New Deduction For Pass-Through Entities Under Tax Cuts And Jobs Act

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Under the new tax laws ("TCJA"), there is a new deduction available to owners of pass-through entities. Section 199A of the Internal Revenue Code allows owners of pass-through entities to deduct up to 20% of their business income from their income taxes. The first portion of this article provides an overview on the various types of pass-through entities that are included under Section 199A. The second portion of the article provides an analysis on the conditions that the owners of pass-through entities must satisfy in order to qualify for the 199A deduction.

PASS-THROUGH ENTITIES

For purposes of Section 199A, the following entities are entitled to the deduction: sole proprietorships, partnerships, limited liability companies, S corporations, trusts, and estates. The most distinguishing characteristic of pass-through entities is that the entities themselves generally do not pay tax. Instead, all of the earnings and expenses are passed through to the owners who pay the taxes on their individual tax returns. The sections below provide an overview on the general characteristics of each type of pass-through entity.

Sole Proprietorships

A sole proprietorship is not a separate entity from the business owner. It is operated by a specific individual. All benefits and obligations alike are limited to only the business owner. It cannot be passed to a different person unless the new owner creates a different sole proprietorship or a different type of business entity. Even if the business has employees, the risks and liabilities of the business are assumed only by the single individual.

Sole proprietors often receive Forms 1099-MISC during the course of their business dealings, which they must report along with their other income. The income and expenses pass through to the business owner and they are reported on the individual's personal tax return on Schedule C (or Schedule C-EZ) of Form 1040. If the sole proprietor accumulates net earnings of $400 or more from his self-employment, he must pay self-employment tax by filing Schedule SE with his Form 1040.

Partnerships

A partnership is generally a business venture between two or more persons who agree to carry on a trade or business. In essence, it is a contractual relationship, which can be written or oral. Each partner contributes money, property, or labor in return for a share in the profits and losses of the business. The rights and responsibilities of the partners are generally included in the Partnership Agreement.

Partners owe fiduciary duties to each other and to the partnership. These duties include the duty of loyalty, care, and the duty to act in good faith. A partner may legally bind the partnership provided that she has authority to engage in a particular course of conduct on behalf of the partnership. Authority is generally presumed if the transaction was part of the usual and ordinary course of the partnership's business operations.

For federal tax compliance purposes, a partnership must report the income, deductions, gains, and losses from its business operations on Form 1065, but the partnership itself generally does not pay tax on its income.

However, the partnership must issue Schedule K-1 to each partner. The partner's share of partnership income is reported on Schedule E.

In a General Partnership ("GP"), all partners are jointly and severally liable for the debts and obligations of the partnerships. For example, if a partnership has two partners and it defaults on a loan, each partner may be personally obligated to satisfy the balance on the loan. Similar to sole proprietorships, this factor is problematic from asset protection standpoint because it does not protect the business owner's assets from the risks that may arise during the course of business operations.

A Limited Partnership ("LP") is a two-tiered partnership entity with at least one general partner and one limited partner. In California, the Partnership Agreement must be in writing and the Certificate of Limited Partnership must be filed with the Secretary of State of California. The general partner legally binds the partnership for any decision she may make throughout the duration of the partnership. She is also liable for all the debts of the LP. On the other hand, a limited partner will generally not be subject to liability unless he loses the protection of limited liability for various reasons, such as when he actively participates in the management of the partnership.

In California, a Limited Liability Partnership ("LLP") is restricted to only certain class of professionals such as lawyers and accountants. The underlying purpose of an LLP is to avoid liability on the members of the partnership for the malpractice of their partners. For instance, if the law firm is an LP instead of an LLP, all of the attorneys who participate in the management of the law firm may be jointly and severally liable for the malpractice of their partners. Since California forbids law firms from forming LLCs, the law firm may in the alternative incorporate. However, corporate formalities can be much more complex than the management of a partnership under a Partnership Agreement.

Limited Liability Companies

A Limited Liability Company ("LLC") is a hybrid business entity which contains elements of a partnership and a corporation. LLCs consist of members and managers. An LLC may provide tremendous benefits for its members, which include asset protection, intergenerational transfers, tax saving strategies, wealth preservation, and flexible management structures.

There are two types of structures in which LLCs operate. There are member-managed and manager-managed LLCs. In member-managed LLCs, the members of the company manage the company by voting in accordance with each member's interest in the LLC. In manager-managed LLCs, members may appoint one or more managers to conduct the business activities that fall within the scope authorized by the company's members.

An LLC can be taxed as a disregarded entity, partnership, cooperative, or corporation. By default, a multi-member LLC is taxed as a partnership. By default, a single-member LLC is taxed as a sole proprietorship (i.e., disregarded entity). Under such classification, the member is considered self-employed and is consequently responsible for self-employment taxes. If the LLC is not taxed as a C corporation, then it will be taxed as a pass-through entity. The earnings and expenses will pass through to the member's personal tax returns. Under a pass-through scenario, the LLC itself will file Form 1065, but it will not pay the income taxes on the LLC's profits.

Five Fundamentals of LLCs

S Corporations

There are generally two types of tax treatments available to corporations under the federal rules. By default, a corporation is taxed under Subchapter C of the Internal Revenue Code. However, a corporation may elect to be taxed under Subchapter S of the Internal Revenue Code.

In order to qualify as an S corporation, (1) the entity must be a domestic corporation, (2) it generally cannot have more than 100 shareholders, (3) it must have only one class of stock, (4) the business must satisfy the definition of a small business corporation under Section 1361 of the Internal Revenue Code, and (5) shareholders that are individuals must generally be U.S. citizens or residents (shareholders that are corporations or partnerships are generally excluded).

The shareholders of S corporations are required to pay estimated taxes if their own tax returns have exceeded or are expected to exceed $500 when the returns are filed. The shareholders are required to report all applicable categories of earnings and losses on Schedule K-1. The shareholders must pay taxes on their share of the corporate income regardless of whether distributions are made.

Anatomy Of A Corporation

Trusts

Trusts are created and operated under the laws of the state in which they are formed. A typical trust generally consists of a Trustor, Trustee and Beneficiary. The Trustor (a.k.a., Grantor, Settlor) is the original owner of the property. The Trustee is the fiduciary party that manages the trust assets. The Beneficiary is the designated party that is entitled to receive the trust income or assets.

A trust may be created during an individual's life or after death under an individual's will. A trust may also be a grantor trust or a non-grantor trust. If it is a grantor trust, then it is not recognized as a separate entity for federal income tax purposes. The most common types of grantor trusts are Revocable Living Trusts, which allow the Trustor (i.e., Grantor) to make changes or end the trust during his lifetime. Many people use Revocable Living Trusts as alternatives or supplemental to wills.

A non-grantor trust is any trust where the assets are not held by the grantor either directly or indirectly. A non-grantor trust is considered a separate legal entity. The most common of these trusts are irrevocable trusts, where the trust cannot be revoked once it is created. The transfer of the asset is deemed a complete gift with gift tax implications. The income and deductions of non-grantor trusts are reported on Form 1041 (Income Tax Return for Estates and Trusts).

Estate Planning In A Nutshell

Estates

An estate is created when a person dies. Upon the distribution of all assets and satisfaction of all liabilities, both estates and trusts generally cease to exist. The assets of the estate must generally be treated on the beneficiary's return in the same manner as they are treated on the estate's return. In addition, the estate's gross income, deductions and credits are calculated in the same manner as that of an individual. However, they are reported on Form 1041 only if the estate's annual gross income exceeds $600.

The beneficiary who inherits the property is generally not taxed on the transfer. However, until the distribution is made, the beneficiary may be subject to income tax if she is receiving distributions before the final distribution of the estate (e.g., during the course of a litigation dispute). Any distributions made to a beneficiary are reported on Schedule K-1.

NEW DEDUCTION UNDER TCJA

The Section 199A deduction is only available to owners of pass-through entities. It will take effect from the 2018 tax year and it is set to expire after December 31, 2025 unless otherwise extended by Congress. The maximum potential amount of the deduction is 20% of the Qualified Business Income ("QBI") from each of the taxpayer's business. For active business owners, the portion of the business income is generally the remaining portion after a business owner receives reasonable compensation (e.g., W-2s).

The eligibility for the QBI deduction is first determined by the taxpayer's total taxable income (e.g., business and investment income) minus adjustments (e.g., deductions). The second inquiry is how much the taxpayer is entitled to deduct. There is generally an "overall limitation" which is determined by the lesser of the combined net business income or 20% of the total taxable income (in excess of any net capital gain). For taxpayers who only receive business income from passive avenues (e.g., rental real estate), the overall limitation is generally sufficient to determine the QBI deduction. It gets more complicated for taxpayers who operate active businesses.

The analysis below focuses on owners of active businesses, such as professionals or entrepreneurs who own and also operate their businesses. Besides the overall limitation test, there are primarily two overarching tests that are used to determine the amount the taxpayer may deduct: the type of business the taxpayer operates and the taxpayer's total taxable income.

Type of Business Test

Whether the taxpayer provides services in a Specified Service Trade or Business ("SSTB") within the meaning Section 199A is a significant factor in determining how much the taxpayer is entitled to deduct. If the taxpayer falls in any of the enumerated classifications as outlined in Section 199A, her deduction may either be reduced or she may not be entitled to any deduction. If the taxpayer provides services in a SSTB, she may not be entitled to any deduction beyond a certain threshold, even though a similarly situated taxpayer may otherwise be entitled to receive a deduction.

There are two classifications of SSTBs within the meaning of Section 199A. The first classification defines SSTB as "any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services" (architects and engineers are expressly excluded under 199A). The second classification involves the performance of services in the areas of investing and investment management, trading or dealing in securities, partnership interests, and commodities.

The first classification also includes a catch-all category of "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." Even though the term "trade or business" is not defined by statute, the factors that may be considered include the profit motive of the business owner and the continuous and regular activity of the business. The proposed regulations limit the definition of "reputation or skill" to (1) income from endorsing products or services, (2) licensing or receiving income for the use of an individual's likeness, or (3) receiving appearance fees from various media platforms such as television.

Total Taxable Income Test

The key factor for determining the QBI deduction is the taxpayer's total taxable income. If the total taxable income falls in Tier 1, regardless of whether the taxpayer's business meets the SSTB test, the taxpayer may be entitled to the maximum deduction. If the taxable income falls in Tier 2, the amount of the QBI deduction is generally reduced. If Tier 3, depending on whether it is SSTB, the QBI deduction is either limited or the taxpayer is not entitled to any deduction.

The threshold of the total taxable income for Tier 1 is $157,500 ($315,000 if filing a joint return), Tier 2 is $207,500 ($415,000 if filing a joint return), Tier 3 is any amount that is in excess of $207,500 ($415,000 if filing a joint return).

Assuming the taxpayer falls in Tier 1, the maximum the taxpayer may deduct is 20% of his combined net business income. This means that the taxpayer who earns $100,000 on his QBI may pay tax only on $80,000. If we assume that the taxpayer falls in the 24% tax bracket, the taxpayer would pay 24% tax on the $80,000 portion (as opposed to the full $100,000). Therefore, the taxpayer would pay only $19,200 on the QBI portion (instead of $24,000).

If the taxpayer falls in Tier 2 or Tier 3, there is a wage and capital (i.e., Qualified Property) limitation. Qualified property is any tangible property that is subject to depreciation and is available for use during the tax year. The depreciation period is determined by the later of the regular depreciation period that would apply to the particular property or 10 years. The 2.5% calculation in the formula is determined by the unadjusted basis of the property, meaning, the basis of the property immediately after its acquisition.

Taxpayers who fall in Tier 2 are subject to a phase-in of the W-2 and Qualified Property limitation. This is true regardless of whether the taxpayer operates an SSTB. However, there are differences between owners of SSTBs versus owners of non-SSTBs when calculating the QBI deduction for Tier 2.

Generally, the formula used to calculate the QBI deduction for taxpayers who fall in Tier 2 is determined by the portion of the taxpayer's total taxable income that is in excess of the Tier 1 threshold yet below the Tier 3 threshold. The difference is then divided by $50,000 ($100,000 for joint filers). For MFJ taxpayers who operate SSTBs, the formula for the QBI deduction is [1 – (taxable income – $315,000) / $100,000)] x (QBI x 20%).

To illustrate the application of the SSTB formula for Tier 2, let's assume that Larry and his wife operate a law firm (SSTB), which is taxed as an S corporation. In 2018, the couple's taxable income is $345,000 and QBI is $95,000. If we apply the formula above, their QBI deduction for 2018 is $13,300 based on [1 – ($345,000 – $315,000) / $100,000)] x ($95,000 x 20%).

If the taxpayer's taxable income falls in Tier 3, the next inquiry is whether the taxpayer's business falls within the realm of SSTB. If it is SSTB, the inquiry ends here and the taxpayer is not entitled to any QBI deduction. If it is not SSTB, then the deduction is equal to the lesser of: (a) 20% of net business income or (b) greater of (i) W-2 x 50% or (ii) W-2 x 25% + 2.5% of Qualified Property.

In order to understand the application of the formula for Tier 3, assume that Ronald owns and operates a golf course (not SSTB). In 2018, Ronald's total taxable income is $400,000. His entire income is from the operation of the golf course. Ronald also purchased $1,000,000 worth of golf clubs and other Qualified Property that have not fully depreciated. Since Ronald operates as a sole proprietor, he cannot receive W-2s. Thus, his QBI deduction is $25,000 because $25,000 is the lesser of: (a) $80,000 (20% x $400,000) or (b) greater of (i) 0 (zero W-2 x 50%) or (ii) $25,000 [0 (zero W-2 x 25%)] + [$25,000 ($1,000,0000 x 2.5%)].

Assume the same facts as in the example above, except that Ronald is a shareholder-employee of an S corporation and received $100,000 in W-2s. He does not have any Qualified Property (e.g., golf clubs). His QBI deduction is $50,000 because $50,000 is the lesser of: (a) $80,000 (20% x $400,000) or (b) greater of (i) 50,000 ($100,000 W-2 x 50%) or (ii) $25,000 [$25,000 ($100,000 W-2 x 25%) + 0 (zero x 25%)].

Planning Techniques

Since the taxpayer's total taxable income is arguably the biggest factor in determining eligibility for the QBI deduction, one technique is to reduce the taxable income to the extent possible. There are various ways to achieve that end. One way is to implement defined benefit or defined contribution plans. If done correctly, these plans may reduce the taxable income, provide asset protection, and secure a peace of mind for the latter years of a person's life.

Another technique is to restructure the business entity. For shareholder-employees of C corporations, it may be better to restructure as a S corporation since 199A is available only to pass-through entities. For sole proprietors and partners of partnerships who fall in Tier 2 or Tier 3, they are generally not entitled to the deduction because they cannot receive W-2s. However, if there is Qualified Property, they may be entitled to the deduction. In any event, converting to a S corporation is not only beneficial for asset protection purposes and reducing the AGI, but it may now also be beneficial for the QBI deduction.

To illustrate the significance of the impact of entity structures, let's assume that Tommy and Dolly (a married couple) operate an online shopping business. The business has no Qualified Property, but in 2018, it generated $500,000 of QBI and $550,000 of taxable income. If the business is treated as a sole proprietorship or partnership, the couple will not be entitled to any QBI deduction. If it is treated as an S corporation, they may be entitled to a deduction in the amount of $50,000 assuming that they pay themselves $100,000 in W-2s.