

## NEW TAX-LAW REGARDING PASS-THROUGH INCOME

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*“While the law related to the deduction for Qualified Business Income is complex, the benefits for qualifying entities can be significant.”*

McCarthy Asset Management, Inc. is an independent, fee-only investment advisory firm that has been helping people invest wisely for over fifteen years. Our mission is to help you better understand and improve your financial situation. We specialize in Retirement Planning, Portfolio Management and Tax Planning.



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The tax law passed in December created a new deduction of up to 20% of net income for many pass-through business owners. Lawmakers made the change as a boon to firms that won't benefit from the cut in the top corporate rate to 21% from 35%. **This deduction for Qualified Business Income (QBI) is created in the new Section 199A (and thus may be referred to as either the “Section 199A deduction” or the “QBI deduction”).**



This portion of the new law contains very complex details, some of which remain to be sorted out once the U.S. Treasury issues regulations. Furthermore, there are limitations on which businesses will qualify for the deduction. The purpose of this article is to provide an overview of this potentially significant tax break.

**What is a pass-through entity?** It is a business that passes its income through to its owner's tax returns, and is taxed at the owner's individual rate. Most private businesses in the U.S. are structured as pass-throughs. Types include:

- Sole proprietorships (no separate entity; reported on individual's Schedule C)
- Real estate investors (no separate entity; reported on the individual's Schedule E)
- Limited liability companies
- S Corporations
- Partnerships
- Trusts and estates, REITs and MLPs

**Income Limitation:**

- Pass-through owners can claim the full 20% deduction if their taxable income (line 43 of Form 1040) is under \$315,000 for joint filers or \$157,500 for single filers.
- Taxpayers can claim a reduced deduction if their taxable income is between \$315,000 and \$415,000 for joint filers and between \$157,500 and \$207,500 for single filers.
- For taxpayers with taxable income above \$415,000 for joint filers and \$207,500 for single filers, the deduction, based on a complex calculation, will only be available to non-services business.

**Service Businesses:** Owners of the following businesses will benefit only if their income is below the income limits stated above:

- Service professions such as doctors, attorneys, accountants, actuaries and consultants.
- Anyone who works in the financial services or brokerage industry.
- Performing artists
- Athletes
- And the catch-all: “Any trade or business where the principal asset is the reputation of skill of the owner.”

So for services businesses, if the taxpayer’s income is above \$415,000 for joint filers or \$207,500 for single filers, there is no QBI/Section 199A deduction.

**Non-Service Businesses:** Like service business owners, non-service businesses qualify for at least a partial 20% deduction if their taxable income is below \$415,000 for joint filers and \$207,500 for single filers. If their income is above these levels, they can still get a deduction, the amount of which is dependent on the level of wages paid to employees and depreciable assets used in the business.

**What About Rental Property Owners?** Most rental property owners should qualify for at least a partial QBI deduction (although it is unclear whether owners with “triple net leases” would qualify). The amount of the deduction will be dependent on the taxpayer’s taxable income:

- Below \$315,000 for joint filers or \$157,500 for single filers, the deduction will be 20% of the rental profit.
- Between \$315,000 and \$415,000 for joint filers or \$157,500 and \$207,500 for single filers, the deduction will be reduced.
- Above \$415,000 for joint filers or \$207,500 for single filers, the deduction will be the lesser of 20% of the rental profit or, assuming there are no W-2 wages paid for the rental business, 2.5% of the original purchase price of the depreciable long-term property (i.e. excluding land and assuming the property is not yet fully depreciated).



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- Income Tax Projections
- Tax Minimization Ideas
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## Other Comments:

- The 20% QBI deduction is available whether the taxpayer itemizes their deductions or takes the standard deduction.
- The calculation is done on an entity-by-entity basis. For example, an individual with two different rental properties must calculate the exclusions separately—their income can't be combined.
- These rules are in effect for the 2018 tax year, but are scheduled to end after 2025.