IRC §199A – Deduction for pass-through income (2017 Tax Act)

The big tax bill passed at the end of 2017 (Tax Cuts and Jobs Act of 2017) contains a deduction for the benefit of many businesses—those not subject to taxation as corporations—for their "business income" reported as ordinary income on the taxpayer's return.

This new deduction is both simple and complex. The central idea is to create a simple deduction for qualified businesses with checks to prevent taxpayers using this as a dodge.

The simple part is that the amount of the deduction for pass-through income is the lesser of 20% of the household's eligible business income or 20% of the household's taxable ordinary income. Taxable ordinary income is the amount you report after deductions (itemized or standard) are subtracted on page 2 of Form 1040. A sole proprietor who earns $40,000 of eligible business income who has no other sources of income would claim the standard deduction ($12,000) and have $28,000 of taxable income. The pass-through deduction for this example is the lesser of 20% of the eligible business income ($40,000 * 20% = $8,000) or 20% of taxable ordinary income ($28,000 * 20% = $5,600).

Determining *eligible business income* introduces the complex aspects of this new law. Income received from a "trade or business" other than "the trade or business of performing services as an employee" is eligible: income from the pass-through entity vs. wages. The law adds to this definition several non-trade or business income from sources such as rental activity and diffidence from real estate investment trusts.

If your taxable income is under $157,500 (individuals) or $315,000 (married filing jointly), then you can stop here an look forward to determining your pass-through income deduction like the example above. Otherwise, you must determine how the limitations to this deduction apply to your situation.

One limitation is that some types of income are not counted as pass-through income. This includes capital gains arising from the pass-through business activity, dividend income, and interest income not allocable to the trade or business (§199A(c)(3)(B)). Reasonable compensation that S corporations are required to pay their active business owners and "guaranteed payments" from partnerships to their partners are not eligible business income.

Another limitation relates to the source of the business income. Income from specific businesses ("specified service trade or business") that otherwise is pass-through income is reduced on a sliding scale for taxpayers making more than $157,500 (individuals) or $315,000 (joint filers). Pending Regulations will define which business activities we know that service businesses in the areas of law, health, accounting, actuarial science, performing arts, consulting, athletics, and financial or brokerage services are categorically subject to this adjustment. The Regulations (when final) will have to be studied to determine whether business income is or is not subject to this limitation.

A further limitation applies when a household has both pass-through and wage income. The amount of the pass-through deduction in these situations is a separate calculation where there is income from one of the specific service trade or businesses referenced above. At this point, you had better be sitting down with your CPA or tax advisor to determine whether/how this limitation applies to your situation and what income or deduction shifting may be possible to reduce the impact of this constraint.

These complications apply to taxable incomes that exceed $157,500/$315,000 until taxable income reaches $315,000 (individuals) and $415,000 (couples filing jointly) when the deduction is completely phased out.

The provisions of the 2017 tax law changes will last only through 2025 unless Congress extends any of them beforehand. So it may be that your efforts to understand and apply this tax benefit will be short-lived. The IRS published proposed regulations on August 8, 2018 which may be relied upon until final regulations are published in the Federal Register.