Federal Tax Client Alert

Tax Cuts and Jobs Act: New Pass-Through Entity Deduction

Great tax break if you can get it!

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This memorandum summarizes perhaps the most important change in federal tax law made under the Tax Cuts and Jobs Act ("Act") that may provide substantial income tax savings to individuals who own businesses in the United States.

The Act, as approved by Congress and signed by the President on December 22, 2017, includes a fundamental and very favorable change in the taxation of "pass-through entity" owners.

Tax Cuts and Jobs Act Change. The Act includes a new Section 199A of the Internal Revenue Code ("§199A") that provides an *additional income based 20% deduction* for an individual taxpayer's share of business income of pass-through entities, subject, however, to specific requirements and some stringent limitations discussed below.

As background, federal tax law generally provides that a business classified for tax purposes as a partnership or an S corporation must file an annual information return to report the income, deductions, gains and losses of the business, but do not pay income tax. Instead, they pass through any profits or losses to the owners (partners or shareholders), and each owner includes his or her share of the business income or loss on his or her individual tax return. This pass-through treatment can apply for businesses operated by individuals as sole proprietorships. Businesses organized as limited liability companies (LLCs) can be classified and taxed as partnerships, S corporations or sole proprietorships. The Act in §199A adds a new and *additional deduction* to be allowed for pass-through entity owners that will reduce the amount of the entity's net income passed through to them.

Allowance of the Deduction. Under the Act the new and additional 20% pass-through entity deduction is allowed for a limited period of tax years beginning after December 31, 2017, and expiring on December 31, 2025. Taxpayers that qualify for the deduction will claim it on their individual tax returns after computing adjusted gross income. Individuals will not need to itemize deductions on their returns to claim the new pass-through income deduction.

Purposes and Congressional Policy on Deduction. A description of the Act published by Congress says the new pass-through income deduction is intended to give new tax relief and an incentive for investment and job creation to "*Main Street job creators*," but the Act also establishes "*safeguards*" intended to prevent what Congress considers upper-income individual taxpayers from having a lower than otherwise required tax rate apply to their pass-through income and other

investment income. These safeguards include specific requirements and limitations as to allowance of the deduction. In other words, the deduction will not generally be allowed to all owners of pass-through entities in the same way.

Requirements, Limitations of Deduction; Complex, But Worth It. Thus, while the new additional pass-through income deduction provided by §199A is a very favorable federal tax change to pass-through entity owners, it also includes a set of built-in limits on the extent to which the deduction is allowed. As a result, the calculation of the allowable amount of the deduction for a given taxpayer will likely often be very complex. The deduction will provide *substantial tax savings* for individual owners of the kinds of businesses Congress intended to benefit over the next eight years. For other individual business owners, it may have limited or perhaps no favorable effect. In short, the fact that an individual is an owner of a pass-through entity does not assure that he or she will be allowed the new deduction. And for almost all businesses and individuals affected, the law should add complexity to, rather than simplify, reporting and payment of their federal taxes.

The complexity of the law, as written by Congress to achieve its intended targeted but limited effect, quickly appears from reading the literal fine print labyrinth in its terms. The law states the deduction is generally *limited to the lesser of: (a) 20% of the owner's share of the qualified business income of the pass-through entity, or (b) the greater of: (i) 50% of the owner's share of the W-2 wages paid by the pass-through entity, or (ii) the sum of 25% of the owner's share of the W-2 wages paid by the pass-through entity, plus 2.5% of the owner's share of the unadjusted basis of all qualified property owned by the pass-through entity.* Working with and through that formula will be required of all individual taxpayers who want to claim the deduction.

The law provides specific definitions of the terms "*qualified business income,*" "*W-2 wages*," and "*qualified property*" that are basic elements of the deduction, and those will need to be determined and used in the case of every pass-through entity and its owners to determine the amount of the deduction that is allowed, and limited, by its terms.

Income Thresholds Affecting Allowance of Deduction. Adding to the complexity of the deduction, the limitations based on W-2 wages and the unadjusted basis of qualified property (the "W-2 Wage/Basis Limits") themselves have a limited and phased-in application, because they begin to be partially applied at one taxpayer income level and then are wholly applied at another level. The limits will only apply if an owner has higher income, and if applicable, are "phased in." The W-2 Wage/Basis Limits only begin to apply when an owner's taxable income exceeds a "threshold" of $315,000 (for married taxpayers filing jointly; $157,500 for all other taxpayers). If the owner's income does not exceed those amounts, the full 20% deduction of qualified business income is allowed. If the owner's income exceeds those amounts, then the W-2 Wage/Basis Limits apply or kick in and are then phased in over a $100,000 range (for married taxpayers filing jointly; $50,000 for all others).

Service Business Limitation. Similarly, the owner taxable income thresholds Congress placed on the deduction ($315,000 for married taxpayers filing jointly; $157,500 for all others) also apply, though somewhat differently, to owners of certain service trades or businesses, referred to as "specified service trades or businesses" in §199A. The term "specified service trades or businesses" is defined to mean businesses involving the performance of services in, among other things, the fields of health, law, consulting, and financial services. Under the law, as it applies to such service trades or businesses, a physician, lawyer or certified public accountant generally cannot conduct business as a

pass-through entity and be assured of benefitting from the full 20% deduction, unless he or she has income that does not exceed the "threshold" limits.

The following is a simple example of how it appears the deduction will work for an individual taxpayer who owns a business that is a pass-through entity.

> Example. John and Suzy are married and file a joint return reporting taxable income of $250,000. John owns 100% of J&S, Inc., classified as an S corporation pass-through entity for tax purposes. The S corporation passes through qualified business income ("QBI") of $200,000 to John, pays a total of $50,000 of W-2 wages and has qualified property with an unadjusted basis of $100,000. It conducts a qualified business of manufacturing and selling equipment, and is therefore not a specified service trade or business. Because the taxable income of John and Suzy is below the $315,000 "threshold" in the law, the W-2 Wage/Basis Limit does not apply. As a result, they are allowed a full 20% deduction of $40,000 (20% x $200,000 of J&S, Inc. QBI) on their personal tax return.

Conclusion. The enactment of the new § 199A pass-through entity deduction by the Act now offers great federal income tax savings opportunities to owners of pass-through entities not possible under the prior law. It is anticipated the Internal Revenue Service will publish explanations, regulations, forms, and other guidance on the deduction. Tax and accounting publications, as well as computer and software programs, should become available to consider and use to determine the amount of the deduction and for business entity planning. Obtaining advice from legal counsel on interpretation and meaning of the new law with respect to its application to a business entity and its owners, especially the meaning and effect of the complex requirements and limits of the deduction, is advised so that owners can claim it 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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