Section 199A Pass-Through Deduction and the Magic Number

Tax Section

By John G. Hodnette

The 2017 Tax Act includes a new deduction for qualifying pass-through entities codified as Section 199A. Taxpayers other than corporations operating a business are generally allowed the deduction, subject to complex limitations, which require thoughtful planning to ensure taxpayers fully benefit. Certain classes of businesses deemed a "specified service trade or business" are subject to severe restrictions. However, for taxpayers not operating a specified service trade or business, use of the magic number equation explained below provides a simple and effective approach to maximize the deduction.

The Section 199A deduction is generally equal to 20 percent of the taxpayer's qualified business income (QBI). QBI is the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business. This flat 20% deduction begins to phase out based on the taxable income of the taxpayer, beginning at $315,000 for married filing jointly taxpayers and $157,500 for single taxpayers. What happens next depends on whether the taxpayer's business is a specified service trade or business. If it is, the deductions phase out as taxable income increases from $315,000 to $415,000 or $157,500 to $207,500 (for married filing jointly or single, respectively). If the business is instead a qualified trade or business, a different limit phases in over the same range of taxable income described above.

A qualified trade or business is any trade or business other than a specified service trade or business. A specified service trade or business is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial sciences, performing arts, 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. Unfortunately for lawyers, practicing law is a specified service trade or business.

If a taxpayer with a qualified trade or business has taxable income above the limits described above, the deduction is not simply 20% of QBI. Rather, the deduction is the lesser of (1) 20% of QBI or (2) the greater of (a) 50% of the W-2 wages of the business or (b) the sum of 25% of W-2 wages and 2.5% of the unadjusted basis immediately after acquisition of all qualified property (generally, depreciable business property). Once above that threshold of taxable income, therefore, the Section 199A deduction is not straightforward. Still, there is a simple way for any qualified trade or business (even one that has only one owner) to maximize the deduction. This simple approach is for the business to be a Subchapter S corporation and for one owner to hire himself or herself as an employee. Once hired, the S corporation will pay the owner a salary that will generate the necessary wages not only to comply with the general requirement of S corporation owners paying themselves reasonable compensation but also to deal with the phased-in restrictions of Section 199A. But exactly how much salary needs to be paid? That is where the magic number comes in. So long as the taxpayer's taxable income is above the full phase-in detailed above, this magic number will work regardless of the amount of the business' QBI.

The magic number is 28.571%. So long as a qualified trade or business owner pays himself or herself a salary (or pays combined salaries to multiple employees) equal to 28.571% of the business' QBI (calculated without taking into account salaries), the highest possible Section 199A deduction will be available.

For example, assume a business owner is married and files a joint return with his spouse. His business has no depreciable property and produces a QBI of $415,000. This is his and his spouse's sole source of income, so their taxable income is also $415,000 (for the sake of simplicity). They are fully phased-in as to the limit. Assume the primary taxpayer converts his business to an S corporation and pays himself a salary of 28.571% of his QBI. His resulting salary is $118,569.65 per year. After taking that salary into account, his new QBI is $296,430.35. Under this approach, 20% of the new QBI is $59,286.07, and 50% of the W-2 wages is $59,284.83. That the numbers are essentially the same means the deduction is maximized.

Assume the next year the business booms and has QBI (before calculating any salary) of $1,000,000. The business owner increased his salary over the year using the magic number as a guide. Therefore, he paid himself 28.571% of the QBI as salary, or $285,710. His business' new QBI, after taking the salary into account, is $714,290. The Section 199A deduction is limited to the lesser of 20% of the new QBI ($142,858) or 50% of the W-2s ($142,855). The use of the magic number results in the numbers being essentially identical, which maximizes the deduction.

If a taxpayer is operating a qualified trade or business and is close to the phase-in taxable income amounts of $315,000 for married filing jointly or $157,500 for single, careful planning based on the magic number may maximize the new tax deduction in Section 199A.