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NAVIGATING THE NEW PASS-THROUGH PROVISIONS: A TECHNICAL EXPLANATION

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The Tax Cuts and Jobs Act of 2017 allows owners of certain pass-through businesses (such as sole proprietorships, partnerships, and S corporations) to take a new deduction. However, the structure of the deduction is complicated[1] because its generosity depends on many factors, such as the nature of the business activity, the business owner's total taxable income, the wages paid by the business, and the value of business property.

Before explaining how the deduction works, it is helpful to lay out a few key definitions, all of which come from Congress in the Joint Explanatory Statement of the Committee of Conference for the legislation:[2]

- **Specified service trade or business:** any trade or business involving the performance of services in the fields of health, law, 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 one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities
- **Qualified trade or business:** any trade or business other than a specified service trade or business and other than the trade or business of being an employee
- **Qualified business income (QBI):** the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business of the taxpayer. Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. (That is, reasonable compensation and

[1] C. Eugene Steuerle, "The TCJA Will Create More Complexity for Taxpayers Than It Claims," *TaxVox* (blog), January 6, 2018, http://www.taxpolicycenter.org/taxvox/tcja-will-create-more-complexity-taxpayers-it-claims.

[2] US House of Representatives Committee on Rules, "Joint Explanatory Statement of the Committee of Conference," Conference Report to Accompany H.R. 1, December 18, 2017, http://docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf.

other costs have already been deducted from gross business income to determine QBI.) Similarly, QBI does not include any guaranteed payment for services rendered with respect to the trade or business

- **Qualified business property:** the unadjusted basis, immediately after acquisition, of tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year
- **W-2 wages:** the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer

The value of the deduction depends, among other things, on the taxpayers' total taxable income before any qualified business deduction. We refer to this as taxable income and note that it is essentially adjusted gross income minus deductions other than the pass-through deduction. The pass-through deduction subsequently reduces taxable income, but it does not affect adjusted gross income.

Let's start with the easy part. A pass-through owner whose total taxable income is less than $315,000 for married joint filers (or $157,500 for single filers) is eligible to receive a deduction equal to 20 percent of his or her QBI. For example, if a married couple filing jointly has taxable income of $150,000 including QBI of $75,000, the couple can deduct $15,000, or 20 percent of $75,000 (table 1). In this range of taxable income, a "qualified trade or business" and a "specified service and trade business" are treated no differently.

If taxable income reaches or exceeds $415,000 (for a married couple filing jointly, or half as much for single filers), an owner of a "specified service trade or business" receives no deduction for pass-through income (table 1).

In contrast, at that income level, for owners of qualified businesses, the 20 percent deduction is capped by the greater of either (a) 50 percent of W-2 wages or (b) 25 percent of wages plus 2.5 percent of qualified business property. Consider the following example: Mary and David are married, and David owns a qualified business, such as a woodworking shop. Their joint taxable income is $575,000, including $75,000 of QBI from the wood shop. David pays an assistant $20,000 in wages and has $90,000 in qualified business property. Item (a), 50 percent of W-2 wages, is $10,000. Item (b), 25 percent of wages plus 2.5 percent of qualified business property, is $7,250 (25 percent of $20,000 plus 2.5 percent of $90,000). The deduction is capped by the greater of (a) or (b), which in this case is (a), $10,000. Because the $10,000 cap is less than 20 percent of Mary and David's QBI ($15,000), their deduction is $10,000 (table 1).

If the taxpayers' taxable income is between $315,000 and $415,000, the calculations are trickier because the deduction phases out over this range. (The comparable phase-out range for single filers is $157,500 to $207,500.)

To illustrate how the deduction works within the phase-out range, imagine Mary and David now have joint taxable income of $400,000 and David is a part-time financial advisor (a "specified service trade or business") with QBI of $75,000. As in the previous example, he pays $20,000 in wages to employees and has qualified business property of $90,000.

If the couple were eligible for the simple 20 percent deduction, they could deduct $15,000 from their QBI (20 percent of $75,000), as they would do if their taxable income were less than $315,000. Because their taxable income is between $315,000 and $415,000, however, their deduction is reduced. QBI is phased out linearly over this $100,000 range. Because of the phase-out, only 15 percent (($415,000 – $400,000) / ($415,000 – $315,000)) of their QBI qualifies for the deduction. Thus, only $11,250 (15 percent of $75,000) qualifies for the deduction. If Mary and David applied no other adjustments, they would receive what could be called a gross deduction of $2,250 (20 percent of $11,250).

However, Mary and David may have to reduce their deduction further because the deduction is affected—albeit in a different way than in the other income groups—by the greater of either the applicable percentage of (a) 50 percent of W-2 wages or (b) 25 percent of wages plus 2.5 percent of qualified business property. Because only 15 percent of QBI qualifies for the pass-through deduction, Mary and David can only include 15 percent of wages or property in the respective calculations. Thus, the applicable amount of W-2 wages is $3,000 (15 percent of $20,000), and the applicable amount of qualified business property is $13,500 (15 percent of $90,000). In Mary and David’s case, item (a’) is now equal to $1,500 (50 percent of $3,000), and item (b’) is equal to $1,087.50 (25 percent of $3,000 plus 2.5 percent of $13,500).

However, the wage limit (related to item a’) is only gradually applied over the $315,000 to $415,000 income range. Because Mary and David’s joint taxable income is $400,000, or 85 percent (($400,000 – $315,000) / ($415,000 – $315,000)) of the way through the phase-out range, only 85 percent of the cap applies. Mary and David must reduce their deduction by 85 percent of the difference between the deduction amount without a cap ($2,250) and the deduction amount if the cap applied in full ($1,500), which in this case is $637.50 (0.85 × ($2,250 – $1,500)). The result is subtracted from the original $2,250, and in this example, Mary and David’s allowable deduction is $1,612.50 (table 1).

If, on the other hand, the gross deduction were less than the deduction cap, Mary and David’s deduction would equal the gross deduction.

Now let’s repeat that example, where their taxable income is in the phase-out range between $315,000 and $415,000, but this time assume David owns a qualified business, such as the woodworking shop in the first example. All of the income, wage, and property values are the same as before, but the deduction is calculated using a different procedure. Unlike with specified service businesses, QBI, W-2 wages, and business property do not phase-out for qualified businesses. Thus, QBI is $75,000, and the gross deduction, before applying any wage or wage-and-capital limit, is $15,000 (20 percent of $75,000).

Because Mary and David’s taxable income is $400,000, their deduction is again partially capped by the greater of either (a) 50 percent of W-2 wages or (b) 25 percent of W-2 wages plus 2.5 percent of qualified business property. Similar to the previous example, the greater of (a) and (b) is (a), at $10,000 (50 percent of $20,000). Thus, Mary and David are not eligible for the full $15,000 deduction (because $10,000 is less than $15,000). However, the wage limit is gradually applied over the income range. Because Mary and David’s joint taxable income is $400,000, or 85 percent of the way through the phase-out range, only 85 percent of the cap applies (($400,000 – $315,000) / ($415,000 – $315,000)).

To calculate the deduction, apply the 85 percent share to the difference between the $15,000 gross deduction amount without a cap and the $10,000 deduction amount if the cap applied in full ($4,250, or 0.85 × ($15,000 – $10,000)). The result is subtracted from the original $15,000 to determine Mary and David’s allowable deduction. Following that procedure, their deduction is $10,750 ($15,000 – $4,250; table 1).

TABLE 1

Example Deductions for Pass-Through Owners

Specified Service Businesses			
	Joint Taxable Income		
	$150,000	$400,000	$575,000
QBI before Limit	$75,000.00	$75,000.00	$75,000.00
Subject to QBI Limit?	No	Partial	Yes
QBI after Limit	$75,000.00	$11,250.00	$0.00
Deduction before Wage Limit	$15,000.00	$2,250.00	$0.00
Wages	$20,000.00	$20,000.00	$20,000.00
Wage Limit if Fully Applied	N/A	$1,500.00	N/A
Reduction Amount from Gross Deduction	N/A	$637.50	N/A
Adjusted Wage Limit	N/A	$1,612.50	N/A
Allowable Deduction	**$15,000.00**	**$1,612.50**	**$0.00**

All Other Pass-Through Businesses			
	Joint Taxable Income		
	$150,000	$400,000	$575,000
QBI before Limit	$75,000.00	$75,000.00	$75,000.00
Subject to QBI Limit?	No	No	No
QBI after Limit	$75,000.00	$75,000.00	$75,000.00
Deduction before Wage Limit	$15,000.00	$15,000.00	$15,000.00
Wages	$20,000.00	$20,000.00	$20,000.00
Wage Limit if Fully Applied	N/A	$10,000.00	$10,000.00
Reduction Amount from Gross Deduction	N/A	$4,250.00	N/A
Adjusted Wage Limit	N/A	$10,750.00	N/A
Allowable Deduction	**$15,000.00**	**$10,750.00**	**$10,000.00**

Source: Author calculations.

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