Federal Tax Client Alert
Pass-Through Deduction under the Tax Cuts and Jobs Act

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On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Act") into law, which provides for the most significant changes to the Internal Revenue Code ("IRC") in more than 30 years. This alert attempts to explain one aspect of these significant changes at a high level—the 20% deduction available for certain owners of pass-through entities under new IRC § 199A.

1. Background

As background, for tax purposes there are essentially four choices for the form and tax classification of a business:

- sole proprietorship,
- partnership,
- C corporation, and
- S corporation.

Note that this includes limited liability companies, or LLCs, which can be taxed as any of the above depending on the number of owners and tax classification election made under the "check-the-box" rules.[1]

A *sole proprietor* generally is someone who owns an unincorporated business by himself or herself. A single member LLC may be treated as a sole proprietorship for federal tax purposes. A sole proprietor generally reports the profit and loss and associated federal income tax on his or her individual tax return.

For federal tax purposes, a *partnership* must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return.

For federal tax purposes, a *C corporation* is a separate taxpaying entity, meaning that it pays tax on its income. C corporation shareholders are also taxed when the C corporation distributes its

[1] An LLC with one member is taxed by default as a disregarded entity, or sole proprietorship. It can also elect to be taxed as a C corporation or S corporation. An LLC with more than one member is taxed by default as a partnership. It can also elect to be taxed as a C corporation or S corporation.

profits to them. In other words, there are two levels of taxation with a C corporation: once at the entity level, and once at the shareholder level.

S corporations are corporations that are authorized to elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes without separately paying taxes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.

There are many differences with the tax treatment of pass-through entities classified as sole proprietorships, partnerships, and S corporations. However, they all provide for a single level of taxation at the owner level. By contrast, there are two levels of taxation with C corporations, as explained above.

Under the Act, the corporate income tax rate is reduced from a top rate of 35% to a flat rate of 21%, effective for tax years beginning after December 31, 2017. Without an adjustment to the taxation of pass-through entities, the corporate rate reduction would dramatically reduce the benefit of the single level of tax offered by pass-through entities. Congress recognized this by enacting the § 199A deduction that is available to certain owners of pass-through entities. This in theory is intended to help owners of pass-through entities retain their federal income tax rate advantage over C corporations.[2] However, because of the specific requirements and limits on the deduction in § 199A, not all owners of pass-through entities will qualify for the full deduction, and some owners will not benefit from the deduction at all.

The 20% pass-through entity deduction under § 199A is very complex, and this memorandum only attempts to provide a high-level overview. Because § 199A is a brand-new addition to the federal tax law, the IRS has not issued any guidance on it as of the date of this memorandum. Based on initial review of the Act, the terms of § 199A, and the conference committee report published by Congress, the following is written to generally describe what appears to be how the new deduction works.

2. <u>Overview</u>

The § 199A deduction is generally available for owners of entities other than corporations (i.e., sole proprietorships, partnerships, S corporations, and LLCs not taxed as C corporations). It applies for tax years beginning after December 31, 2017, and it is currently set to expire on December 31, 2025. The deduction has been described as a "between-the-line" deduction, meaning individual taxpayers will take the deduction after computing adjusted gross income, or AGI, and they will not need to itemize deductions on their individual tax returns in order to claim the deduction. Taxpayers who take the increased standard deduction enacted under the Act will

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[2] Under the Act , the top effective tax rate on C corporation shareholders is up to 39.8%, which is the sum of the new 21% corporate income tax rate + the 79% after-tax corporate income multiplied by the sum of the top 20% rate on qualified dividends + the 3.8% net investment income tax rate. Without § 199A, the tax rate on owners of pass-through entities runs up to the top 37% individual income tax rate, meaning that the corporate tax rate reduction would have severely limited the rate benefit for owners of pass-through entities. However, with § 199A—assuming an owner can take the full benefit of the deduction—the effective rate for an owner of a pass-through entity is reduced from the top rate of 37% to 29.6%, which equals 80% of the top 37% individual income tax rate.

be able to use the § 199A deduction, just as those who itemize their deductions will be able to use the § 199A deduction. The deduction is only allowed for federal income tax purposes.

The deduction is generally equal to 20% of the business income passed through to the owner of a pass-through entity. However, the actual calculation of the deduction is much more complicated, and the deduction is limited in a number of ways. Certain owners will not be able to benefit from the deduction depending on the type of business in which the pass-through entity is engaged, as well as the amount of the owner's taxable income.

Section199A(a) provides that the deduction is equal to the sum of:

(1) The lesser of—
  a. The combined qualified business income of the taxpayer, or
  b. 20% of the excess of
    i. The taxable income of the taxpayer for the taxable year, minus
    ii. the sum of any net capital gain, plus the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year,

Plus

(2) The lesser of—
  a. 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or
  b. Taxable income of the taxpayer for the taxable year, minus net capital gain.

Finally, the deduction amount cannot exceed a taxpayer's taxable income for the taxable year, reduced by net capital gain.

Although the total deduction allowed under § 199A depends on several additional factors, the discussion and explanation in this memorandum will focus primarily on the part of the deduction that is available for the combined qualified business income of the taxpayer, which is the thrust of § 199A. The explanation that follows will include the necessary defined terms and provide illustrating examples.

3. Defined Terms

An understanding of the deduction for combined qualified business income under § 199A requires consideration of a number of specifically defined terms in § 199A. These terms include:

Combined Qualified Business Income. For any taxable year, this means an amount equal to the ***sum of***—

(1) The ***lesser of***—
  a. 20% of the taxpayer's qualified business income with respect to the qualified trade or business, ***or***
  b. The ***greater of***—
    i. 50% of the W-2 wages with respect to the qualified trade or business, ***or***

ii. The ***sum of*** 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property,[3]

Plus

(2) 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

Section 199A provides that combined qualified business income means the sum of the deductible amounts determined by the above method for each qualified trade or business carried on by the taxpayer.

Qualified Business Income ("QBI"). For any taxable year, this essentially means the net income of the business. However, it specifically does not include any wages or guaranteed payments received by an owner from the business, nor does it include "investment income" of the pass-through entity, which includes its short-term capital gains or losses, long-term capital gains or losses, dividend income, and interest income.

W-2 Wages. This means wages paid to an employee, including certain elective deferrals. To be considered W-2 wages, a payment must be included on a payroll tax return. For purposes of the limitation on the deduction based on W-2 wages, a partner or S corporation shareholder's share of W-2 wages is equal to the partner or shareholder's allocable share of the entity's wage expense deduction.

Qualified Property. This means tangible, depreciable property, held by and available for use in the qualified trade or business at the close of the taxable year, used to produce QBI at some point during the taxable year, and for which the depreciable period has not ended before the close of the taxable year. For purposes of this definition, the depreciable period is the later of: (1) 10 years after the taxpayer first placed the property in service, and (2) the last day of the last full year of the property's regular depreciable period. For purposes of the limitation on the deduction based on basis of qualified property, a partner or S corporation shareholder's share of the unadjusted basis is equal to the partner or shareholder's allocable share of the entity's depreciation expense for the property.

Threshold Amount. This means the amount above which both a phase-in of the limitation based on the W-2 wages paid by the entity and/or the unadjusted basis of the entity's qualified property applies to limit the deduction (the "W-2/Basis Limitation"), as well as a phase-out of the deduction applies to owners of specified service trades or businesses. The threshold amount is designed to limit and/or disallow the deduction for upper-income individual taxpayers. For 2018, the threshold amount is $315,000 of taxable income for married taxpayers filing jointly, and $157,500 of taxable income for all other taxpayers. These amounts are indexed for inflation.

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[3] Because the definition is restricted to the *lesser* of: (a) the amount attributable to qualified business income, or (b) the amount attributable to the W-2 wages paid and/or basis of qualified property, the amount attributable to the W-2 wages paid and/or basis of qualified property acts as a limitation on the amount of the available deduction. This is further explained below, and the limitation is referred to as the "W-2/Basis Limitation."

Qualified Trade or Business. This is any trade or business, other than a specified service trade or business, or the trade or business of performing services as an employee.

Specified Service Trade or Business. This is any business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners, and any trade or business involving the performance of services consisting of investing, investment management, trading, or dealing in securities, partnership interests or commodities.

Qualified REIT Dividends. This is any dividend from a real estate investment trust that is not taxed as capital gain or a qualified dividend (which is also taxed at favorable capital gain rates).

Qualified Publicly Traded Partnership Income. This is the net amount of a taxpayer's allocable share of QBI from a publicly traded partnership, plus any gain on the sale of a publicly traded partnership that is taxed as ordinary income.

These definitions are designed to make the deduction available to pass-through entity owners of active, "main street" trades or businesses, other than service businesses, and to limit or disallow the deduction for service businesses and upper-income taxpayers.

4. Examples

The examples below are intended to illustrate how the deduction and the § 199A definitions work when applied to different facts and circumstances, including pass-through entities that are engaged in trades or businesses that are *not* "specified service trades or businesses" (e.g., manufacturing or sales of goods), and others that *are* "specified service trades or businesses" (e.g., law firms or CPA accounting firms), as well as pass-through entities whose owners are upper-income individuals affected by the income threshold limitation on allowance of the deduction.

Example 1. Non-Specified Service Business with Taxable Income Below Threshold Amount.

John and Suzy are married and file a joint return reporting taxable income of $250,000. John owns a 50% membership interest in an LLC taxed as a partnership that has QBI of $400,000, paid a total of $50,000 of W-2 wages and has no qualified property. John is allocated 50% of all items of the LLC. John and Suzy do not have any qualified REIT dividends or qualified publicly traded partnership income.

Because taxable income is below the $315,000 threshold amount, the W-2/Basis Limitation does not apply, and John and Suzy are entitled to the full 20% deduction for $200,000 of QBI, which represents John's share of the LLC's QBI. John and Suzy can take a $40,000 (20% x $200,000) deduction on their return.

Example 2. Non-Specified Service Business with Taxable Income Exceeding Phase-In Range.

Same as example 1, except John and Suzy's taxable income equals $510,000.

The full 20% deduction would be $40,000 (20% x $200,000). However, it is necessary to determine the effect of taxable income exceeding the threshold amount of $315,000. The W-2/Basis Limitation is phased in over a $100,000 range for married taxpayers filing jointly (and $50,000 for all others). In this example, total taxable income exceeds the threshold amount plus the $100,000 phase-in, meaning the W-2/Basis Limitation fully applies to limit the amount of the deduction.

The deduction is thus calculated as follows:

The lesser of—
    20% of share of QBI (20% x $200,000 = $40,000), or
The greater of—
    50% of share of W-2 wages (50% x $25,000 = $12,500), or
    The sum of 25% of share of W-2 wages, plus 2.5% of the unadjusted basis of qualified property ((25% x $25,000 = $6,250) + 0 = $6,250).

Thus, John and Suzy can take a $12,500 deduction on their return.

Example 3. Non-Specified Service Business with Taxable Income in Phase-In Range.

Same as example 1, except John and Suzy's taxable income equals $360,000.

As shown in example 1, the full 20% deduction would be $40,000 (20% x $200,000 share of QBI). However, taxable income exceeds the threshold amount by $45,000 ($360,000 taxable income - $315,000 threshold amount).

As shown in example 2, if the full W-2/Basis Limitation applied, the deduction would be limited to $12,500. However, taxable income does not exceed $415,000, which is the sum of the $315,000 threshold amount plus the $100,000 phase-in of the W-2/Basis Limitation.

Therefore, it is necessary to calculate the percentage by which the W-2/Basis Limitation has phased in. This is equal to 45% ($45,000 excess taxable income over threshold amount / $100,000 phase-in). In other words, John and Suzy should lose 45% of the difference between the full deduction of $40,000 and the fully limited deduction of $12,500, or 45% x ($40,000 - $12,500) = $12,375. Thus, John and Suzy can take a $27,625 deduction on their return.

Example 4. Non-Specified Service Business with Qualified Property and Taxable Income in Phase-In Range.

Same as example 2, except now the LLC owns qualified property with an unadjusted basis of $1,000,000.

As in example 2, total taxable income exceeds the $315,000 threshold amount plus the $100,000 phase-in, meaning the W-2/Basis Limitation fully applies to limit the amount of the deduction. The difference with this example is that the LLC now owns qualified property.

The deduction is thus calculated as follows:

> The lesser of—
>
> > 20% of share of QBI (20% x $200,000 = $40,000), or
>
> The greater of—
>
> > 50% of share of W-2 wages (50% x $25,000 = $12,500), or
> > The sum of 25% of share of W-2 wages, plus 2.5% of the share of unadjusted basis of qualified property ((25% x $25,000 = $6,250) + ($500,000 x 2.5% = $12,500) = $6,250 + $12,500 = $18,750).

Thus, John and Suzy can take a $18,750 deduction on their return

Example 5. Specified Service Business with Taxable Income Below Threshold Amount.

Same as example 1, except now the LLC is conducting a specified service business. Because total taxable income of $250,000 is below the $315,000 threshold amount, despite the LLC being engaged in a specified service business, John and Suzy can take the full 20% deduction, or $40,000.

Example 6. Specified Service Business with Taxable Income Above Phase-Out Range.

Same as example 2, except now the LLC is conducting a specified service business. For specified service businesses, the deduction is phased out for those with taxable income above the threshold amount. The phase-out is calculated over a $100,000 range (for married taxpayers filing jointly; $50,000 for all others).

Therefore, because taxable income of $510,000 exceeds $415,000, which is the $315,000 threshold amount plus the $100,000 phase-out, John and Suzy are not entitled to a deduction on their return.

Example 7. Specified Service Business with Taxable Income in Phase-Out Range.

Same as example 3, except now the LLC is conducting a specified service business. Taxable income equals $360,000, meaning it exceeds the $315,000 threshold amount but does not exceed $415,000, which is the $315,000 threshold amount plus the $100,000 phase-out.

Accordingly, it is necessary to calculate the "applicable percentage," which is the percentage by which John and Suzy should still benefit from the deduction even though taxable income is in the phase-out range. Taxable income exceeds the threshold amount by $45,000 ($360,000 - $315,000). The applicable percentage thus equals 55% (1 – ($45,000 / $100,000 phase-out range)).

The applicable percentage is then applied to reduce the amounts used to calculate the deduction. The tentative phased-out deduction is thus calculated as follows:

The lesser of—

20% of share of QBI x the applicable percentage (20% x ($200,000 x 55%) = $22,000), or

The greater of—

50% of share of W-2 wages x the applicable percentage (50% x ($25,000 x 55%) = $6,875), or

The sum of 25% of share of W-2 wages x the applicable percentage, plus 2.5% of the unadjusted basis of qualified property x the applicable percentage (25% x ($25,000 x 55%) = $3,437.50) + (2.5% x (0 x 55%) = $3,437.50 + 0 = $3,437.50).

The tentative deduction is thus $6,875. However, the W-2/Basis Limitation is also phased in over the same $100,000 range that the deduction is phased out for owners of specified service businesses. In other words, the W-2/Basis Limitation does not fully apply in this example because taxable income does not exceed $415,000 (the $315,000 threshold amount plus the $100,000 phase-in).

Therefore, it is necessary to calculate the phase-in of the W-2/Basis Limitation to determine the final deduction allowed. The difference between the full deduction amount of $22,000 and the fully limited deduction amount of $6,875 equals $15,125. As seen before, John and Suzy should lose 45% of the excess deduction, or $6,806.25. Therefore, the final deduction that John and Suzy should receive is $15,193.75 ($22,000 - $6,806.25).

5. **<u>Conclusion</u>**

The new 20% deduction under § 199A was enacted to provide advantageous tax reform for "main street" business owners in the U.S., increase investment and job creation and retain the federal income tax rate advantage that owners of pass-through entities have historically enjoyed when compared to C corporations and their shareholders. However, § 199A is very complex, and not all individual taxpayers that own interests in pass-through entities will benefit from the new § 199A deduction.

The § 199A deduction may present planning opportunities for pass-through businesses and owners who may be able to rearrange or modify the nature and extent of their business activities, income and deductions. As with the basic calculation and claiming of the deduction, implementing a plan to take full advantage of the deduction will require a sound working knowledge of the deduction, while remembering that the deduction will only be available through the end of 2025 without further action by Congress.

Because of the complexity of § 199A and its special controlling definitions, it is recommended that pass-through businesses and their owners obtain legal advice as to how the convoluted requirements and limitations apply to a given set of facts so that the deduction may be claimed correctly and most advantageously.

Additional information regarding the new tax law is available at www.gablelaw.com. If you have questions or would like to discuss the new federal tax law generally or how this law may affect you, please contact a GableGotwals attorney, including an attorney in the Firm's Tax Law Practice Group.

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