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Ken Berry • Jan. 08, 2018

The new tax law – the Tax Cuts and Jobs Act (TCJA) – creates numerous tax-saving opportunities for businesses of all shapes and sizes. Notably, the new law carves out a brand-new tax deduction for owners of pass-through entities, including partners in partnerships, shareholders in S corporations, members of limited liability companies (LLCs) and sole proprietors.

But this new tax break is so complex even tax experts are befuddled by it. Here are the essentials for you to pass along to your small business clients.

For starters, owners of pass-through entities are effectively taxed on earnings at individual tax rates, similar to the way corporate owners are taxed on wages. Under the TCJA, tax rates for individuals are generally lowered over seven brackets, featuring a top tax rate of 37%. In contrast, C corporations will be taxed at a flat rate of 21%, which might be considerably lower than a business owner's individual rate.

To balance things out, lawmakers have provided a deduction of up to 20% for pass-through entities on “qualified business income” (QBI), subject to certain limits and restrictions. QBI is generally defined as net income from your business without counting amounts in the nature of compensation, in addition to excluding any investment income from the pass-through entity. Note that QBI is figured separately for each business activity rather than on a per-taxpayer basis.

But there are two main hurdles for claiming the full 20% deduction. The deduction may be reduced or even eliminated under a test for “specified service businesses” and a “wage and capital” limit.

1. Specified service businesses: This includes virtually every occupation that

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for use in your business). This limit is phased in pro-rata based on the same income thresholds as the ones stated above for personal service businesses. Once you exceed the upper threshold, the phase-in of the limit is complete.

In other words, taxpayers who have income below the lower income threshold have no worries at all. They are entitled to the full deduction. However, individuals in certain service professions that are traditionally high-paid, such as physicians and attorneys, may not qualify for any deduction. The deduction for taxpayers in other businesses can vary widely.

Sound confusing? It is. In any event, no matter how the phase-in rule is applied, the deduction can't exceed your taxable income for the year (reduced by net capital gain). If the net amount of your QBI is a loss, you can carry it forward to the next tax year.

Obviously, the rules are designed to curb abuses, such as having business owners who do substantial work artificially reclassifying wages as QBI eligible for the deduction. Nevertheless, taxpayers may be tempted to establish themselves as independent contractors, further increasing the number of conflicts with the IRS on this issue. Independent contractor status has already been a point of contention in recent years.

For taxpayers who take this approach, or are already treated as independent contractors, the main objective will be to stay below the income thresholds that will allow a deduction. For instance, even if work is characterized as consulting, it is likely to be subject to the specified service business test. And since this test includes all taxable income – including capital gains from securities sales – it may be difficult for certain high-income taxpayers to qualify.

These are just the basics on this complex new deduction. It is expected that the IRS

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