

Tax Reform: Passthrough Entities

Headline Rate Reduction is Helpful, but Beware of Limitations

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Executive Summary

- Section 11011 of the Tax Cuts and Jobs Act (H.R. 1), signed into law in December 2017, created a new Internal Revenue Code section 199A that generally allows an individual taxpayer to deduct 20% of “domestic qualified business income” from a partnership, S corporation, or sole proprietorship.
- “Qualified business income” generally means the net amount of domestic qualified items of income, gain, deduction, and loss with respect to the taxpayer’s qualified businesses (*i.e.*, any trade or business other than specified service trades or businesses, except for a limited exception described below).
- Qualified business income of a taxpayer does not include any amount paid by an S corporation that is treated as “reasonable compensation” of such taxpayer, certain service payments to partners, and certain investment-related income.
- In the case of a taxpayer who has qualified business income from a partnership or S corporation, the amount of the deduction is limited to the greater of: (a) 50% of W-2 wages paid, or (b) the sum of 25% of W-2 wages, plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property.
- The deduction generally does not apply to “specified service businesses,” except in the case of a single taxpayer with under \$157,500 in taxable income or \$315,000 for a couple filing jointly (with a complete phase-out at certain income levels).
- “Specified services businesses” include: financial services; brokerage services; legal services; accounting; any trade or business in which the reputation or skill of an owner or employee is a principal asset (except engineering and architecture are carved out); and services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

PASSTHROUGH ENTITIES QUICK FACTS

New section 199A generally allows an individual taxpayer to deduct the lesser of:

(1) 20% of the taxpayer's qualified business income (QBI) with respect to the trade or business, or

(2) The greater of:

(a) 50% of the W-2 wages with respect to the trade or business, or

(b) the sum of 25% of the W-2 wages with respect to the trade or business and a capital component (2.5% of the unadjusted basis, immediately after acquisition, of all qualified property).

The new passthrough deduction generally does not apply to service businesses, with a few exceptions.

- The new law permits trusts and estates to take advantage of the deduction and the deduction is not disallowed or otherwise limited by the individual AMT.
- The deduction for qualified business income from a passthrough entity is for income purposes. Passive income can still be subject to the 3.8% net investment income tax.
- The rules for determining the amount of the deduction and the applicable limits are applied at the taxpayer level, not the entity level. In other words, the computations of the amount of the deduction and any limits are applied to the individual, estate or trust receiving the income through the pass-through entity based on ownership shares, not to the pass-through entity itself.
- The new rules are effective for taxable years beginning after December 31, 2017 and before January 1, 2026.

Next Steps

- **Implementing the new tax law:** New section 199A is a complex provision, and the IRS has announced plans to issue “computational, definitional, and anti-avoidance guidance under new § 199A” to help taxpayers adjust to the new taxation scheme for passthrough entities. Regulatory directives relating to section 199A in the text of the Tax Cuts and Jobs Act include:
 - IRC § 199A(f)(4) generally instructs the Treasury to prescribe regulations to carry out the purposes of IRC § 199A, including rules on appropriate reporting requirements, allocating items and wages, and applying the IRC § 199A deduction to tiered entities.
 - New IRC § 199A(b)(5), as added by the Tax Cuts and Jobs Act, instructs the Treasury to issue guidance on how the combined qualified business income amount rules apply when the taxpayer has a short tax year, or acquires or disposes of a major portion of a trade or business or a separate unit of a trade or business.
 - New IRC § 199A(h) instructs the Treasury to provide guidance for determining the unadjusted basis immediately after qualified property is acquired in involuntary conversions or like-kind exchanges.
 - New IRC § 199A further provides that payments to a partner for services the partner renders to the passthrough business in a capacity other than that of a partner are excluded from the calculation of qualified business income subject to clarifying regulations.
- **Rule Timing:** CREFC warns members not to expect speedy guidance from the IRS on complex provisions such as new § 199A. While the agency is currently working on the guidance, it will likely be many months – perhaps a year – before final rules are issued.
- **Technical Corrections Legislation:** There have been numerous technical correction issues identified in the first weeks since the law’s enactment. To address these issues legislatively, 60 votes in the Senate likely will be required. Therefore, passage of any such bill in this mid-term election year will be a very difficult process.

CREFC Policy & Strategy

To the extent CREFC members identify the need for technical corrections, regulatory guidance and/or additional clarity with respect to the provisions governing passthrough entity taxation under the new law, CREFC will remain engaged throughout any regulatory and/or technical corrections processes to ensure these provisions are implemented in a clear, workable, beneficial manner.

Additional Background & History

- Under the pre-H.R. 1 tax code, net income earned by a passthrough entity was reported and taxed as ordinary income for the individual owners and shareholders of the passthrough entity.
- The new deduction for qualified business income from a passthrough entity is a reduction in taxable income, not adjusted taxable income.

CREFC Resources

[Step toe & Johnson Memo on CRE-related Tax Issues, December 4, 2017](#)

[CREFC Side-by-Side Comparing Various Tax Vehicles, December 4, 2017](#)

For further information, see CREFC's Resource Center at: <https://www.crefc.org/library>

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