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Parsing the passthrough deductions under the Tax Cuts and Jobs Act

TAXING MATTERS
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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.

The new rule can provide material benefits, especially for taxpayers in certain industries. It is also a feast for the tax lawyer, full of complexities, exceptions and special rules.

In this article, I will attempt to explain the passthrough deduction in simple terms and to illustrate its application by example. To befit the complexity of the law, I have included some tongue-twisting illustrations.

Generally, the new provision provides 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 operating as partnerships.

Like many of the non-corporate provisions in the act, the new passthrough deduction terminates in 2025.

The deduction applies only to qualified business income. This is generally defined as all trade or business income other than wage-like and investment-related income. In particular, for partnerships, it excludes income from "guaranteed payments" (payments to partners in their non-partner capacity). Similarly, for S corporations, reasonable compensation to the S corporation shareholder is not included.

The availability of the deduction is limited by a formula. This formula allows the deduction in full for businesses that pay sufficient wages or have a certain amount of property. (This stands in contrast to the corporate rate cuts, which are generally without reference to factors of this type.)

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.

Notably for local small businesses, these 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.

Perhaps you will permit an example: Peter and Paul are 50 percent owners of Peter Piper's Pepper Pickling, a partnership. In 2018, partnership income was $1,000,000 per pickling partner, producing a passthrough deduction of $200,000. The total wages for the pickling employees were $500,000 per pickling partner. Because the picklers' paychecks exceed the passthrough deduction, the full passthrough deduction is permitted. It's not necessary to analyze the basis of the equipment used in the business (e.g., the pepper pots).

The rules provide exceptions for income from certain service businesses. Specifically, the 20 percent deduction is not available for income from health, law, consulting or financial and investment businesses if income exceeds the stated threshold. More broadly, the limitation applies where the principle asset of the trade or business is the reputation or skill of one or more of its employees or owners.

Notably, architecture and engineering were previously included in this list, however they were removed in the final bill. Accordingly, architects and engineers enjoy the benefits of the deduction under the rules above.

An exception from this rule applies if income is below $157,000 (single taxpayers) or $315,000 (married taxpayers) with a phaseout over the next $50,000 to $100,000. For individuals below these thresholds, the wage limitation does not apply.

Application of these rules is illustrated by Peter's brother Pablo. Pablo pursued partnership in a law firm rather than the family pickling business. Because he is a plaintiff's attorney, his income fluctuates periodically. Partway through January 2018, he has already received a payout of $1,000,000. In this year, Poor Pablo will receive no benefit from the deduction due to the limitations. However, if in 2019 his pecuniary fortunes reverse and he earns a paltry purse of $100,000, he would be eligible for the passthrough tax deduction in the amount of $20,000.

The introduction of the passthrough limitation as well as the decreased corporate rate changes the consideration with respect to choice of entity for new businesses. Next week's article will review choice of entity based on these changes.

In addition to the changes with respect to the introduction of the income limitation, the Act also made other changes to taxation of passthrough entities. The most significant relates to carried interest of private equity and hedge fund managers.

It is typical for these managers to be paid a "carried interest" equal to 20 percent of the increase in value of assets that are sold by the private equity fund. It is possible to structure the partnership so that this income is taxed at capital gains rates rather than ordinary income rate. Closing the "carried interest" loophole has become a politically explosive issue that has defied legislative reform for years.

The act finally makes a dent in these rules. It states that if a partner in an applicable partnership receives a carried interest in the entity, any gain realized will be taxed at ordinary income rates unless held for at least three years.

Even though it was intended to deal with the titans of Wall Street, this provision applies broadly to investment businesses. It also applies locally to the extent that investment businesses, including real estate businesses, grant "profit interest" to employees.

While the profit interest provisions apply mostly to private fund profiteers, the passthrough deduction applies more broadly. To summarize, the president's peculiar preference for partnerships produces passthrough deductions for the public.

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