act created a pretty complex new tax concept – the pass-through deduction.

Section 199A provides for a deduction of up to 20% of the taxpayer's qualified business income from a pass-through entity. For purposes of 199A:

- Pass-through entities include partnerships, S corporations and sole proprietorships.
- A qualified business is any business other than (i) a specified service business or (ii) the business of performing services as an employee. However, if the taxpayer's taxable income is under the threshold amounts (discussed below), a specified service business will be a qualified business.
- A specified service business is any trade or business that involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.
- Qualified business income includes items of income, gain, deduction and loss effectively connected with a business within the US that are allowed in determining taxable income. Qualified business income excludes compensation paid to the taxpayer for services rendered, guaranteed payments to a partner, payments under IRC 707(a) to a partner for services rendered, and capital gains/losses, dividends, interest.

Section 199A is fairly straightforward if the taxpayer doesn't have too much income. Too much income is defined as taxable income of $157,500 (for single taxpayers) and $315,000 (for married taxpayers, filing joint), referred to as the threshold amounts.

I. Assuming the taxpayer is under the taxable income threshold, the pass-through deduction is generally equal to the lesser of:

1. 20% of the taxpayer's qualified business income with respect to each qualified trade or business, and
2. 20% of the taxpayer's taxable income less net capital gains and qualified cooperative dividends.

Example: Donald, a single taxpayer, has taxable income of $150,000, earning $187,500 from his consulting business of which he is a partner. His taxable income includes net capital gains of $10,000. Donald's Sec. 199A deduction of $28,000 is calculated as the lesser of:

1. $37,500 (20% of the $187,500 in qualified business income), or
2. $28,000 (20% of $140,000. Donald's taxable income of $150,000 net of the included capital gains of $10,000).

The real complexity kicks in when the taxpayer has too much taxable income.

II. If the taxpayer has too much taxable income, but is not in a specified service business, then:

If a single taxpayer's taxable income exceeds $207,500 (the threshold amount for a single taxpayer plus $50,000), or if a married filing joint taxpayers' taxable income exceeds $415,000 (the threshold amount for married filing joint plus $100,000), and the taxpayer's business is not a specified service business, the pass-through deduction is then subject to additional limitations based on the W-2 wages paid to the entity's employees and the entity's depreciable property.

In that case, the pass-through deduction is limited to the lesser of:

1. 20% of the taxpayer's qualified business income from the qualified trade or business, or
2. the greater of:

i. 50% of the W-2 wages paid by the qualified t/b, or

ii. 25% of the W-2 wages paid plus 2.5% times the cost of depreciable property (ignoring accumulated depreciation);

Example: Donald, a single taxpayer, has taxable income of $250,000, earning $187,500 from his consulting business of which he is a partner that pays employees $80,000 in W-2 wages, and has depreciable property with an original cost of $300,000. Donald's Sec. 199A deduction of $37,500 is limited to the lesser of:

1. $37,500 (20% of the $187,500 in qualified business income), or
2. the greater of:

i. $40,000 (50% of W-2 wages of $80,000), or

ii. $27,500 (25% of W-2 wages of $80,000 ($20,000) plus 2.5% of $300,000 ($7,500)).

III. If the taxpayer has too much taxable income and is in a specified service business:

If a single taxpayer's taxable income exceeds $207,500 (the threshold amount for single plus $50,000) or a married filing joint taxpayers' taxable income exceeds $415,000 (the threshold amount for married filing joint plus $100,000), and if the taxpayer's business is a specified service business, the taxpayer is not entitled to a pass-through deduction.

Example: Donald, a single taxpayer, has taxable income of $225,000, earning $187,500 from his consulting business of which he is a partner. Because Donald's taxable income exceeds $207,500 (the full phase-out threshold) and his pass-through income was from a specified service business, Donald's Sec. 199A deduction is $0.

However, if the taxpayer's taxable income is between $157,500 and $207,500 (for a single taxpayer) or $315,000 and $415,000 (for a married filing joint taxpayer), and the taxpayer's business is a specified service business, the pass-through income deduction is phased out. In that case, in computing the pass-through deduction the taxpayer takes into account only the applicable percentage of qualified business income. The applicable percentage is 100 percent reduced by the percentage equal to the ratio of the taxable income of the taxpayer in excess of the threshold amount, to $50,000 ($100,000 in the case of a joint return).

Example: Donald, a single taxpayer, has taxable income of $187,500, earning $187,500 from his consulting business of which he is a partner. Because Donald's taxable income is halfway between $157,500 and $207,500 (applicable percentage is $25,000/$50,000 or 50%), and his pass-through income is from a specified service business, Donald's Sec. 199A deduction would be $18,750 ($187,500 times 20% times 50%).

So, if you're still with me, you see that §199A is loaded with potential issues – the Code section itself is several pages long, containing multiple formulas and numerous definitions. §199A instructs the Treasury Department to prescribe regulations as necessary to carry out the purposes of this section, including such things as providing guidance on how §199A is applied in the case of tiered entities. I'm sure things will be much clearer when the regulations are published.

Other, non-regulatory issues include:

- LLC vs S corp and the employment tax – LLC's often make an election to be treated as an S corporation, with payment of reasonable compensation to the now employee-shareholder, as a way to reduce the employment tax. The analysis of whether to elect S is further complicated by the pass-through deduction and the impact of converting pass-through income to compensation, which is not eligible for the pass-through deduction.
- Pass-through vs. C corp – beginning January 1, 2018, C corporations pay a federal tax of 21%. Even though the pass-through deduction narrows the gap between the tax rates, a pass-through entity may want to convert to C status, particularly if the shareholder(s) are planning on leaving some of the profits in the business.

All this is further complicated by the sunset provisions that result from the Tax Cuts and Jobs Act being passed via the reconciliation process. §199A sunsets as of January 1, 2026. Will Congress extend to make the pass-through deduction permanent? Or will Congress let the deduction lapse? Most of us didn't think many of the George Bush tax cuts (like treating dividends as capital gain) would make it past 2010, and here we are.

So, its déjà vu all over again – come the fall of 2025 we once again will be peering over that dreaded fiscal cliff.