How are pass-through businesses taxed?

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A. Pass-through businesses are not subject to an entity-level tax; instead, profits flow through to owners and are taxed under the individual income tax. Some pass-through income is eligible for a 20 percent deduction through 2025.

Pass-through income is only subject to a single layer of income tax and is generally taxed as ordinary income up to the maximum 37 percent rate. However, certain pass-through income is eligible for a 20 percent deduction, which reduces the top tax rate to a maximum of 29.6 percent. (Payroll and/or net investment income taxes may also apply.) Pass-through businesses generally face the same tax rules as C-corporations for inventory accounting, depreciation, and other provisions affecting the measurement of business profits.

20 PERCENT PASS-THROUGH DEDUCTION

The 2017 Tax Cuts and Jobs Act (TCJA) created a new 20 percent deduction for certain pass-through income through 2025, after which the measure is scheduled to expire. The so-called 199A (named for the relevant IRS code section) or “qualified business income” deduction effectively reduces the top marginal tax rate on qualifying pass-through income from the top ordinary rate of 37 percent to 29.6. This tax expenditure will reduce federal revenues by between $50 billion and $60 billion a year, according to the Joint Committee on Taxation.

The 199A deduction is subject to several restrictions and exceptions (Gale and Krupkin, 2018). For single filers with taxable income above $157,500 and joint filers with taxable income above $315,000, the pass-through deduction is potentially subject to two limitations:

Specified service limitation. Income earned by certain “specified service” businesses is excluded from the definition of qualified business income and therefore receives a reduced deduction or no deduction. Specified service activities include “any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade of business is the reputation or skill of one or more of its employers or owners.” The qualifying income is phased out for singles with taxable income between $157,500 and $207,500 (between $315,000 and $415,000 for joint filers).

Wage/asset limitation. The 20 percent deduction may also be limited based on the wages and/or depreciable asset of the associated business. Specifically, the deduction is limited to the greater of 50 percent of W-2 wages paid or 25 percent of W-2 wages paid plus 2.5 percent of the acquisition cost of qualifying depreciable property. That limitation is phased-in over the same income range as the specified
service limitation.

Updated May 2020

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