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IRS issues 184 pages of guidance on passthrough deductions

As part of the Tax Cuts and Jobs Act, Congress created a new and much-publicized passthrough deduction, designed to provide owners of non-corporate entities with benefits similar to the reduced tax rates for corporations.

Determining who would receive the benefit—already a feast of complexity under a law riddled with exceptions and special rules—was made more complex by the absence of IRS guidance.

Now, the IRS has issued 184 pages of proposed guidance on the new rules, explaining their application in great detail. (While the guidance is merely proposed, taxpayers are entitled to rely on certain provisions until final rules are issued.)

In this article, I will attempt to explain key points from the guidance in simple terms, with a focus on their application for small business locally.

General overview

Generally, the new provision allows a new 20 percent deduction to non-corporate owners for their qualified business income from a partnership, S Corp, or sole proprietorship. For this purpose, partnerships include limited liability companies that are treated as partnerships for tax purposes.

The deduction applies only to qualified business income. This is generally defined as all income from a qualified trade or business income other than wage-like and investment-related income. Taxpayers must compute the qualifying income from each trade or business. The new rules clarify that the definition of trade or business from elsewhere in the Code applies, with minor modifications.

For taxpayers with multiple trades or businesses, the proposed regulations explain how to allocate expenses among trades or businesses. They also describe how to compute the deduction where one business loses money and the other makes money and how to address carryovers of losses.

Wages to employees, guaranteed payments (payments to partners in their non-partner capacity) as well as reasonable for S corporation shareholders are not eligible for the passthrough deduction.

One strategy companies, particular professional services firms, have considered to get around this rule is to make large numbers of employees owners so that they could take advantage of the deduction. The proposed regulations nip this strategy in the bud, providing that employees are presumed to remain employees in cases of wholesale changes in structure.

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Wage limitation

While the deduction is generally 20% of qualified income, its availability is limited by a formula. This formula allows the deduction in full only for businesses that pay sufficient wages or have a certain amount of property.

Specifically, the passthrough deduction is limited to the greater of 50 percent of the partner's allocable wages that the business pays to its employees. In a last-minute compromise, Congress added an alternative test, whereby, if greater, the deduction is limited to 25 percent of the wages plus 2½ percent of the unadjusted basis immediately after acquisition of qualified property.

The proposed regulations allow trades or businesses to be aggregated for the purpose of determining these limits are met. However, once a decision to aggregate is made, it must be continued in subsequent years.

The proposed regulations provide that wages paid by professional employer organizations or related entities under payroll agency arrangements can be treated as W-2 wages. The proposals also provide detailed technical rules for the determining the basis of qualified property.

Simultaneously with the proposed regulations, the IRS issued a notice that describes how wages are computed for this purpose. Wages reported on the business's W-2 are adjusted to reflect certain technical issues.

Notably for local small businesses, the wage/basis limitations do not apply to individuals with taxable income less than $157,500 (single taxpayers) or $315,000 (married taxpayers). They phase in over the next $50,000-$100,000 of income. New proposed anti-abuse rules prevent taxpayers from using certain trust arrangements to circumvent these limitations.

Service businesses

Income from certain service businesses is not eligible for the passthrough deduction. Specifically, the deduction is not available for income from health, law, consulting or financial and investment businesses if income exceeds a stated threshold.

An exception from the unavailability of the passthrough deduction for specified businesses applies if a taxpayer's income from a specified business is below $157,000 (single taxpayers) or $315,000 (married taxpayers) with a phaseout over the next $50,000 to $100,000. This may apply to many taxpayers locally.

The new guidance explains the contours of each of the excluded fields. We learn, for example, that excluded services in the field of athletics include coaching billiards. Notably for local business, these rules clarify that real estate brokers and insurance brokers are not subject to the special limitation on the deduction. Banks are also excluded from the limitation.

In addition, the proposed regulations narrowly interpret the clause expanding the definition of specified services business to include any business where the principal asset is reputation or skill of its employees or owners. This clause is limited to celebrity endorsements or appearance fees.

The proposed regulations also adopt rules to prevent taxpayers subject to the limitation on specified business from trying to spin off a qualifying portion of their business to a separate entity to obtain a partial passthrough deduction.

Specifically, the proposed rules provide that the deduction is not available for services to the related business where the original business and the spinoff have at least half of their ownership in common and most of the spun off entity's services are provided to the related business.

Conclusion

Overall, the new 199A guidance is critical. The IRS, required by law to estimate how long compliance will take, estimates that taxpayers will spend a total of 25 million hours engaging with the proposed new rules. The five-minute overview in this article should give you a good start.

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