

Tax Notes

Navigating Pass-Through Tax Reform

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So much for tax simplification...

Over the past several weeks, literally millions of words have been written in connection with the recently enacted tax reforms. What was originally touted as tax simplification quickly evolved into what most would agree is anything but simple. And nowhere is this more evident than in the new provisions addressing the taxation of income from pass-through entities.

The new pass-through tax provisions are indeed complex, and at this early stage many unanswered questions exist regarding their content, interpretation, and applicability. Guidance will certainly be forthcoming. But in the meantime, business goes on and decisions must be made. With that in mind, we set out to provide a clear, concise, and user-friendly roadmap as a tool for analysis.

Illustrative Materials

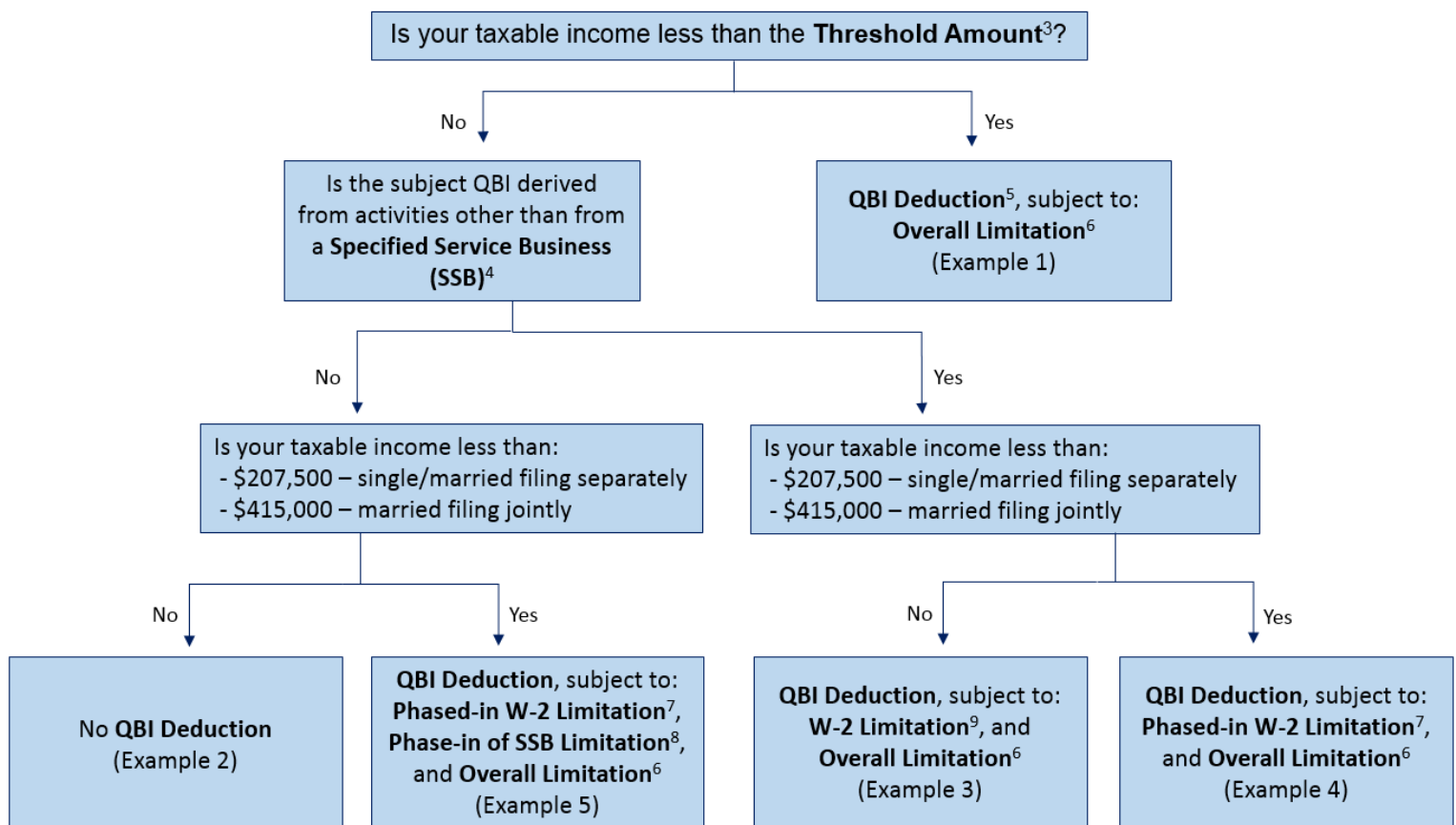
Believing that “a picture is worth a thousand words,” we have prepared the following flowchart, along with coordinated numerical examples.

- The flowchart takes the rather complicated framework of the new law and distills it into a binary decision tree.
- The examples provided illustrate the computations required for practical application.

Together, we believe that this material will prove an extremely useful reference tool in navigating the new pass-through tax architecture.

Please continue to the flowchart on page 2.

§199A Deduction for Pass-Through¹ Qualified Business Income (QBI)²



Footnotes

¹ **Pass-Through** – Any limited liability company, partnership, S corporation, or sole proprietorship.

² **Qualified Business Income (QBI)** – For any taxable year, the amount of net income effectively connected to the U.S. with respect to any Qualified Trade or Business of the taxpayer, determined on an entity by entity basis. The following items shall not be taken into account in determining QBI: interest, dividends, capital gains/losses, guaranteed payments to partners, and reasonable compensation to S corp shareholders. **Qualified Trade or Business** – Any trade or business other than a specified service trade or business, or the trade or business of performing services as an employee.

³ **Threshold Amount** – \$157,500 for single/married filing separately, \$315,000 for married filing jointly.

⁴ **Specified Service Business (SSB)** – 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, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. Definition is derived from §1202(e)(3)(A), except for engineering and architectural businesses, which are excluded.

⁵ **QBI Deduction** – A deduction in determining taxable income in the amount of 20% of QBI, not to exceed the Overall Limitation⁶.

⁶ **Overall Limitation** – Lesser of aggregate QBI or 20% of total taxable income (excluding capital gains).

⁷ **Phased-in W-2 Limitation** – The Excess Amount¹⁰ reduced by the Reduction Percentage¹¹.

⁸ **Phase-in of SSB Limitation** – Deduction after Phased-in W-2 Limitation⁷ multiplied by Applicable Percentage¹².

⁹ **W-2 Limitation** – Limits the QBI Deduction⁵ to the greater of; 50% of W-2 Wages¹³, or the sum of 25% of W-2 Wages¹³ plus 2.5% of unadjusted basis (acquisition cost) of all qualified property¹⁴.

¹⁰ **Excess Amount** – The amount by which the W-2 Limitation⁹ would reduce the QBI Deduction⁵.

¹¹ **Reduction Percentage** – The ratio of taxable income in excess of Threshold Amount, over \$50,000(single/married filing separately) or \$100,000 (married filing jointly).

¹² **Applicable Percentage** – 1 minus the Reduction Percentage¹¹.

¹³ **W-2 Wages** – The total wages [as defined by Sec. 3401(a)] subject to wage withholding, elective deferrals [as defined by Sec. 402(g)(3)], and deferred compensation [Sec. 457] paid by the Qualified Trade or Business to its employees during the calendar year ending during the taxable year of the taxpayer.

¹⁴ **Qualified Property** – Tangible property of a character subject to depreciation that is held by, and available for use in, the Qualified Trade or Business at the close of the taxable year, and which is used in the production of QBI.

§199A QBI Examples

Example 1 – Taxable income below Threshold Amount (QBI from SSB or non-SSB)

Full QBI deduction, subject to Overall Limitation.

Example 2 – Taxable income above \$207,000 (single/married filing separately) or \$415,000 (married filing jointly) (QBI from SSB)

No QBI deduction.

Example 3 – Taxable income above \$207,000 (single/married filing separately) or \$415,000 (married filing jointly) (QBI from non-SSB)

A files a joint return and has total taxable income of \$450,000 from all sources.

A receives \$200,000 of line 1 ordinary income from an LLC not engaged in an SSB. **A**'s allocable share of the LLC's W-2 Wages is \$30,000, and allocable share of unadjusted basis in qualified property is \$0.

W-2 Limitation. 20% of **A**'s QBI = \$40,000. 50% of **A**'s share of W-2 Wages = \$15,000.

The QBI deduction is limited to the lesser of 20% of QBI or the greater of 50% of W-2 Wages, or the sum of 25% of W-2 Wages plus 2.5% of unadjusted basis of qualified property.

A's QBI deduction = \$15,000 [lesser of \$15,000 or \$40,000]

A's deduction is not limited by the Overall Limitation, as the deduction does not exceed QBI or 20% of taxable income.

Example 4 – Taxable income between \$157,500-\$207,000 (single/married filing separately) or \$315,000-\$415,000 (married filing jointly) (QBI from non-SSB)

B files a joint return and has total taxable income of \$385,000 from all sources.

B receives \$200,000 of line 1 ordinary income from an LLC not engaged in an SSB. **B**'s allocable share of the LLC's W-2 Wages is \$30,000, and allocable share of unadjusted basis in qualified property is \$0.

Phased-in W-2 Limitation. 20% of **B**'s QBI = \$40,000. 50% of **B**'s share of W-2 Wages = \$15,000. The Excess Amount is \$25,000 (\$40,000 less \$15,000).

Taxable income exceeds the threshold by \$70,000 (\$385,000 - \$315,000). The Reduction Percentage is 70% (\$70,000/\$100,000). The QBI deduction is reduced by the Reduction Percentage multiplied by the Excess Amount.

B's QBI deduction = \$22,500 [\$40,000 - (70% x \$25,000)]

B's deduction is not limited by the Overall Limitation, as the deduction does not exceed QBI or 20% of taxable income.

Example 5 – Taxable income between \$157,500-\$207,000 (single/married filing separately) or \$315,000-\$415,000 (married filing jointly) (QBI from SSB)

C files a joint return and has total taxable income of \$385,000 from all sources.

C receives \$200,000 of line 1 ordinary income from an LLC engaged in an SSB. **C**'s allocable share of the LLC's W-2 Wages is \$30,000, and allocable share of unadjusted basis in qualified property is \$0.

Phased-in W-2 Limitation. 20% of **C**'s QBI = \$40,000. 50% of **C**'s share of W-2 Wages = \$15,000. The Excess Amount is \$25,000 (\$40,000 less \$15,000).

Taxable income exceeds the Threshold Amount by \$70,000. The Reduction Percentage is 70% (\$70,000/\$100,000). The QBI deduction is reduced by the Reduction Percentage multiplied by the Excess Amount.

C's QBI deduction before SSB Limitation = \$22,500 [\$40,000 – (70% x \$25,000)]

Phase-in of SSB Limitation. The Applicable Percentage is 30% (1 – 70%). The QBI deduction before SSB Limitation is multiplied by the Applicable Percentage to determine the QBI deduction.

C's QBI deduction = \$6,750 [\$22,500 x 30%]

C's deduction is not limited by the Overall Limitation, as the deduction does not exceed QBI or 20% of taxable income.

Contact Us

As alluded to above, each set of facts will present its own set of interpretational issues. In the weeks and months ahead, we will follow up with additional articles addressing these issues, with a particular emphasis on structuring and business planning to maximize tax efficiencies.

In the meantime, we encourage you to reach out to the author Thomas J. Riggs, Partner, at triggs@pkfod.com or to your PKFOD engagement professionals for guidance or simply to ask questions.

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