Income Tax Challenges for Subcontractors in 2024-2025

2024 and 2025 present unique challenges and uncertainties, primarily due to the looming expiration of several key provisions of the Tax Cuts and Jobs Act (TCJA) of 2017. This article delves into the most significant income tax changes that subcontractors need to be aware of and prepare for in the coming years.

The 20% Qualified Business Income Deduction Sunset

The most significant concern for subcontractors is the scheduled expiration of the 20% Qualified Business Income Deduction, AKA the Section 199A deduction, at the end of 2025. This deduction has been significant for pass-through entities, including sole proprietorships, partnerships, and S corporations, allowing them to deduct up to 20% of their qualified business income from federal income taxes. The potential loss of this deduction looms large, as it could result in a substantial tax increase for most subcontractors starting in 2026.

The impact of this change cannot be overstated. This deduction has provided crucial financial breathing room for many businesses, allowing for reinvestment in growth, hiring, and operational improvements.

Individual Income Tax Rate Adjustments

The TCJA implemented reductions in all individual income tax rates. These rates will revert to pre-2017 levels if the law expires as scheduled. This tax increase could be significant for subcontractors who pay taxes on their business income through their individual returns.

This shift in tax rates will require careful planning and potentially new strategies for income timing and business structure. Subcontractors may need to reconsider how they compensate themselves and structure their business to optimize their tax situation under the new rates.

Standard Deduction and Personal Exemption Flip-Flop

One of the most talked-about changes implemented by the TCJA was the near-doubling of the standard deduction and the elimination of personal exemptions. If these provisions expire, we'll see a reversal of this arrangement. The standard deduction for married couples filing jointly is to decrease from a projected $30,725 to $16,525 in 2026, while the personal exemption (estimated at about $5,275 per person) will be reinstated.

This change could have varied impacts on small business owners, depending on their family size and typical deduction strategy. Some may find themselves better off, while others might see an increase in their taxable income. It will be crucial for subcontractors to reassess their tax planning approach in light of these changes.

There are other potential tax increases for business owners, including reducing the child tax credit and potentially increasing exposure to the bewildering alternative minimum tax.

SALT Limitation expires

The ability to deduct state and local income taxes on individual income tax returns was limited to $10,000 under the TCJA. This limitation is set to expire after 2025, potentially giving taxpayers, especially in states with higher tax rates, a larger deduction.

Preparing for the Future

As these potential changes loom on the horizon, subcontractors must take proactive steps to prepare:

1. Consider accelerating income or deferring deductions in anticipation of higher tax rates in 2026.

2. Stay informed about legislative developments, as Congress may act to extend some or all of these provisions.

3. Engage in scenario planning to understand how different outcomes might affect your business and personal finances.

4. Review your business structure to ensure it remains optimal under the new tax landscape.

5. Invest in professional tax advice to navigate these complex changes and identify strategies to mitigate their impact.

2024 and 2025 will be critical for subcontractors as they prepare for potential significant shifts in the tax landscape. Subcontractors can position themselves to weather these changes by staying informed and planning ahead.