

*Wealth Planning Update*

# Pass-Through Entity Taxation Deduction – What Does it Mean for You?

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***In this Wealth Planning Update:***

- » *Tax reform legislation has resulted in significant changes for business owners.*
- » *Business owners of “pass-through” entities have new opportunities due to the deduction now available. Your financial future can be substantially impacted by your “what’s next”*
- » *Since the changes for pass-through entities are not straightforward it is important to work with your advisors to understand how these changes impact you and your plan to maximize your available deduction*

In the last weeks of 2017, Congress passed and the President enacted legislation reforming the tax code. These are the most comprehensive changes to tax law since 1986. By understanding the implications of these changes, we can help you identify and implement strategies to take advantage of the reform for you individually, for your businesses and investments, and your family wealth planning.

The focus of this piece is on the changes and opportunities related to business owners of “pass-through” entities (defined generally as any business other than a “C” corporation). Under the new law (Section 199A), **owners of these pass-through entities benefit from an income tax deduction of up to 20% of qualified business income.** For business owners taxed at the highest individual tax rate (now 37%, rather than 39.6% under the old tax rates), the result of this deduction is an effective rate of only 29.6% on the business income.

While this deduction appears fairly straight forward, consideration must be given to specific rules and significant limitations to this Section 199A deduction.

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Many may discover that these rules severely restrict or entirely eliminate the availability of this deduction. By understanding how these limitations apply to your business(es), we can work with you and your other advisors to help you explore and identify the most effective ways to take advantage of this deduction through discussions and planning options.

To summarize Section 199A, three critical questions must be answered:

**(1) Who does it apply to? (2) What does it apply to? (3) What are the limitations?**

Only then can we understand **(4) Why Section 199A?** and **(5) How does it work?**

### WHO DOES IT APPLY TO?

This new tax deduction benefits the owners of “pass-through” business entities, which include:

- Partnerships
- S corporations
- LLCs (not taxed as a “C” corporation)
- Sole proprietorships

The income earned by these business entities passes directly through to the owner’s personal tax return, hence the name.

In general, this deduction is available for business owners of pass-through entities engaged in any type of business activity (e.g. service, manufacturing). However, for owners with taxable income in excess of relatively modest thresholds (described below), the deduction is subject to certain limitations. Most significantly for owners of personal service businesses\* with taxable income in excess of the thresholds, the new deduction is phased out until it is eliminated entirely.

### WHAT DOES IT APPLY TO?

The 20% deduction applies to “Qualified Business Income” which is essentially defined as ordinary income from a taxpayer’s trade or business that is conducted within the United States. In general, it does not include investment income, such as capital gains, dividend income, or interest income. The definition also specifically excludes reasonable compensation paid to the owner of the pass-through, whether through guaranteed payments or wages. So, Qualified Business Income is the earnings from the operation of the business itself after all expenses are paid (including compensation to the owner).

In addition, the Section 199A deduction applies to a few other less common income sources, which are beyond the scope of this article.

### WHAT ARE THE LIMITATIONS?

In the broadest context, a taxpayer cannot deduct greater than 20% of total taxable income less capital gains (i.e. qualified business income plus income from all other sources less capital gains). Thus, the Section 199A deduction is the **lesser of** (a) 20% of the qualified business income, referred to in the statute as the Combined Qualified Business Income Amount (CQBIA), OR (b) 20% of the taxable income minus capital gains (TIMCG).

Further, if the owner's taxable income exceeds \$157,500 for single filers or \$315,000 if married filing jointly, the 20% deduction is subject to limitations. For personal service businesses, the limitation is structured as a phase-out reducing the owner's deduction on a pro-rata basis to the extent taxable income exceeds the thresholds above.\*\* When taxable income reaches \$207,500 or \$415,000, respectively, the deduction is no longer available against income from a personal service business.

For all other businesses, the phase-out is actually a phase-in of limitations on the available deduction, a new "greater of" test. The "greater of" test further limits the 20% deduction to the **greater of:**

- (1) 50% of the W-2 wages paid by the business\*\*\*, or
- (2) 25% of the W-2 wages paid by the business *plus* 2.5% of the unadjusted income tax basis in business property.

This test is phased in for taxable income of \$157,500 through \$207,500 for single filers or \$315,000 to \$415,000 for married filing jointly. For taxable income of \$207,500 or \$415,000, respectively, this "greater of" test is fully applicable.

**It is important to note that these tests are applied on a Qualified Trade or Business (QTB) by QTB basis.\*\*\*\*** Therefore, income from multiple businesses (and more importantly W-2 wages and unadjusted income tax basis) may not be aggregated if the taxpayer has ownership in more than one QTB. Rather, a separate calculation of qualified business income for each separate QTB is required. Once the deduction amount is determined for each QTB, these deductions are accumulated on the owner's tax return.

### WHY SECTION 199A?

Before we look at the application of this Section 199A deduction, it is helpful to understand the rationale behind it. In general, Congress wanted to make sure the small business owner was not overlooked by this tax reform. C Corporations (most large publicly traded corporations) benefit from a reduction in tax rates from a top rate of 35% to a flat 21%. Providing this Section 199A deduction for other business types was Congress' tip of the hat to the small business owners. However, it is worth noting that the C Corporation tax rate reduction is permanent under the new law, whereas the Section 199A deduction is set to sunset on December 31, 2025.

The details of Section 199A provide additional insight into its purpose. For instance, the first variable in the "greater of" test (50% of W-2 wages) is an incentive to businesses creating job opportunities. The more wages the business pays, the more deduction is available to the owners. The second variable in the "greater of" test (25% of W-2 wages plus 2.5% of unadjusted income tax basis) is an incentive for businesses making significant investments in the economy, but that may not employ a large work force. This may include real estate developers and similar industries. In this test, the business owner is able to take advantage of large investments such as buying or constructing a building.

This “greater of” test introduces a basis concept that is new to tax law and refers to the *unadjusted* income tax basis (that is, the actual cost of acquisition of the asset without depreciation) if the asset meets four requirements.

To be used in this calculation, the asset must be:

- (1) Depreciable property
- (2) Available for use in the business
- (3) Still within the depreciation period or 10 years of acquisition
- (4) Held at the end of the year

### HOW DOES IT WORK?

Now that you have the background and rules, let’s look at how this Section 199A deduction is applied.

#### Example 1:

Alice is the 100% owner of a non-service business S-Corporation. The business generates \$2.5MM of qualified business income and Alice has \$600K of capital gain with \$100K of deductions for total personal (form 1040) taxable income of \$3MM. The S Corporation has an overall W-2 payroll of \$500K (which includes \$275K the company pays to her as compensation) and \$3MM in unadjusted income tax basis in business property.

Alice’s available deduction is the **lesser of** (i) the combined qualified business income amount or (ii) 20% of the taxable income minus capital gains (TIMCG).

First, we determine the combined qualified business income amount. If Alice’s taxable income were less than \$157,500, then this amount simply equals 20% of qualified business income. However, her taxable income is \$3MM, which exceeds the threshold amount and phase-in amounts. As a result, we must determine the lesser of (i) 20% of qualified business income or (ii) the amount from the “greater of” test.

- (i) 20% of Qualified Business Income:  $\$2.5\text{MM} * 20\% = \$500\text{k}$
- (ii) “Greater Of” Test:
  - a. 50% of W-2 Wages:  $\$500\text{k} * 50\% = \$250\text{k}$
  - b. 25% of W-2 Wages plus 2.5% of Unadjusted Basis:  $\$500\text{k} * 25\% + \$3\text{MM} * 2.5\% = \$125\text{k} + \$75\text{k} = \$200\text{k}$

Based on this analysis, the qualified business income amount is **\$250k**.

Second, we determine 20% of taxable income minus capital gains (TIMCG).

$$20\% * (\$3\text{MM} - \$600\text{k}) = \mathbf{\$480\text{k}}$$

The third and final step is to determine the lesser of (i) **\$250K** and (ii) **\$480K**. Having completed all three steps, the Section 199A deduction is \$250K.

#### Example 2:

Assume, instead, that Alice had \$10MM in unadjusted income tax basis in business property (such as a building she constructed) with the same amount of W-2 payroll. In that case, the

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second “greater of” test would result in **\$375K** (which is 25% of the W-2 wages [\$125K] plus 2.5% of \$10MM [\$250K]). Now, the third and final step is to take the lesser of (i) **\$480K** and(ii) **\$375K**. Therefore, the Section 199A deduction under Example 2 is \$375K.

### NOW WHAT?

With many variables (such as type of business, wages paid, and unadjusted income tax basis) and calculations to be done on a QTB by QTB basis, the Section 199A deduction is more complex than it may seem on its face. We are available to help you examine the underlying operations of each business to determine how you can maximize the Section 199A deduction. For instance, you may consider a shift in entity organization or operation, restructure of wages, separation of service activities, or transfers to complex trusts. Although this is not an exhaustive list, careful consideration should be made to both the tax and non-tax benefits now available under the reformed tax code.

If you have questions about your current entity structure, your ability to use the Section 199A deduction or are considering a reorganization of your business, please reach out to your Relationship Manager, Financial Advisor or Wealth Planning Specialist in your market.

*\* Such as health, law, accounting, investments or any field in which the principal asset is the skill of an owner or employee. Architects and engineers were excluded from the definition of service businesses. There is significant ambiguity regarding the definition of a “personal service business,” and we expect clarity from the IRS over time.*

*\*\* The exact calculation of the available deduction within the phase-out and phase-in of limitation threshold range is beyond the scope of this article.*

*\*\*\* W-2 wages do not include guaranteed payments or other owner compensation from pass-through entities except in the case of S Corporation wages paid to a shareholder.*

*\*\*\*\* The term Qualified Trade or Business has not been clearly defined in the Code or Treasury Regulations. Additional clarification from the IRS or Department of Treasury is required.*

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