

The New 20% Pass-Through Tax Deduction

BY RONALD KOCH AND MICHAEL DIMANNA

This article discusses the basic features of the new section 199A pass-through tax deduction.

On December 22, 2017, the President signed the Tax Cuts and Jobs Act¹ (the Act) into law. While the Act will impact many taxpayers, some of the more significant changes relate to how individuals and other non-corporate taxpayers are taxed on income from certain types of businesses and investments. Chief among these is the so-called “pass-through” deduction, under new section 199A of the Internal Revenue Code of 1986, as amended (the Code).² This one new section is over 22 pages long, employs approximately 20 defined terms, and includes 26 cross-references to other Code sections.

Whenever there is a new tax law or regulation, it is not uncommon for there to be confusion and different interpretations of Code provisions. With that in mind, this article will cover some of the basics so attorneys can be sure to relate the correct information to their clients.³

Who Qualifies for the Section 199A Deduction?

Starting January 1, 2018, and before 2026, anyone who generates “qualified business income” (QBI) will be entitled to take a deduction of 20% of QBI on their tax return in arriving at taxable income.⁴ The section 199A deduction is available⁵ *only for tax years after 2017 and before 2026*.⁶

Pursuant to section 199A(c), “qualified business income” for a taxable year means “the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.” The term does not include “qualified REIT dividends,” “qualified cooperative dividends,” or “qualified publicly traded partnership income.”

Any taxpayer that is not a C corporation *may* qualify for the section 199A deduction.⁷ This includes individuals, trusts, and estates, regardless of whether the taxpayer is subject to alternative minimum tax.

A “qualified trade or business” is defined at section 199A(d) to be a business *other than* a “specified service trade or business” (SSTB) or services performed as an employee. However, an SSTB may be treated as a qualified trade

or business if the taxpayer’s taxable income meets the specified thresholds, which are discussed below.

Generally, an SSTB is a trade or business where the principal asset is the skill of one or

do not earn too much taxable income. The deduction is available for taxpayers engaged in an SSTB that do not have taxable income of more than the threshold amounts of \$315,000 for joint filers, and \$157,500 for single and all other qualified taxpayers, including head of household and married filing separately.⁹ Taxpayers with taxable income over these threshold amounts by a limited amount (i.e., an additional \$100,000 for joint filers and \$50,000 for single and all other qualified taxpayers) are entitled to take a partial deduction under section 199A(d)(3). Taxpayers engaged in other trades or businesses (All Other Entities) do not need to worry about these thresholds, except as to the W-2 and basis limitation discussed below.¹⁰

The Deduction Applies to Most Pass-Through Structures

Depending on the nature, size, and type of business a taxpayer engages in (as well as other factors), small-business structures (including sole proprietorships, partnerships, limited liability companies, and S corporations) may benefit from the new 20% pass-through deduction.¹¹ That said, the precise benefit a taxpayer receives will vary depending on the type of pass-through structure employed. For instance, clients *may* receive the deduction on all business income received from a sole proprietorship (net profits), but only on some or all of the net income they report per their Schedule K-1 from an S corporation.¹² The section 199A deduction applies to each trade or business separately.¹³

The following types of entities will generally qualify for the deduction, because they generate pass-through earnings or income:

- sole proprietorships (Schedule C);
- real estate investors (Schedule E);
- disregarded entities, such as single member LLCs (Schedule C);
- partnerships and multi-member LLCs (Schedules C and/or E);
- entities taxed as an S corporation (Schedule E); and
- trusts and estates, REITs, and qualified cooperatives (Schedule E).

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more employees or owners.⁸ This means that lawyers, doctors, nurses, financial service providers, actuaries, investment managers, consultants, artists, and accountants will be able to use the section 199A deduction if they

Entities under section 199A that have income derived from SSTBs, as defined in section 199A(d)(2), are defined under section 1202(e)(3)(A) to include the following, and are subject to limitation under section 199A(d)(3):

- traditional service professionals such as doctors, attorneys, accountants, actuaries, and consultants;
- performing artists who perform on stage or in a studio;
- paid athletes;
- anyone who works in the financial services or brokerage industry—for example, in banking, insurance, financing, and leasing; and
- “any trade or business where the principal asset of such trade or business is the reputation or skill” of one or more of the owners or employees.

Section 199A(d)(2)(B) provides that any business consisting of investing and investment management, trading or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) is also an SSTB.

All Other Entities includes, but is not limited to:

- manufacturing, retail, publication, construction, wholesale, warehousing, and transportation;
- liquor stores, food service companies, and insurance companies (not including insurance brokerage services);
- mining, oil and gas, utilities, agriculture, and forestry; and
- real estate (other than those that involve the performance of personal services, such as land developers, where the principal asset is the reputation or skill of one or more of the owners or employees) and medical services not involving personal services (e.g., hospitals, clinics, and MRI imaging centers would not fall into this category).

As noted above, for taxpayers with income above certain thresholds, the proper calculation of the section 199A deduction depends on whether a pass-through trade or business is within the definition of an SSTB. The deduction is computed differently for an SSTB and for All Other Entities.

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Calculating the Deduction

Generally, the section 199A deduction computation is partially based on taxable income,¹⁴ not adjusted gross income, and in some cases is adjusted downward due to a limitation calculated with reference to wages and the initial cost of a pass-through’s depreciable assets. This is more fully discussed below.

The section 199A deduction for all taxpayers is based on 20% of the pass-through qualified business income as determined under sections 199A(a)(1) and (2).¹⁵ The deduction is the sum of A plus B:

A. The LESSER OF:

1. 20% of combined qualified business income of the taxpayer, qualified REIT dividends, and qualified publicly traded partnership income,¹⁶ or
2. 20% of the taxpayer’s modified taxable income.¹⁷

B. The LESSER OF:

1. 20% of qualified cooperative dividends, or
2. 20% of the taxpayer’s modified taxable income.¹⁸

If the taxable income exceeds \$157,500/single or \$315,000/married, but is *not* greater than the end of the phase-out range (\$207,500/single or \$415,000/married), the section 199A deduction is determined based on additional limitations under section 199A(b)(2)(B). The combined qualified business income is the lesser of A or B for each qualified trade or business:

A. 20% of the qualified business income of the taxpayer, or

B. THE GREATER OF:

1. 50% of the *allocable share* of the “W-2 wages” paid by the business, or
2. 25% of the *allocable share* of the “W-2 wages” paid by the business, PLUS 2.5% of the *allocable share* of the “unadjusted (i.e., cost) basis” of all qualified property immediately after acquisition.

A few examples hopefully will make the basic mechanics of the new 20% deduction much easier to understand:

Example 1

Collin, a single taxpayer, has a “regular” job where he earns a \$100,000 W-2 salary as an employee. He also “moonlights” as a consultant and earns \$50,000 of net profit via his Schedule C sole proprietorship. Assume that Collin’s taxable income is \$133,500 (before application of the pass-through deduction) after self-employment taxes and the standard deduction. Collin’s business income of \$50,000 is less than his taxable income of \$133,500. As a result, the 20% pass-through deduction will be applied to Collin’s \$50,000 of business income, resulting in a \$10,000 (\$50,000 x 20% = \$10,000) deduction. Note that because Collin is not a “high earner,” the W-2 and qualified asset limitation does not apply.

Example 2

Gabrielle, a single taxpayer, is a real estate agent who earns \$100,000 of net profit via her Schedule C sole proprietorship. This is Gabrielle’s only source of income. After factoring in Gabrielle’s deductions for self-employment taxes and the

standard deduction, her taxable income is \$73,000 (before application of the pass-through deduction).

Contrary to our first example, here, Gabrielle's taxable income of \$73,000 is *less* than her eligible business income of \$100,000. Therefore, Gabrielle's 20% pass-through deduction will be applied to her \$73,000 of taxable income. This results in a \$14,600 ($73,000 \times 20\% = \$14,600$) deduction. Also note that because Gabrielle is not a "high earner," her W-2 and qualified asset limitation does not apply.

Example 3

Emily, a taxpayer filing a joint return with her spouse, works as an executive with a large company and earns a W-2 salary of \$155,000, and her spouse's W-2 wages are \$84,000. She has \$18,000 in capital losses from portfolio investments. In addition, she is the sole owner

of an LLC that owns and operates an apartment complex as rental real estate. Emily reports \$185,000 net income from the apartment complex (i.e., gross rental income less all operating expenses and depreciation expense). Emily's total taxable income, including her spouse's income, is \$382,000 (before application of the pass-through deduction) after self-employment taxes and the standard deduction ($\$155,000 + \$185,000 + \$84,000$, less \$18,000 in capital losses and \$24,000 for standard deduction). Because the net capital loss of \$18,000 is not related to the businesses, the joint adjusted taxable income stays at \$382,000. The unadjusted basis of the qualified assets of the LLC's rental real estate properties is \$800,000 (at *cost*, before all depreciation and the section 179 expense deduction, and not its fair market value). The LLC also paid W-2 wages to a property manager and maintenance personnel of \$50,000

(remember all wages, including the owner's, if any, are relevant).

Emily and her spouse's adjusted joint taxable income is well beyond the beginning of the phase-out range and she is considered a high earner. Her LLC is not an SSTB. While Emily is not precluded from taking the 20% pass-through deduction due to the nature of her business, the deduction is not simply determined by the lesser of eligible business income or taxable income (excluding capital gains) and is subject to the additional section 199A(b)(2)(B) test noted above. Emily's pass-through deduction would be \$37,000 ($\$185,000 \times 20\%$) *before* the phase-out application. Because the adjusted combined (joint) taxable income is \$67,000 greater than the starting phase-out taxable income figure of \$315,000 but less than the top end of the phase-out figure of \$415,000, the W-2 and qualified asset limitation must be applied.



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The 67% is determined as $(\$67,000/\$100,000)$, and the \$100,000 is the difference of the spread of the phase out range \$315,000 to \$415,000 per section 199A(b)(3)(B). Her W-2 and qualified asset limitation is:

1. THE GREATER OF:

- A. 50% of the *allocable share* of the “W-2 wages” paid by the business, or
- B. 25% of the *allocable share* of the “W-2 wages” paid by the business PLUS 2.5% of the *allocable share* of the “unadjusted (i.e. cost) basis” of all qualified property immediately after acquisition.

Thus, her limitation is the greater of 50% of \$50,000 (i.e., \$25,000) or 25% of \$50,000 plus 2.5% of \$800,000 (i.e., \$12,500 + \$20,000 = \$32,500). Pursuant to section 199A(b)(3)(B) (iii), the excess of \$37,500 over \$32,500 is \$5,000. Thus, the deductible amount for her apartment complex pursuant to section 199A(b)(3)(B) (ii) is the \$37,000 less 67% of \$5,000, leaving a section 199A deduction of \$33,650.

Example 4

Aidan is a partner in a law firm. He is married and files a joint tax return with his spouse and has joint taxable income of \$800,000. Aidan’s share of the income of the law firm is \$700,000, his share of the W-2 wages of the law firm is \$100,000, and his share of the unadjusted basis of the assets of the business is \$20,000. Aidan

is not entitled to a deduction, because a law firm is an SSTB and the joint taxable income exceeds \$415,000, meaning he is completely phased-out of any possible deduction.

Example 5

Addison is a partner in an accounting firm. She is married and files a joint tax return with her spouse, who has income of \$100,000. Addison has joint taxable income of \$300,000: her share of the income of the accounting firm is \$200,000, her share of the W-2 wages of the accounting firm is \$60,000, and her share of the assets of the accounting firm is \$40,000. Even though Addison is an accountant, she may take the deduction because her taxable income is below \$315,000 (threshold for joint returns), the start of the phase-out threshold. As a result, Addison can take a deduction of 20% of \$200,000, or \$40,000.

QBI and “Reasonable Compensation”

It is important to remember that QBI does not apply to “reasonable compensation” paid to the shareholder(s)/owner(s).¹⁹ This means that even if an attorney or an accountant set up an S corporation to deduct \$300,000 of what was once wages and pass them through as QBI according to section 199A, this could be challenged. The Internal Revenue Service (IRS) could state that some or all of the \$300,000 should be reclassified as reasonable compensation, which

is not treated as QBI. However, even if the IRS reclassified \$120,000 of the S corporation’s income as reasonable compensation, \$180,000 of the S corporation’s income would be eligible for QBI treatment.

It appears under section 199A(c)(2) that when a taxpayer has a loss in Year 1 from a QBI-type activity, even if that loss is used in computing taxable income in Year 1, when you get to Year 2, that QBI loss from Year 1 “carries over” and reduces Year 2 QBI solely for purposes of computing the 20% of QBI deduction.

To illustrate, Bonnie owns 50% of an S corporation. In 2018, the S corporation allocates a \$100,000 loss to Bonnie. Because Bonnie materially participates in the S corporation, she is able to use the \$100,000 loss in full to offset her husband’s \$200,000 of wages.

In 2019, the S corporation allocates \$200,000 of income to Bonnie. While Bonnie would generally start the process of determining her section 199A deduction by taking 20% of \$200,000, section 199A(c)(2) provides that in determining Bonnie’s QBI deduction for 2019, the \$200,000 of income must be reduced by the \$100,000 of loss from 2018. Thus, while Bonnie will still include the full \$200,000 of S corporation income in her taxable income in 2019, her deduction will be limited to \$20,000 (20% x \$100,000) rather than \$40,000 (20% x \$200,000).

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Section 199A(f)(4)(B) provides that detailed regulations are to be drafted to establish how to determine the deduction in the case of multi-tier entities.

The Bottom Line

Single filers with more than \$207,500 of taxable income and joint filers with more than \$415,000 of taxable income whose business income stems from an SSTB²⁰ will not get the 20% pass-through deduction for *any* of their SSTB business income.

Conclusion

The section 199A deduction will allow owners of sole proprietorships, S corporations, partnerships, and even stand-alone rental properties reported on Schedule E to take a deduction of 20% against certain income from the business. The result will be a reduction in the effective top rate on these types of business income from approximately 37% under current law to roughly 29.6% under the new law (a new 37%

top rate x a 20% deduction = 29.6%), before the application of self-employment tax, Medicare tax, and other taxes. This deduction represents a significant amount of cash flow from the U.S. Treasury to taxpayers. Over the coming months, tax advisors and business owners will be tasked with accessing that cash flow.

It is not every day that we get to wrap our minds around a brand new Code section. Additional guidance should be forthcoming. The American Institute of Certified Public Accountants sent a request to the IRS and the Treasury Department asking for “immediate guidance on pass-through business income under new tax law.” And new section 199A will be interpreted by the IRS and the tax court. Practitioners should remain alert for additional guidance on the application of section 199A. ^{CL}

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NOTES

1. Public Law 115-97, “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” is a congressional revenue act originally introduced in Congress as the Tax Cuts and Jobs Act (TCJA).
2. References throughout this article to “section” are references to sections of the Internal Revenue Code, Title 26 USC.
3. Opinions expressed by the authors are their own and do not represent legal or accounting advice. Readers should obtain legal or accounting advice regarding the facts of particular situations.
4. 26 USC § 199A(c).
5. 26 USC § 199A(a) and (b).
6. 26 USC § 199A(i).
7. 26 USC § 199A(a).
8. 26 USC §§ 199A(d)(2) and 1202(e)(3)(A).
9. 26 USC § 199A(e)(2).
10. 26 USC § 199A(d)(1). For purposes of this article, trades or business that are not SSTBs are referred to as “All Other Entities.”
11. 26 USC § 199A(a).
12. Owner salary earned from the S corporation is not eligible for the deduction, just the reported income (loss). 26 USC § 199A(c)(4)(A).
13. 26 USC § 199A(b)(1).

14. Taxable income as used under section 199A(a) is defined under section 63(a). Generally, taxable income (single, or in the case of a joint return, combined) is gross income from all sources after itemized or standard deductions per sections 63(b) and (c). Taxable income is reported on pages one and two of IRS Form 1040. For purposes of section 199A, the taxable income is reduced by any net capital gains for the taxable year pursuant to section 199A(a)(1)(B)(ii). As noted above, if the tax return is a joint return, the relevant taxable income is the combined income of both taxpayers.
15. QBI is defined in section 199A(c)(1) as “the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business.” In section 199A(c)(3)(A) and (B), qualified items is defined to essentially look at gross income, less all ordinary deductions (including depreciation expense) “effectively connected with” a pass-through entity, excluding all items of investment income such as: short-term capital gain or loss; long-term capital gain or loss; dividend income; interest income that is earned by the trade or business (non-earned trade or business interest income is excluded); and annuity income described in section 945(c)(1). QBI also does not include any income that is not “effectively connected with the conduct of a qualified trade or business” (within the

- meaning of section 199A) under section 199A(c)(3)(A)(i). For shareholders or partners in a pass-through business, QBI is determined by deducting, among other things, all wages or guaranteed payments paid by the business. To illustrate, in a pass-through entity that is owned 30% by a shareholder of an S corporation that pays \$40,000 of wages to the shareholder and allocates the shareholder \$80,000 or 30% share of the business income, the shareholder’s QBI from the S corporation is \$80,000 of income. The shareholder’s wages of \$40,000 are not added back to the QBI.
16. “Qualified publicly traded partnership income” is defined under section 199A(e)(5) as the net amount of any qualified business income from a publicly traded partnership (PTP), plus any gain on the sale of a PTP interest that is included in the taxpayer’s ordinary income. A PTP is any partnership interest that is regularly traded on an established securities market or a secondary market or the substantial equivalent thereof. 26 USC § 7704.
17. See note 14.
18. See note 14.
19. 26 USC § 199A(c)(4).
20. For example, this would include doctors, attorneys, accountants, actuaries, and consultants.