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Pass-through Deduction for Qualified Income from the Pharmacy

The last time major tax reform was signed into law I was a one year old baby in 1986. But sure enough The Tax Cuts and Jobs Act is finally here after all these years and it's quite a change. One of the bigger changes in the bill for most pharmacy owners is the 20% deduction for pass-through income from pharmacies. If your pharmacy is a sole proprietor, partnership, LLC or S Corporation – which most pharmacies are structured – you may qualify for this substantial deduction.

Prior to tax reform and for 2017, any income from a pass-through entity as listed above was (and still is) reported on the personal tax return of the individual owner. There was not a deduction for this income on your tax return and it was taxed at individual tax rates which were as high as 39.6%! With The Tax Cuts and Jobs Act now passed, the net income from the pharmacy will still flow to the individual on their personal tax return but there will now be a potential deduction for the qualified net income from the pharmacy thus lowering your overall tax. The simple goal behind this deduction – other than reinvestment and jobs – is to lower the tax rate for pass-through income to more closely align with the tax cut for Corporations which was lowered under this bill from 35% to 21%.

The deduction is equal to 20% of domestic "qualified business income" or QBI from the pass-through entity. Net income from the pharmacy is considered qualified business income. Easy enough right? Not so fast, if the taxpayer's taxable income on their personal tax return is between $315,000 and $415,000 for married filing jointly or $157,500 and $207,500 for single filers, then your deduction will be reduced.

To make things even more complicated, if the taxpayer's taxable income is higher than $415,000 for married filing jointly or $207,500 for single then a new set of calculations come into play to determine your deduction. In this case the deduction will be the *lessor* of (1) 20% of your QBI or (2) the greater of (a) 50% of all W-2 wages of the pharmacy or (b) 25% of all W-2 wages of the pharmacy *plus* 2.5% of unadjusted basis in property.

Finally, the next step is to determine if there are any more limitations to your deduction. The deduction you have calculated above cannot exceed the *lessor* of (1) your combined QBI amount (from several pharmacies or qualifying businesses) or (2) 20% of your total taxable income minus capital gains.

Let's try and put this all together with an example.

> Bob is a married filing joint taxpayer with taxable income of $475,000. Both he and his wife are pharmacists. His pharmacy ABC Pharmacy, Inc. is an S Corporation and he is the 100% owner. ABC Pharmacy, Inc. is an average size pharmacy in terms of revenue, wages and bottom line net income. The pharmacy revenues are $3.5 million, W-2 wages are 11% of pharmacy revenue or $385,000 ($3.5 million X 11%). The pharmacy bottom line net income or QBI is 5% or $175,000 ($3.5 million X 5%). Bob has bought a $30,000 script system which is shown on the pharmacy fixed asset schedule.
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> Since Bob's taxable income is above the threshold of $415,000 mentioned above, his deduction will be limited. His deduction will be the lesser of (1) 20% of qualified business income $35,000 (20% X $175,000) or (2) the greater of (a) 50% of W-2 wages $192,500 (50% X $385,000) or (b) the sum of 25% W-2 wages $96,250 (25% X $385,000) plus 2.5% of basis of acquired property before depreciation $750 (2.5% X $30,000) for a total sum of $97,000 ($96,250 + $750).
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> As we can see, Bob's deduction at this point is $35,000 which is the lessor of (1) QBI multiplied by 20% or (2) greater of (a) 50% of W-2 wages or (b) 25% of W-2 wages plus 2.5% of unadjusted basis in acquired property. This $35,000 deduction cannot exceed the lessor of (1) his combined QBI amount or (2) 20% of total taxable income minus capital gains. Assuming Bob's only QBI amount is $175,000 from the pharmacy, let's also assume Bob has no capital gains which would mean 20% of taxable income would be $95,000 ($475,000 X 20%). Clearly his 20% of QBI of $35,000 is the lessor of $175,000 and $95,000 and therefore Bob claims this amount as his QBI deduction.

The Tax Cuts and Jobs Act made some monumental changes to the tax code and this complex provision is no exception. The average pharmacy owner should be able to take advantage of this valuable opportunity especially as margins get tighter and cash gets squeezed. However, the limitations and the exceptions to this QBI deduction are vast and much more indepth than we touched on here so take caution and consult with your CPA! Stay tuned for more updates from Sykes & Company, P.A. as we pick apart tax reform and what it means to you the pharmacy owner!

Scotty Sykes, CPA, CGMA
252-632-0026
scotty@sykes-cpa.com