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RESPONSIVE SOLUTIONS

The Pass-Through Deductions: Five Misconceptions

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The Tax Cut and Jobs Act was passed in late 2017, but most of the key provisions did not go into effect until 2018. Given that fact, the impact of the Act's most significant parts is only now being fully realized as most individuals and businesses run up against their 2018 filing deadlines.

One of the most widely recognized but least-understood portions of the Act continues to be the Section 199A "pass-through deduction." As tax returns for last year are being finalized, there is no doubt the actual dollar impact of the pass-through deduction has generated some surprises. The complexity of the deduction, coupled with the fact that the Treasury Department did not release final guidance on how to apply it to real-world situations until late January, has all but guaranteed a chaotic finish for the 2018 tax filing season.

CONSIDER THESE TOP FIVE PASS-THROUGH DEDUCTION MISCONCEPTIONS.

1. "I'm Going to Get a Big Fat 20 Percent Deduction!"

The pass-through deduction can provide a deduction equal to 20 percent of a taxpayer's total "qualified business income." But the deduction is taken against net income, as opposed to typical deductions, which reduce gross income. So if a qualifying business generates $1 million in gross receipts but only $10,000 in net profit, its owner is eligible for a $2,000 deduction. The pass-through deduction may be further reduced if the underlying trade or business performs certain types of services or does not pay any salaries, or the owner has other losses. With all these limitations, many taxpayers are unlikely to be eligible for the full 20 percent deduction advertised.

2. "The Pass-Through Deduction Is a Deduction."

The pass-through deduction is computed by figuring the net business income from all qualifying trades or businesses owned by the taxpayer and then aggregating the totals. Although the pass-through deduction is nominally a deduction from income, it's more helpful to understand the possible benefit by conceptualizing it as a form of rate relief on business income. In this sense, the pass-through deduction should be viewed as something akin to the lower rate on long-term capital gains.

3. "The Pass-Through Deduction Isn't Available for Service Trades or Businesses."

It is commonly believed that the pass-through deduction is not available to reduce business income derived from performing personal services, like the practice of law, medicine, or accounting. But this is only half true. The "specified service trades or businesses" limitation applies if, and only if, the underlying taxpayer also reports total net income over a certain threshold. The threshold for married-filing-jointly taxpayers is currently $315,000. So, assuming a married physician reports $250,000 in practice earnings and reports no other income, no limitation applies.

4. "My Client Is Performing Personal Services for Clients. He or She Must Not Qualify."

Even when a taxpayer is reporting income over the income threshold, it is incorrect to say that service businesses will not qualify for the pass-through deduction. The limitation applies only to specified service trades or businesses. Whether a service business is specified depends on the technical language in the law and Treasury interpretations, not any sort of rule of thumb.

5. "The Pass-Through Deduction Treats All Taxpayers Equally."

What is probably least understood about the pass-through deduction is that most of the limitations are computed at the individual taxpayer level. This fact makes it difficult to predict who will receive relief.

For example, assume Lawyer 1 and Lawyer 2 each own half of a successful law firm generating $200,000 in qualified business income during the year. Lawyer 2 is independently wealthy and has $500,000 of extra income from investments. On these facts, Lawyer 1 is eligible for a $20,000 pass-through deduction, whereas Lawyer 2's deduction is $0.

IN CLOSING

The takeaways are clear: The pass-through deduction is complicated, and estimating the potential benefits can be challenging, even for an experienced tax professional. On the other hand, commonly held misconceptions may actually present opportunities for CPAs, as the Treasury Department has indicated it will permit taxpayers to file refund claims that are based on pass-through deductions. In any event, this will be a challenging area of focus for many tax professionals through at least the end of 2025. **FT**

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