# Taxation of Pass-Through Entities

## A New Regime

Individuals, trusts and estates are allowed to deduct from taxable income 20% of "qualified business income" received from a pass through company.

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Much has been said and written about the Tax Cuts and Jobs Act signed into law on December 22, 2017. Though the law is still so new that no regulations have been issued or judicial interpretations made, the individual provisions of the law present U.S. taxpayers with interesting issues and opportunities. One provision of particular interest to UBS clients is Internal Revenue Code Section 199A, which deals with the income tax treatment of the income and losses of "pass-through companies," or PTCs.

The vast majority of businesses in the U.S. are PTCs.[1] In 2015 the Brookings Institute reported that U. S. Treasury figures suggest that about 95% of all U.S. companies were structured as PTCs.

PTCs are not taxed on income at the company level. The income of the company is "passed through," or treated as the income of the investors /owners. PTCs in the United States generally take the following forms:
– Sole proprietorships
– Partnerships
– Limited Liability Companies
– Subchapter S Corporations
– Income trusts or grantor trusts

These companies use Form K-1 to declare and report income to both owners and tax collectors.

Compare these businesses with non-PTCs—most commonly the Subchapter C corporation. C-corporations are taxed at the entity level. Distributions of profit to the shareholders in the form of dividends are taxed as income to the shareholders, hence the double taxation stigma.

The new tax law provides for a flat 21% rate for non-pass-through corporations like C-corporations. Congress debated alternative methods of providing a similar tax cut for small businesses not structured as C-corporations. Some legislators wanted a new tax rate applied to PTCs. Others proposed preferential tax treatment of PTC income for small business owners.

Creating and imposing a new tax rate for PTCs would thwart their most popular attribute: the pass-through nature of the entity. The debate was finally resolved by continuing to tax business income received from a PTC at owner levels and at the owners' tax rates. However, as of January 1, 2018, a portion of that income can be deducted. Preferential treatment for PTCs prevailed, but not permanently; these rules regarding PTCs are scheduled to "sunset" (revert to pre-2018 rules) after 2025.

Individuals, trusts and estates are allowed to deduct from taxable income 20% of "qualified business income" received from a PTC. "Qualified business income" or QBI is generally the net income of a domestic business (but excludes any amount paid by an S corporation that is treated as reasonable compensation, any guaranteed payment to a partner for services, or payment to a partner for services outside his/her capacity as a partner). QBI specifically excludes investment income such as long-term capital gains, dividends, interest income (other than that which is properly allocable to a trade or business) and amounts received under an annuity contract. QBI is determined on a per business, not a per taxpayer, basis. So, if a PTC business owner's taxable income is $50,000 and QBI is $40,000, then the deduction applied is $8,000 (20% of $40,000).

This deduction, however, is subject to limitations that have the effect of reducing the benefits for higher income taxpayers. Deductibility is limited for taxpayers reporting taxable income exceeding $315,000 for married taxpayers filing jointly and $157,500 for individual taxpayers. (Deductibility limits will rise with inflation in coming years.) These limits are known as "threshold amounts." Taxpayers with income in excess of these threshold amounts see the benefit of the deduction completely phased out over the next $100,000 for joint filers and $50,000 for individual filers with respect to QBI from specified service trades or businesses. When determining income thresholds use taxable income from all sources, however, when determining QBI, multiple businesses are aggregated and the deduction is allowed against the total net QBI reported by the taxpayer.

Above these threshold amounts are certain limitations to the application of the deduction, with the result that the deduction decreases as income increases. The statutory limitations follow:

a) The W-2 limitation: the deduction cannot exceed the greater of:
    a. 50% of W-2 wages paid by the qualified business, or
    b. 25% of wages paid plus 2.5% of the unadjusted basis of tangible depreciable assets used in the business. This provision allows real estate businesses with large capital investments but low wages paid to employees to still take advantage or the deduction.

b) The Specified Service Limitation: The deduction is not available at all for income from "specified service businesses." The list of specified service businesses includes:
    a. Health
    b. Law
    c. Accounting
    d. Actuarial science
    e. Performing arts
    f. Consulting
    g. Athletics
    h. Financial services
    i. Brokerage services
    j. Businesses in which the principal asset is the reputation or skill of one or more of its employees or owners
    k. Businesses involving the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests or commodities.

In practical terms, the following decision tree can be used to determine the deduction for the married taxpayers filing jointly:

A. Taxable income is less than $315,000:
    a. Deduct 20% of qualified business income.
        i. The specified service income and the W-2 limitation do not apply.

B. Taxable income is more than $315,000, but less than $415,000:
    a. Divide QBI into two categories: (i) Regular QBI and (ii) Specified Trade or Business QBI (STBQBI).

b. With respect to STBQBI, the ability to deduct 20% is phased out between $315,000 and $415,000 of income *and* subject to a phased-in W-2 limitation.

c. With respect to Regular QBI, the ability to deduct 20% is subject to a phased-in W-2 limitation.

C. Taxable income is greater than $415,000:

a. You cannot deduct STBQBI.
b. With respect to your Regular QBI, your ability to deduct 20% is subject to the full W-2 limitation.

The W-2 limitation is the greater of: (i) 50% of the W-2 income paid by the business and (ii) 25% of the W-2 income paid by the business plus 2.5% of the unadjusted basis in qualified property. This limitation is applied business by business to prevent the use of high W-2 businesses to offset low W-2 businesses, like a CPA (high W-2 income) who also owns a number of rental properties (low W-2 income). The goal of these limitations is to reward and encourage ownership of and capital investment in small business.

For a business with multiple owners (e.g., a partnership or S corporation) each owner is treated as having W-2 wages for the tax year in an amount equal to his/her allocable share of the W-2 wages of the business.

Here's an example of the application of these limitations to a taxpayer over the threshold amount but not above the income level that fully limits the benefit of this deduction ($207,500 for a single taxpayer, $415,000 for a married couple filing jointly). If an unmarried business owner's taxable income is $200,000, her STBQBI is $100,000 and her business is the practice of law paying W-2 wages of $90,000, the deduction is determined as follows:

a. The percentage of the deduction available is 15% [100% minus ($200,000 minus the threshold amount of $157,500) divided by $50,000].
b. Apply the available deduction to QBI (15% of $100,000 = $15,000) and to W-2 wages (15% of $90,000 + $13,500).
c. The available deduction is the lesser of 20% of $15,000 ($3,000) or 50% of $13,500 ($6,750): $3,000.

Since the taxpayer's small business income is coming from the practice of law (a specified service), the entire deduction would be disallowed if her taxable income (from all sources) exceeds the threshold amount by $50,000 or more.

Whether the W-2 limitation or the Specified Service limitation applies, the deduction may not exceed taxable income for the year (reduced by net capital gain). If the net amount of your QBI is a loss, it can be carried forward as a loss to the next tax year. Further, keep in mind that these deductions from income reduce the taxable income on an *individual's* tax return. It does not change the calculation of taxable income inside the business. Business expenses remain deductible.

Finally, it should be noted that the law also clearly provides that trusts and estates that own or hold interests in PTCs are eligible for the 20% deduction under the provision. Rules similar to the rules under present-law section 199 apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital.

There is a great deal of complexity in the wording of this law. Its administration and application will likely present even greater challenges. It will no doubt consume a great deal of time and resources on the part of accountants, tax preparers, attorneys, the Internal Revenue Service and, eventually, the courts. The confusion is understandable. One of the greatest minds in recent times, Albert Einstein, is credited with saying "The hardest thing in the world to understand is the income tax." Good tax counsel is essential when addressing the opportunities this law presents.

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– See important notes and disclosures on the next page

[1] brookings.edu/research/9-facts-about-pass-through-businesses