porterwright

TAX ALERT

JANUARY 25, 2018

Dave Tumen
614.227.2260
dtumen@porterwright.com

Mark Snider
614.227.2150
msnider@porterwright.com

Is the new 20 percent pass-through business deduction for you?

Most everyone is aware that the Tax Cuts and Jobs Act (Tax Act) lowered the C corporation tax rate to a flat 21 percent. However, certain taxpayers that are not C corporations will benefit from the Tax Act as well. Taxpayers may be able to deduct up to 20 percent of qualified business income from pass-through businesses (PTB), subject to certain limitations, for the next eight years. The available deduction on a taxpayer's share of qualified business income from a qualified pass-through trade or business will depend on facts, such as (i) whether the qualified business income comes from a specified service trade or business (SSTB), (ii) the taxpayer's share of wage income or capital expenditures from qualified property, and (iii) whether the taxpayer's taxable income exceeds a threshold amount. Eligible taxpayers in the new highest 37 percent tax bracket might reduce their tax rate on qualified business income to 29.6 percent.

In order to better understand the new rules on eligibility for the 20 percent deduction, it is crucial to understand the terms:

- **Pass-through businesses** (PTB) include S corporations, tax partnerships (including multi-member limited liability companies) and sole proprietorships (including single-member limited liability companies that are disregarded entities for tax purposes). Basically, this is most every business that is not a C corporation.
- **Qualified business income** is generally net income calculated on a per-business basis (not per-taxpayer). If a business is an S corporation,

it must exclude the amount that should be paid to employees (including the shareholder(s)) as reasonable compensation (i.e. wages). Further, a partner in a partnership (such as many accountants, physicians or attorneys) cannot include "guaranteed payments" in qualified business income, as they resemble wages.

- **Qualified property** is tangible property subject to depreciation and available for use in a business at the end of the tax year. The qualified property must be used to produce qualified business income and the depreciable period must not have ended for such property.
- **Qualified trade or business** (QTB) includes any trade or business, other than an SSTB defined below, and the trade or the businesses of being an employee.
- **Specified service trade or business** (SSTB) is any business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, businesses where the principal asset is the reputation or skill of one or more of its employees or owners, or businesses that involve the performance of services regarding certain investment activities. Architects and engineers escaped the SSTB designation.

Planning note: The law is confusing because an SSTB is generally treated like a QTB until it exceeds the threshold amount plus the phase-out amount.

- **Threshold amount** is the amount above which both the limitation on SSTBs and the wage limit (discussed below) may apply. The threshold amount is $157,500 for individual taxpayers and $315,000 for married taxpayers filing jointly. The application of the limit is phased-out for individuals with taxable income exceeding the threshold amount, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals). Therefore, for 2018, the limitation fully kicks in for married taxpayers with taxable income over $415,000 and other individuals with taxable income over $207,500.

Planning note: Some partnerships may want to give more partners a share in the profits and have fewer partners receive guaranteed payments that are not eligible for the 20 percent deduction.

Planning note:

If you are a taxpayer below the threshold amount, no W-2 wage limitation should apply.

Planning note: Because of these limits, married taxpayers may want to consider filing separately.

As noted above, an owner of a PTB may be able to deduct up to 20 percent of the income from a QTB. If a taxpayer is at or below the threshold amounts noted above (whether a QTB or SSTB), the taxpayer may deduct 20 percent of qualified business income without the wage limitation, subject to a 20 percent taxable income limitation. If a QTB is above the threshold amount **plus** the phase-out amount, the amount of any deduction generally depends on:

1. Total taxable income, except for capital gain
2. Share of qualified business income
3. Share of W-2 wages paid to employees of a qualified trade or business
4. Share of cost basis of qualified property

An SSTB above the threshold plus phase-out amounts gets no deduction. Generally for QTB taxpayers that are above the threshold plus phase-out amounts, the deduction is equal to the lesser of the following amounts:

Planning note: SSTB taxpayers get no deduction if they are above the thresholds plus phase-out amounts. Other taxpayers are not so limited.

- 20 percent of the qualified business income from all qualified trade or businesses on a per-business basis, or
- Whichever is greater: (i) 50 percent of the allocable share W-2 wages paid to employees with respect to qualified business income, or (ii) 25 percent of the W-2 wages paid to employees with respect to qualified business income plus 2.5 percent of the cost of qualified property

Planning note:

If you are a taxpayer between the threshold and phase-out amounts, it is unclear whether the W-2 wage limitation applies.

Planning note: Allowing qualified property in the calculation may help real estate businesses that don't have many employees take advantage of the deduction.

The more complicated issues involve taxpayers that are above threshold but below the phase-out amounts (taxable income amount between $315,000-$415,000 for married filing jointly; or $157,500-$207,500 for other taxpayers). The statute suggests there is only a 20 percent limitation and no W-2 limitation. The Senate report suggests a 20 percent and W-2 limitation apply. There may need to be technical considerations to resolve the issue.

Notwithstanding the above, a taxpayer's deductions may not, in general, exceed 20 percent of their taxable income (less net capital gains).

The tax planning possibilities are unlimited. For example, employees may consider becoming independent contractors (if they meet the requirements) to qualify for the deduction. Employers may want to turn independent contractors into employees to increase the wage limitations. Corporations may want to consider dropping their assets into a partnership and make former employees partners. These are just a few of the many planning opportunities available.

Despite the 20 percent pass-through deduction, more businesses may want to start out as, or elect to become, C corporations because the 21 percent flat rate will be lower than the pass-through rate. However, if C corporation profits are distributed, two levels of tax may apply (i.e. up to a 23.8 percent dividend or capital gain tax). Some factors to consider in this decision are:

- Do I need capital to grow my business or will I distribute profits?
- What is my exit strategy?
- If I want to convert to a different type of entity; will there be a tax cost?
- Will a buyer of my business want to buy stock or assets?

Whether you are starting a new business or are a long time owner, the tax attorneys at Porter Wright can help guide you through the new tax law and what decision is best for your circumstances. For more information or assistance, please contact Dave Tumen, Mark Snider or any member of Porter Wright's Tax Practice Group.