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PASS-THROUGH INCOME UNDER THE NEW TAX BILL

There has been a lot published about the pass-through deduction for income from pass-through entities (partnerships, LLC's, and S Corporations) which will lower the effective tax rate on business income, but very little has been talked about in the press as to the limit on this benefit, or definitions of how "qualified business income" subject to the deduction is determined – I have outlined below the way the calculation of the deduction and reduction works:

1. **Determine qualified business income** – Defined as the sum of the amounts for each qualified trade or business (**but excluding capital gains**) plus 20% of the aggregate amount of qualified real estate investment trusts (REIT's) dividends and qualified publicly traded partnership income.
2. **Deduction for qualified business income** - The deduction for each taxable year is an amount **equal to the sum of**:
 - a. The **lesser** of:
 - i. The combined qualified business income, **or**
 - ii. An amount equal to 20 percent of the excess (if any) of:
 - a) The taxable income for the year over
 - b) The sum of any net capital gain; **plus**
 - b. The lesser of (**note that this likely won't apply to you so for practical purposes ignore the following**):
 - i. 20% of aggregate amount of qualified cooperative dividends, or
 - ii. Taxable income (reduced by the net capital gain for the year)
 - c. **The deduction can't exceed taxable income for the year (reduced by capital gain)**
3. The deduction is limited by the **greater** of 50% of W-2 wages for the entity, or 25% of wages plus 2.5% of the unadjusted basis of depreciable assets of the entity as of the acquisition and excluding depreciation (this period only lasts 10 years from the date the property is acquired, or the last day of the last full year that the property is being depreciated). So for real estate entities where there are typically very low or no wages, the cap will be based on the 2.5% of the unadjusted basis, immediately after acquisition. The limit on the deductions described above only apply when taxable income is above the "threshold amounts" which are **\$157,500** for single returns or **\$315,000** for joint returns.
4. Losses carry forward from one year to the next for purposes of determining the 20% deduction.
5. The deduction is not permanent – it runs from **2018 – 2026** unless extended or eliminated.
6. The deduction only applies to Domestic business income



7. Qualified business income does not include income from some specified service businesses. A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or 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, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. **It also does not include capital gains, dividends or interest income.**
8. Note the good news is that the deduction is applied to pass through income allocated to trusts as well.
9. The deduction is applied at the partner level and it does not reduce gross income for purposes of applying the limits on gross income (i.e. for medical expenses, miscellaneous itemized deductions, etc.)

To illustrate, let's assume the following facts:

- a. Income is above the threshold amount so the limits to the 20% deduction will be applied
- b. Pass-through income is 2 million dollars
- c. Wages of the pass-through entity are zero
- d. The unadjusted basis of real estate as of the acquisition date and excluding depreciation is 10 million

The maximum deduction allowed would be 20% of the 2 million, or \$400,000, limited to 2.5% of \$10M asset cost or \$250,000. If the unadjusted basis of the asset was 20M, then the deduction would be the full \$400,000.