The Deduction for Passthrough Firms: A Hodgepodge of Ideas

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Starting this year, the owner of any business not classified as a corporation for federal tax purposes can deduct up to 20 percent of the owner’s share of the income from the business. This deduction is due to expire after 2025. This article describes the principal features of the deduction under the Tax Cuts and Jobs Act for the owner of any business that is not classified as a corporation for tax purposes. He also offers several personal observations about the law.

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I. Eligible Taxpayers

The passthrough deduction is available to any taxpayer other than a corporation. That would include individuals, trusts, and estates. To claim the deduction, the taxpayer must carry on a qualified trade or business, including conducting a business as a sole proprietor. This would also include the conduct of a business through a business entity classified as a partnership or S corporation for federal tax purposes. Thus, taxpayers who derive income from a business conducted through a limited liability company will be eligible unless the firm affirmatively elected to be treated as a corporation for federal income tax purposes. However, merely working as an employee does not count as a qualified trade or business.

Taxpayers may be eligible to claim the deduction in various situations other than those involving the active conduct of a trade or business. Special rules apply to some agricultural or horticultural cooperatives. This article does not address these situations.

II. The Basic Structure and Approach

The statute implicitly draws a distinction between the deduction itself and the amount the

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1Section 199A. It is not uncommon to see the deduction described as being available to owners of passthrough firms. This is incorrect because the term “passthrough” is not used to describe a sole proprietorship, which is one way to conduct a business and remain eligible for the deduction.

2Section 199A(i).

3Section 199A(a).

4Section 199A(b)(1)(A).

5Section 199A(f).

6Section 199A(d)(1)(B).

7The deduction is available if the taxpayer receives cooperative dividends. Section 199A(a)(2)(A). Taxpayers who derive income from a real estate investment trust or a publicly traded partnership are also eligible. See section 199A(b)(1)(B).

8Section 199A(g).
taxpayer can actually use to offset taxable income. The deduction is based on what the statute calls the taxpayer’s qualified business income.⁹ Up to 20 percent of that amount will be the taxpayer’s deduction.⁸ Below specific threshold amounts of taxable income, there are limits on what will count as qualified business income. However, above those thresholds, two important additional restrictions come into play. After determining the deductible amount of qualified business income, the taxpayer must determine how much of it can be used. I refer to this as the overall limitation on the deduction.

III. Amount of the Deduction — In General

An eligible taxpayer who carries on a qualified trade or business can deduct up to 20 percent of the taxpayer’s qualified business income.¹¹ If the business generated a loss in any year, that loss will be factored into the computation of qualified business income in the following year.¹² Each partner in a partnership and each shareholder in an S corporation must compute the deduction separately.¹³ If a taxpayer derives qualified business income from multiple businesses, the amounts are combined.¹⁴

Qualified business income generally consists of the net amount of income, gains, deductions, and losses from each qualified U.S. trade or business of the taxpayer.¹⁵ However, the legislation identifies several items that do not factor into this net figure, including income from publicly traded partnerships, some real estate investment trust dividends, specific cooperative dividends, capital gains and losses, and several items of passive income to the extent they are unrelated to the conduct of the taxpayer’s business.¹⁶

Qualified business income does not include some amounts the taxpayer might receive for performing services. Thus, the term does not include any compensation the taxpayer receives for performing services for the business or any guaranteed payment a partner receives from a partnership for services rendered to the firm.¹⁷ Nor does it include any partnership allocation that constitutes actual or disguised compensation to a partner in return for services performed for the partnership.¹⁸ The exclusion of these amounts seems consistent with the way the statute explicitly denies the deduction to individuals who are mere employees.¹⁹ However, the statute does not contemplate the full range of situations in which the income derived through a business entity represents a return on the taxpayer’s labor. This is explored more fully later in this article.

IV. Taxable Income Thresholds

There are two additional sets of rules that limit what counts as qualified business income. The first limit is based on the nature of the business; the second considers the amount the business spent on payroll and depreciable property. However, these portions of the statute come into play only when the taxpayer’s taxable income exceeds specific threshold amounts.²⁰ Therefore, if a taxpayer’s taxable income is below these thresholds, 20 percent of the taxpayer’s qualified business income as described in the prior section is tax free up to the overall limitation. When the additional restrictions apply, they effectively reduce the amount of the deduction itself.

For married taxpayers filing a joint return, the threshold amount is $315,000 in 2018.²¹ For all other taxpayers, the threshold amount is $157,500 in 2018. These figures are adjusted annually to

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⁹ See section 199A(a)(1)(A).
¹⁰ See section 199A(b)(2)(A).
¹¹ Id.
¹² See section 199A(c)(2).
¹³ See section 199A(f)(1)(A)(i) and (ii).
¹⁴ See section 199A(b)(1)(A).
¹⁵ See section 199A(c)(1). The statute requires the items to be effectively connected with the conduct of a trade or business within the United States, as that term is used in section 864(c). See section 199A(c)(3)(A)(i). The statute treats Puerto Rico as part of the United States for identifying qualified business income from sources in the United States. Section 199A(f)(1)(C). That is a departure from the general rule. See section 7701(a)(9).
¹⁶ See section 199A(c)(1) and (c)(3).
¹⁷ See section 199A(c)(4)(B).
¹⁸ See section 199A(c)(4)(C). The statute refers to payments described in section 707(a).
¹⁹ See section 199A(d)(1)(B).
²⁰ See section 199A(d)(3)(A)(i) (exclusion for specified service businesses) and 199A(b)(3)(A) (limitation tied to payroll and depreciable property of the business).
²¹ See section 199A(e)(2)(A).
reflect inflation.\textsuperscript{27} If the taxpayer’s taxable income exceeds the threshold, the limitations described below are phased in until the taxpayer’s taxable income reaches a different threshold level. For married taxpayers filing a joint return, that level is $415,000 in 2018.\textsuperscript{23} For all other taxpayers, that level is $207,500 in 2018. These higher threshold amounts are adjusted annually in tandem with adjustment to the lower threshold amounts so that the difference between the two will always be the same dollar amount.\textsuperscript{22} The phase-in range for married couples is $100,000; the phase-in range for all other taxpayers is $50,000.

V. The Business Activities Restriction

One of the income-based restrictions prevents any income derived from specific service businesses from counting as qualified business income.\textsuperscript{25} Ineligible businesses include those involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services.\textsuperscript{26} A business will also be ineligible if it involves the performance of services in investing and investment management, trading, or dealing in securities, partnership interests, or commodities.\textsuperscript{27} There is a catchall category of ineligible businesses consisting of those whose principal asset is the reputation or skill of one or more of their owners or employees — whatever that means.\textsuperscript{28} However, the statute created a safe harbor of sorts for architects and engineers.\textsuperscript{29} Any income derived from a business in those fields is not automatically disqualified under this restriction.

If a taxpayer’s income was derived from an ineligible business, none of the income derived from the business will count as qualified business income in any year when the taxpayer’s income is beyond the phase-in threshold amount. This would cause the deduction itself to be zero for that business, preventing it from enjoying any tax relief. The statute doesn’t indicate how the rules operate if the firm derives income from a mix of eligible and ineligible business activities. However, even if a firm derives all its income from an eligible business, the amount of qualified business income will be subject to the separate limitation based on payroll and depreciable property described in the next section.

VI. The Payroll and Property Restriction

As a general rule, the deduction is equal to 20 percent of the qualified business income. However, when the taxpayer’s income exceeds the applicable threshold, the amount that can count as qualified business income is limited to what the business has spent on depreciable property and payroll. The deductible amount cannot exceed the higher of two figures: The first is 50 percent of the business’s W-2 wages for the year;\textsuperscript{30} the second is a combination of (a) 25 percent of the business’s W-2 wages for the year, and (b) 2.5 percent of the taxpayer’s original basis in any tangible depreciable property used in the business.\textsuperscript{31} Notably, the depreciable property component does not reflect items of property the business acquired during the year. Instead, it reflects any item of depreciable property the business used during the year to produce income.\textsuperscript{32} In most cases, that property will be used to compute the limit only if its depreciation recovery period has not expired.\textsuperscript{33} Even if the recovery period has expired, the item’s original basis will still count toward computing the limit if it was placed in service within the past 10 years.\textsuperscript{34}

\textsuperscript{27}Section 199A(e)(2)(B).
\textsuperscript{28}Section 199A(d)(2)(A) (cross-referencing and modifying section 1202(e)(3)(A)).
\textsuperscript{29}Section 199A(d)(2)(B).
\textsuperscript{30}Section 199A(d)(2)(A) (cross-referencing section 1202(e)(3)(A)).
\textsuperscript{31}Section 199A(d)(2)(B).
\textsuperscript{32}Section 199A(d)(2)(A) (cross-referencing and modifying section 1202(e)(3)(A)).
\textsuperscript{33}Section 199A(d)(2)(A) (cross-referencing section 1202(e)(3)(A)).
\textsuperscript{34}Section 199A(d)(2)(A) (cross-referencing section 1202(e)(3)(A)).
\textsuperscript{23}Section 199A(d)(3) (exclusion for specified service businesses) and 199A(b)(3)(B)(i)(I) (limitation tied to payroll and depreciable property of the business).
\textsuperscript{24}Section 199A(e)(2)(B).
\textsuperscript{25}Section 199A(d)(1).
\textsuperscript{26}Section 199A(d)(2)(A) (cross-referencing and modifying section 1202(e)(3)(A)).
\textsuperscript{27}Section 199A(d)(2)(B).
\textsuperscript{28}Section 199A(d)(2)(A) (cross-referencing section 1202(e)(3)(A)).
\textsuperscript{29}Section 199A(d)(2)(B).
\textsuperscript{30}Section 199A(b)(2)(B)(i) and (a)(4)(A).
\textsuperscript{31}Section 199A(b)(2)(B)(i) and (a)(4)(A).
\textsuperscript{32}Section 199A(b)(2)(B)(ii) and (b)(6).
\textsuperscript{33}Section 199A(b)(6)(A)(ii).
\textsuperscript{34}Section 199A(b)(6)(A)(i).
\textsuperscript{34}Section 199A(b)(6)(B).
When the business is conducted through an S corporation or a partnership, this restriction is determined at the level of the shareholder or partner. Accordingly, the computations the partner or shareholder must perform will take into account that individual’s share of the relevant items. Thus, for a taxpayer who exceeds the applicable threshold, the qualified business income would be zero if the business did not employ anyone or use any depreciable property during the year.

VII. The Overall Limitation

As indicated above, the statute first requires a taxpayer to determine what counts as qualified business income. Twenty percent of that amount will be potentially deductible by the taxpayer. However, there is a cap on the amount of the deduction the taxpayer can actually use. That cap is equal to 20 percent of the taxpayer’s taxable income (other than net capital gain). There is no provision permitting the taxpayer to use any excess in future or past tax years. The overall limitation has interesting implications that are described in the next section.

VIII. Observations and Implications

A. A Tax Shelter for Nonbusiness Income

The overall limitation prevents the deduction from causing someone’s taxable income to fall below 80 percent of what it would have been in the absence of the deduction. That effectively prevents the taxpayer from enjoying the full benefit of the deduction in some cases. Consider the following hypothetical.

Assume an individual is unmarried, derives $100,000 of net income from a business, and claims the standard deduction of $12,000. The maximum deductible amount would be $20,000, representing 20 percent of the income derived from the business. However, the actual deduction would be limited to 20 percent of taxable income, which would be $88,000 once gross income is offset by the standard deduction. That would translate to an overall limitation of $17,600, meaning the taxpayer would be unable to use $2,400 of the deduction. Moreover, the taxpayer would be unable to use this wasted portion of the deduction in other tax years.

However, the taxpayer could use the entire deduction if there was at least $12,000 of ordinary income from other sources reflected on the tax return. One possibility might be wages from a job. Under that scenario, the taxpayer would actually be using the deduction to reduce the tax bill on income that does not even count as domestic qualified business income. In fact, in this example, the deduction is reducing the tax on compensation from employment, an item that the statute purportedly attempts to avoid treating as qualified business income.

B. Non-Passive Owners Get (Another) Free Pass

The statute seems intended to reduce the tax on business income other than amounts that essentially compensate the taxpayer for the taxpayer’s own labor. The statute communicates that message when it declares that qualified business income does not include any compensation a taxpayer might receive for performing services for the business. The law similarly states that working as an employee does not count as a qualified trade or business. This antilabor bias is also reflected in the rule that prevents qualified business income from including the earnings from specified service businesses and other firms whose principal asset is the reputation or skill of any of their owners or employees.

Despite those efforts to steer the deduction away from taxpayers in these situations, some holes remain. Consider the situation of an individual who works for and owns shares in an S corporation. If the work performed is material, one could make the case that at least a portion of any amounts allocated and distributed to the taxpayer represents compensation for the work, especially if the firm never separately pays the taxpayer anything for that work. The law contains virtually no safeguards that would prevent someone from deliberately disguising the taxpayer’s compensation as a dividend.

Indeed, S corporations and limited partnerships already offer ways for owners to

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36 Section 199A(f)(1)(A) (flush language).
37 Section 199A(a)(1)(B).
avoid employment taxes and the 3.8 percent tax on net investment income when they also work for the business. Because of a set of outdated and formalistic rules, any allocation of S corporation income is exempt from Social Security tax and the 3.8 percent tax if the owner materially participates in the business. Likewise, any allocation of partnership income is exempt from these same taxes if the partner materially participates in the business. These loopholes effectively rob the Social Security and Medicare systems of funds they should be receiving. Now it appears that active limited partners and active S corporation shareholders will enjoy yet another tax benefit: a reduction in income tax. Ironically, this will happen thanks to a deduction that appears to be intended for passive investors, not active participants in the business.

C. The Indirect Payroll Subsidy

For individuals whose taxable incomes exceed the applicable thresholds, amounts they receive as compensation play two conflicting roles in the statute. On one hand, any compensation a qualified business pays to an employee-owner will be ineligible for the deduction. So if a firm with no depreciable property spends all its earnings to cover salaries and bonuses for its employee-owners, there will be no qualified business income. On the other hand, the larger the firm’s payroll, the higher the limit on the amount of business income that will qualify for the deduction. In other words, bigger payrolls — even amounts paid to employee-owners — indirectly translate into a higher deduction. However, a higher limit is meaningless when the deductible amount is zero.

One way around this dilemma would be for the owners to simply pay themselves a bonus that is carefully calibrated to produce the optimal tax results. However, hiring workers might be an equally viable alternative, if the firm is prepared to incur the expense. Assume that an unmarried taxpayer owned a 50 percent interest in the firm and received no remuneration for his work other than amounts allocated and distributed to him. Assume his share of income was $400,000. The maximum amount of the deduction would be $80,000, or 20 percent of that allocation. However, the deductible amount cannot exceed 50 percent of his share of the firm’s payroll. So if the firm had no workers, the deductible amount would be zero. But if the total payroll was $200,000, his share would be $100,000 and the limit on his deductible amount would be $50,000. Thus, the deduction can effectively operate as an indirect payroll subsidy when the taxpayer’s taxable income exceeds the applicable threshold.

D. A Reward for Capital-Intensive Businesses

Hiring workers is one way a taxpayer can increase the limit on the amount of qualified business income factored into the computation of the deduction. However, the limit is also a function of amounts the business has invested in depreciable business property. Thus, the more a firm has spent on such items, the higher the limit and the larger the potential deduction.

However, the amounts that count toward the computation of the limit are not restricted to the amounts the business may have invested in the current tax year. Instead, the statute takes into

38. Richard Winchester, “Carried Interest for the Common Man,” Tax Notes, Mar. 17, 2014, p. 1250. This is the tax dodge made famous by Newt Gingrich and John Edwards. See Willard Taylor, “Payroll Taxes — Why Should We Care? What Should Be Done?” Tax Notes, Nov. 26, 2012, p. 983, at note 38 and accompanying text. Strictly speaking, S corporation owners are subject to employment tax on the reasonable compensation for their work, whether paid in the form of a salary or a dividend. Rev. Rul. 74-44, 1974-1 C.B. 287. However, there is ample evidence that S corporations routinely severely limit amounts paid out as wages and pay employment tax on only these artificially low amounts. Moreover, the government apprehends only a small fraction of these offenders, setting the stage for a multimillion-dollar tax shelter. See Treasury Inspector General for Tax Administration, “Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S corporations,” 2005-30-080, at 3 (May 20, 2005).

39. Winchester, supra note 38, at 1257. An outdate set of rules is the source of the employment tax dodge for limited partners. Specifically, the tax definition of a limited partner has not kept pace with nontax rules. Historically, limited partners could be only passive investors under state law, and that’s why the employment tax did not apply to them. H.R. Rep. No. 95-702 (Part 1) at 11 (1977), reprinted in 1978-1 C.B. 469. However, that restriction no longer exists. See Uniform Limited Partnership Act (2001) (last amended in 2013) (adopted in 22 states). Treasury attempted to update the rules in 1994 and again in 1997. See prop. reg. section 1.1402-2(h); and prop. reg. section 1.1402(a)-2. However, Congress imposed a one-year moratorium on the rulemaking process. See Taxpayer Relief Act of 1997, section 935. Treasury has not resumed the rulemaking process.

40. Section 199A(c)(4)(A).

41. Section 199A(b)(2)(B).
account 2.5 percent of the initial amount spent to acquire all depreciable property in use during the year, no matter when it was acquired. The computation excludes an item of property only after it has reached the end of its recovery period, or 10 years if sooner.

Thus, there will be many cases in which a firm receives a tax benefit for property that is already fully depreciated. Further, because only 2.5 percent of the property’s basis counts toward increasing qualified business income, it’s hard to see how this would operate as an incentive to invest in new property. Instead, it’s really more of a tax benefit to businesses that use high dollar amounts of depreciable property in the first place. It is this aspect of the statute that caused critics to deride it as a windfall for people like President Trump and Sen. Bob Corker, R-Tenn., who hold substantial investments in real estate partnerships.

E. Crumbs for Architects and Engineers

Architects and engineers escaped the list of specified service industries whose earnings will be ineligible for the deduction when the taxpayer’s income exceeds the threshold amounts. However, there may be many cases in which individual architects and engineers cannot claim the full deduction anyway. Consider the following hypothetical.

Assume a firm consists of three architects whose capital investments are minimal to nonexistent. The owners do all the work and there are no employees. They could access the earnings in one of two ways. The earnings could be withdrawn in the form of wages. Alternatively, the earnings could be allocated to each and withdrawn as distributions. If the earnings are paid out as wages, the business would have no income, the amount of qualified business income would be zero, and the deduction would be zero. Conversely, if the earnings are simply allocated and distributed, the entire amount would be eligible to count as qualified business income. However, because the business has a payroll of zero, the deduction would be zero.

This is an example of the predicament facing any business that is subject to the payroll and depreciable property restrictions on what counts as qualified business income. The options available to such businesses have already been described. However, it’s worth focusing on the specific case of architects and engineers because the statute was drafted to protect them from being completely ineligible for the deduction when the taxpayer’s income exceeds the applicable threshold. Although these two professions remain eligible for the deduction, it nevertheless appears that the actual tax savings will be rather limited, especially when the firm has no employees and uses no depreciable property. Perhaps this will lead the owners to consider acquiring, instead of renting, the premises they occupy. However, that seems like a drastic step under the circumstances.

Assume the firm invests $100,000 in an item of depreciable property. That will increase the limit on the firm’s qualified business income by $2,500 each year. For someone in the 25 percent tax bracket, a $2,500 tax deduction would translate into $625 in tax savings each year. Because the deduction is due to expire after 2025, the taxpayer could count on a maximum tax savings of only $5,000 over the course of eight years. That may be a large enough tax benefit to justify the $100,000 investment for some taxpayers. However, it won’t be large enough for many others.

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42. Section 199A(b)(6)(A).
43. Section 199A(b)(6)(B).