Tax Reform: The Pass-Through Deduction

To Our Clients and Friends: January 16, 2018

One of the most significant and least understood provisions of the Tax Cuts and Jobs Act (the "Act"), which became law on December 22, 2017, is a special tax deduction available for certain pass-through businesses. For tax years beginning on or after January 1, 2018, individuals and other non-corporate taxpayers are allowed a deduction of up to 20% of certain types of income earned through partnerships, "S" corporations and sole proprietorships. The deduction ("Pass-Through Deduction") effectively reduces the maximum federal income tax rate on qualifying income from 37.0% (the new maximum federal income tax rate applicable to individuals) to 29.6%. This rate should be compared with the approximately 39.8% maximum combined (corporate and individual) federal income tax rate that now applies to earnings that "C" corporations pay to their stockholders as dividends.

The Pass-Through Deduction is one of the most complex and ambiguous provisions of the new tax law. Many questions will need answering through IRS guidance, judicial interpretation and possibly legislative amendment. However, given the popularity of flow-through businesses and the potential tax savings that the new deduction may provide, business owners can benefit from at least a basic understanding of this new deduction.

Following is a brief summary of the Pass-Through Deduction and, for those potentially affected, a more detailed analysis.

Summary

The Pass-Through Deduction is generally available with respect to income that is taxable on a flow-through basis to owners of sole proprietorships, partnerships, LLCs, "S" corporations and certain other business entities. (It does not apply to income from "C" corporations or entities that "check the box" to be taxed as "C" corporations.) The deduction is available only with respect to income from a United States trade or business. Certain categories of income, and income from specified types of service businesses, are not eligible for the deduction. The deduction may not exceed 20% of the taxpayer's overall taxable income for the year (not including any net capital gain), and it is further limited based on the "W-2 wages" paid by the business and the cost of certain property used in the business.

The deduction is generally available against most categories of income, such as rents, royalties and income from the sale of inventory and certain services. Certain categories of income are excluded, most notably capital gains or losses, dividends and interest and annuity income (if unrelated to the business).

Income from certain types of service businesses is not eligible for the deduction. These include healthcare, law, accounting, consulting, brokerage, financial services, investment management, securities trading, "or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners". A special exception allows individual owners of these excluded businesses to take the Pass-Through Deduction in a given year if their overall income falls below certain specified thresholds. Whether or not the income from a particular business is eligible for the deduction is likely to be one of the most contested aspects of the Act.

For taxpayers that qualify, the deduction is capped at the larger of:

- 50% of the taxpayer's allocable share of the W-2 wages paid by the business to employees; or
- the sum of (i) 2.5% of the taxpayer's allocable share of the acquisition cost of certain tangible depreciable property used in the business plus (ii) 25% of the taxpayer's allocable share of the W-2 wages paid by the business.

This cap does not apply to taxpayers whose income falls below certain specified thresholds. A separate, overall limit also applies, as described above.

Detailed Analysis

The Pass-Through Deduction is generally available with respect to "qualified business income" (QBI) earned by a "qualified trade or business" (QTB) conducted through a sole proprietorship, partnership, LLC, "S" corporation, trust or estate, or certain other specified entities. (Importantly, the deduction is not available to "C" corporation earnings.)[1] Taxpayers with investments in multiple QTBs[2] must calculate the QBI separately with respect to each QTB. If the taxpayer's combined QBI from all QTBs is a positive amount, the taxpayer then calculates the deductible amount with respect to each separate QTB by applying a limitation (discussed below) based on the amount of W-2 wages paid by, and the original cost basis of certain depreciable property used in, the QTB. If the combined QBI attributable to all of a taxpayer's QTBs in any year is a negative amount, the combined loss must be carried forward for purposes of determining the taxpayer's combined QBI for the succeeding year. An overall limit also applies to ensure that a taxpayers' total Pass-Through Deduction in any year does not exceed, generally, 20% of his/her

[1] The Pass-Through Deduction is also allowed for certain REIT dividends, publicly traded partnership income and cooperative dividends, but these deductions will not be discussed in this Alert. If you have income of this nature, please seek additional guidance.

[2] Rules governing the calculation of the Pass-Through Deduction in the case of tiered entities are to be set forth in future Treasury Regulations.

overall taxable income (excluding any net capital gain) for the year.

QBI is generally net income earned in connection with a U.S. trade or business, other than the following "investment items": capital gains or losses, dividends, interest and annuity income (if unrelated to the business), commodity and foreign currency gains and losses, and income and loss from notional principal contracts.[3] QBI generally includes rents, royalties and income from the sale of inventory and certain services.

A QTB is any trade or business other than those 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 or business is the reputation or skill of 1 or more of its employees or owners".[4] Also excluded is any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities. Conversely, engineering and architectural services are specifically included as QTBs.

A special exception allows individual owners of the foregoing excluded businesses to take the Pass-Through Deduction in a given year if the individual's taxable income (from all sources) does not exceed $157,500 ($315,000 for joint return filers). The exception begins to phase out for income above these amounts and is fully phased out for individuals with taxable income of at least $207,500 ($415,000 for joint return filers). These dollar amounts are to be adjusted for inflation for tax years beginning after December 31, 2018.

An interesting issue in this context is whether an employee can take the Pass-Through Deduction against his or her compensation, since the provision of services as an employee is recognized as a trade or business under the tax code. The Act attempts to preclude this by stating that the trade or business of performing services as an employee is not a QTB. Despite this clear statement, some have speculated that it may be possible for one or more employees to form a flow-through entity and have their employer hire the entity as an independent contractor. The entity would then pay its owner/employees a small salary and treat the rest of its income as QBI, eligible for the Pass-Through Deduction. This approach raises a number of interesting issues worth consideration; at least until the government eliminates this potential loophole.

The maximum Pass-Through Deduction that a taxpayer can take in a given year with respect to any QTB is limited to the taxpayer's allocable share of the greater of

[3] In determining their QBI, QBTs must deduct amounts paid to owners (and other service providers) as compensation for services rendered, including wages paid by an "S" corporation and so-called guaranteed payments paid by a partnership. Note that "S" corporations that do not pay adequate compensation to shareholder/employees may be required to treat a portion of any dividends distributed to such shareholder/employees as wages for purposes of this rule.

[4] The above-quoted category is one that surely needs further clarification. For example, would a clothing alteration business' principal asset be the tailor/owner's sewing skills?

the following two amounts: (i) 50% of the W-2 wages allocable to the QTB or (ii) the sum of 25% of the W-2 wages attributable to the QTB plus 2.5% of the QTB's "unadjusted basis" in certain "qualified property". For purposes of the wage-based limitation, W-2 wages include elective deferrals funded into a 401(k) or similar plan and certain deferred compensation (including employer contributions to certain IRAs and Roth accounts).[5] Qualified property is defined as tangible depreciable property (e.g., buildings and machinery, but not, e.g., inventory or undeveloped land) held by the QTB that is used during the year in the production of QBI and with respect to which the depreciable period has not expired before the close of the year. For this purpose, all property depreciable (for income tax purposes) over a period of less than 10 years will be treated as 10-year property. Unadjusted basis means the cost basis of the qualified property immediately after its acquisition, unreduced by any later depreciation deductions. The limitation described in this paragraph is computed separately with respect to each trade or business carried on by the taxpayer.

For example, assume an LLC with two equal members is taxable as a partnership. In 2018 the LLC earns $800,000 of QBI from a QTB, has a W-2 payroll of $300,000, and pays $100,000 to each of the members as a guaranteed payment. The QTB owns and uses qualified property that it purchased in 2011 for $1,000,000 and which has been fully depreciated for income tax purposes over its 5-year depreciable life (so that in 2018 the adjusted basis of the qualified property is zero). Each member will be allocated $400,000 of QBI and will have an allocable share of the QTB's W-2 payroll of $150,000 and an allocable share of the QTB's unadjusted basis in its qualified property of $500,000. The limitation on the Pass-Through Deduction described in the preceding paragraph that will apply to each member is equal to the greater of (i) $75,000 (50% of the member's 50% share of the W-2 payroll) or (ii) $50,000 (25% of the member's 50% share of the W-2 payroll [($37,500] plus 2.5% of the member's 50% share of the cost basis of the qualified property [$12,500]). Accordingly, while 20% of each member's share of the QBI equals $80,000, the maximum Pass-Through Deduction that each member can take in 2018 would be limited to $75,000.

Note that in calculating the limitation described above, the adjusted tax basis of the qualified property is irrelevant, as is the fact that this property was fully depreciated by 2015. The unadjusted basis of qualified property is the relevant amount and the depreciable period is deemed 10 years under the special rule described above. Note also that while the QTB paid $100,000 to each member as a guaranteed payment (deductible in arriving at the $800,000 of QBI), the Act does not treat guaranteed payments as W-2 wages for purposes of the limitation.

[5] Note that under current law, when an employee of a partnership or LLC is granted equity in the entity (such as a so-called "profits interest"), compensation payable to the employee is properly reported on Schedule K-1 and not Form W-2. Accordingly, absent further guidance, these amounts would not be treated as W-2 wages for purposes of the wage-based limitation described above. This may lead to fewer grants of actual equity (and more frequent use of phantom equity) as incentive compensation in these entities.

Note also that the deduction limits described above do not apply to any individual whose taxable income (from all sources) does not exceed $157,500 ($315,000 for joint return filers). The limits begin to phase in for income above these amounts and are fully applicable to individuals with taxable income in excess of $207,500 ($415,000 for joint return filers). These dollar amounts are to be adjusted for inflation for tax years beginning after December 31, 2018.

The Pass-Through Deduction reduces a taxpayer's taxable income but not his/her adjusted gross income and is available for both itemizers and non-itemizers. And the deduction is not added back (i.e., the deduction is allowed) for purposes of the individual AMT.

The Pass-Through Deduction will not apply to taxable years beginning after December 31, 2025.

As is obvious, the scope and application of the Pass-Through Deduction depends on a variety of factors and complex calculations. Given the potential tax savings, it may even make sense for some business owners to restructure how they own and operate their businesses to maximize the benefits of this provision. Of course, before doing so, each taxpayer must take into consideration the many other tax changes in the Act that affect businesses and their owners, including the reduction of the tax rate on "C" corporations to 21%, the repeal of the corporate AMT, new limits on flow-through losses, interest expense and NOL deductions, expanded bonus depreciation and "Section 179" expensing, and repeal of the domestic production manufacturing deduction.

If you would like to discuss how the Pass-Through Deduction – and more generally the new tax law – applies to you and your business, please contact:

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