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Tax Reform Alert: Pass-Thru Section 199A deduction

The Tax Cuts and Jobs Act made significant changes to flow-thru entity taxation with the enactment of new code Section 199A – pass thru deduction. Overall, the deduction can lower stated ordinary tax rates by a maximum of 20%. Therefore, the new top individual rate of 37% could be a low as 29.6%. What follows is a discussion of this new deduction and excludes the specific REIT dividend, publicly traded partnership income, and cooperative dividend provisions of the new law.

Who is Eligible for the 20% Deduction?

All taxpayers, other than a C corporation (S corporation, partnership (LLC), trust or estate, sole proprietor (individual taxpayers) are eligible. Therefore, unincorporated business are eligible for this deduction as long as the underlying business is eligible. On the surface, then there is no need to incorporate or form an LLC to make a taxpayer eligible for the deduction (more on this later).

How is the Deduction Computed?

In its simplest form, the deduction is equal to 20% of Qualified Business Income (QBI). This is generally "trade or business" net income (noninvestment income). QBI does not include reasonable compensation (wages) paid to S corporation owners or guaranteed payments to partnership owners. QBI could potentially include rental income as well, although the definition of a "trade or business" is found nowhere in the Internal Revenue Code. In particular, a triple net lease may not constitute a trade or business in the eyes of the IRS.

QBI is any trade or business other than a Specified Service Business (SSB), or the trade of being an employee (wages reported on a W-2).

What is a Specified Service Business (SSB)?

Businesses that involve the performance of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, or trading or dealing in securities, partnership interests, or commodities are classified as SSB.

In addition, there is a "catchall" category which includes any business where the principal asset of such business is the reputation or skill of one or more of its employees or owners.

It is quite unclear how to interpret these definitions, particularly the "catchall" category. The IRS is expected to issue some preliminary guidance in the first half of this year.

Are There Limitations to the 20% of QBI Deduction?

In short, the answer is yes.

For taxpayers who have taxable income less than $315,000 (married) or $157,500 (single), the only limitation is that the deduction cannot also be more than 20% of taxable income excluding investment income (capital gains). Note: this 20% of taxable income limitation applies to all taxpayers no matter the income level.

For taxpayers with taxable income over $415,000 (married) or $207,500 (single), there are two additional limitations to the deduction:

First, specified service business pass thru income would not be eligible for the deduction.

Second, for non-specified service businesses, the 20% deduction cannot be more than the greater of:

1. 50% of <u>wages</u> paid by the entity (owner share of wages paid at the entity level), or
2. 25% of <u>wages</u> paid by the entity plus 2.5% of <u>qualified property</u> unadjusted cost basis

> The practical impact of first limitation is that wages must be 40% of net business income. Or similarly, for the second limitation, the combination of wages and 2.5% of qualified property need to be 40% of net business income.

If a taxpayer falls within the phaseout range - $315,000 to $415,000 (married) or $157,500 to $207,500 (single) there are additional computations to both limitations which effectively serve to gradually reduce the benefit over the range of income - $100,000 (married) or $50,000 (single). Contact our office for more information on this phaseout computation.

What is Qualified Property?

Qualified property is property that is depreciable (not land), held at the end of the tax year, used in the production of QBI and for which the "depreciable period" has not ended. The "depreciable period" is the longer of 10 years or the depreciable life of the property for tax purposes. For property with lives of 3, 5, or 7 years, these assets will be a factor in the §199A computation for 10 years. For assets over 10 years (15, 27.5 years, or 39 years) these assets would be a factor for the entire depreciable life of the property.

How Does §199A Impact the "Choice of Entity" for Flow-Thru's?

This is very much an evolving question as we await IRS guidance on several items. As previously stated, on the surface, any trade or business (whether incorporated or not) is eligible for the deduction. However, there are circumstances where the choice of being an S corporation, partnership, or sole proprietor may matter.

S Corporation Advantage?

(This discussion is based on our current understanding of the law, there are several items waiting on guidance from the IRS. See also our "Choice of Entity" alert for for a more detailed discussion of the current tax landscape.

The primary disadvantage is for a non-S corporation business where taxable income exceeds the $415,000/$207,500 threshold (at the individual level). Here, the wage limitations take effect, and the fact that partnerships or sole proprietors cannot pay wages to owners can be problematic.

> Because an S corporation owner needs to pay themselves a reasonable wage, this provides additional wages to help with the overall wage limitation. Of course, the owner wages paid are not eligible for the QBI deduction, so the computation becomes circular in nature (contact our office for more information). Any tax analysis here must also consider the payroll taxes related to the wage amounts.
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> In contrast to the S corporation owner, a partner or sole proprietor cannot pay wages to owners, therefore in the worst-case scenario where there are no other wages or qualified property, those businesses would be ineligible for the deduction. This could swing the pendulum more towards the S corporation form of organization over the LLC partnership form that has become quite common in recent years. It is hoped that the IRS might provide guidance to clarify that guaranteed payments could count as wages, but this would be a different position than the now repealed Section 199 Domestic Production Activities deduction that was around for 13 years.
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> If partnership guidance was changed regarding wages, then the sole proprietor would still be limited if there were no other wages or qualified property. A partner in a partnership is generally treated as being self-employed, so it may be unlikely that one is changed (partners in a partnership) without the other (sole proprietors). It is also unclear how certain "page one" deductions of a self-employed taxpayer will be treated. Items such as self-employed health insurance, retirement plan contributions, and self-employment taxes may or may not reduce QBI.

Is This a Deduction for Illinois Income Tax Purposes?

The Section 199A deduction is after the computation of Adjusted Gross Income on "page one" of the federal return, therefore it does not reduce Illinois taxable income.

Summary

There are several more complications to this deduction that are unable to be discussed in an article of this length, please contact our office for more information. Our office has calculators that can help quantify the tax consequences of the new 199A pass-thru deduction given certain levels of taxable income, type of business, wages, or qualified property amounts.