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### Pass-Through Entities

Ruth M. Wimer of Winston & Strawn LLP discusses new tax code Section 199A and the extraordinarily complex rules and formulas for determining when a taxpayer might exclude up to 20 percent of pass-through trade or business income. Wimer says Form W-2 wages paid to both the taxpayer and others is the key for higher income individuals to obtain the 20 percent exclusion and describes the steps to get there.

## Tax Reform: Form W-2 Significance for Pass-Through 20% Section 199A Deduction

BY RUTH M. WIMER

As part of its quest to provide tax simplification, Congress enacted new tax code Section 199A providing extraordinarily complex rules and formulas for determining when a taxpayer might exclude up to 20% of pass-through trade or business income (sole proprietorship, partnership, LLC, S corporation) referred to as “Qualified Business Income.” For higher income taxpayers, (2018 thresholds of \$157,500 single/\$315,000 joint) the key to the analysis of obtaining the nirvana of the 20% exclusion is Form W-2 wages, paid both to the taxpayer *and to others*. Form W-2 wages can be relevant in the analysis in up to two parts of the new Section 199A requirements, and higher wages can be both good and bad, depending upon the facts. This article explains the impact of Form W-2 wages for purposes of new Section

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199A and the now necessary coordination with the payroll department in order to determine many taxpayers potential 20% deduction. The conclusions in this article may motivate the taxpayer with Qualifying Business Income to make changes or re-structure the taxpayer’s businesses to pay more Form W-2 wages.

### Introduction

There are thorough and lengthy articles on new Section 199A; this article is intended to give a brief overview of the basic rules, with a more in-depth focus on the Form W-2 impact. First, a taxpayer must be lucky enough to have Qualified Business Income which is generally defined by Section 199A(c) as ordinary income, gain, deduction, and loss, of a “trade or business” (a term not precisely defined by Section 199A), effectively connected with the conduct of a trade or business within the U.S. under Section 864(c) (with modification), and excluding the taxpayer’s wages, guaranteed payments, and investment type income such as most capital gains, interest, and dividends. The Qualified Business Income is subject to a maximum 20% deduction based on the type of income, specified service or not specified service, and the level of the taxpayer’s total taxable income.

### Form W-2 Limit

As can be seen from the chart, only higher income taxpayers are subject to the “Form W-2 Limit.” The Form W-2 Limit is the *greater of*:

Total Taxable Income (e.g. similar to Line 43 of 2016 Form 1040)	Not exceeding threshold Single: \$157,500 Joint: \$315,000	Threshold plus Phase Out/in Single: \$157,501- \$207,500 Joint: \$315,001- \$415,000	Over Threshold Single: \$207,501 Joint: \$415,001
Specified Service trade or business (e.g. accounting, law, consulting)	Full 20% Deduction No W-2 Limit applied	20% Deduction subject to phase-out, W-2 Limit phased in	No 20% Deduction at all permitted, so W-2 Limit irrelevant
Non-specified Service trade or business (e.g. rental)	Full 20% Deduction No W-2 Limit applied	20% Deduction subject to phase-in of W-2 Limit	20% Deduction permitted but fully subject to W-2 Limit

1. 50% of all (taxpayer and non-taxpayer) Form W-2 wages specifically attributable to the applicable trade or business and allocated to the particular taxpayer owner, or

2. 25% of the wages as described above, *plus* 2.5% of Section 167 depreciable qualified tangible property unadjusted acquisition cost, currently owned and used by the trade or business for the greater of the depreciation period or 10 years.

Clearly, the above Form W-2 Limit treats higher Form W-2 wages as “good” for purposes of the 20% of Qualified Business Income maximum deduction. Importantly, however, for those businesses which have *substantial depreciable assets* such as real estate, aircraft, or machinery used in the trade or business, the second method above may be sufficient to provide the maximum 20% deductions *without the necessity of any wages at all*. In other words, the Form W-2 Limit also has a non-wage component added to the statute to assist trades or business with significant assets but no employees. For example, a taxpayer with \$5,000,000 of Qualified Business Income and \$40,000,000 of depreciable qualified property, would meet the requirement to fully deduct the maximum \$1,000,000 (20% of \$5,000,000) without any employees to which it pays wages (25% of wages = 0, plus 2.5% of \$40,000,000, = \$1,000,000). However, absent sufficient depreciable assets to meet the Form W-2 Limit independently, the high income taxpayers will need to know the rules for determining Form W-2 wages.

Based on the above, it would initially appear that Form W-2 wages are only “good.” However, Form W-2 wages, as well as Form K-1 guaranteed payments attributable to the actual taxpayer’s services are in a sense “bad” because those amounts do not count as Qualified Business Income to which the 20% deduction may apply. In other words, the taxpayer’s own wages or guaranteed payments are not Qualified Business Income and would reduce the amount of available income. As the example at the end of the article illustrates however, a business can be structured, perhaps by forming an S-Corporation, to optimize the Section 199A deduction by paying out the minimal amount of wages necessary to obtain that 20% maximum deduction.

Because Form W-2 wages, in contrast to Form 1099-MISC remuneration, is generally helpful to the Section 199A deduction, taxpayers may be tempted to engage workers as employees rather than independent contractors where that type of relationship is warranted. It is well known that the IRS prefers employee status, but the taxpayer should be mindful of the associated employment tax and benefits costs.

## The Basics: Formula for the Section 199A Pass-Through Deduction

The formula (absent the special favorable rules applicable to REIT dividends, qualified cooperative dividends, and qualified publicly traded partnerships), for the maximum pass-through deduction *before* application of the Form W-2 Limit, is generally the lessor of:

- 20% of the taxpayer’s total taxable income, less capital gains as defined in Section 1(h), or
- The sum of 20% of each qualifying trade or business income.

Note, a “20%” maximum limit comes in to the equation in two places: each qualifying trade or businesses income is limited to 20% deductibility, and then those amounts combined may not exceed 20% of the taxpayer’s taxable income less capital gains. If the trade or business is a specified service business, then further limits apply differently as compared to a non-specified service business. Taxpayers with *total income* over the Phase Out Range, i.e. the threshold amounts \$157,500 for single taxpayers and \$315,000 for joint returns (indexed after 2018), plus the phase out amounts, \$50,000 (single) or \$100,000 (joint), receive *no deduction at all* for specified service income. For taxpayers with taxable income within the Phase Out Range, the maximum deduction for specified service income is phased out under a formula, using the Form W-2 Limit, for amounts over the threshold levels.

Importantly, and in contrast, if the trade or business is *not* a specified service business, then even taxpayers with billions of taxable income can receive the 20% deduction, but subject to the Form W-2 Limit.

### Specified Service

As can be seen from the chart above, whether a trade or business is a specified service is key for higher total taxable income taxpayers because once the taxpayer is over the threshold amount plus Phase Out (\$207,500 /\$415,000), *no Section 199A deduction* is available at all, no matter the size of the Form W-2 amounts.

Specified services are defined by reference to (1) Section 1202(e)(3)(A) substituting “owners and employees” for “employees”, but excluding engineering and architectural services, and (2) the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Section 475(c)(2)), partnership interests, or commodities (as defined in Section 475(e)(2) (financial services)).

Thus the specified services list includes health, law, accounting, actuarial science, 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.

This definition puts stress on the analysis of which trades or businesses may be caught as a “consulting” firm or one in which the skill and experience of employees or owners is key, an analysis with subjective overtones. In *Owen v. Commissioner*, T.C. Memo. 2012-21, addressing the narrow issue of whether the pre-paid legal/estate planning insurance sales business fell in to the definition of specified service business, the court

noted that while the success of the business was due to the owner, that because independent contractors did most of the actual work, the definition would not apply. Note that engineering and architectural firms that fall into either the consulting or "skill and reputation" categories would also be included in the harsher rules applicable to specified services.

**Example:** An attorney "of counsel" receiving a Form 1099-MISC, with total taxable income of less than the threshold amount, would obtain a full 20% exclusion despite being clearly a specified service. This "of counsel" attorney would have a reduced deduction if his total taxable income was between the threshold and the threshold plus phase-out amount subject to phased Form W-2 Limits, and would have no deduction if his total taxable income was over the threshold amount plus the phase-out amount. In contrast, an associate or partner attorney with the same levels of income, but receiving only wages or guaranteed payments, would not have any deduction because *neither of such amounts* are Qualified Business Income.

## Form W-2 Wage Limit Number – Not on Form W-2

The wage limit component of the "Form W-2 Wage Limit" is defined by the new statute with reference to "Section 6051(a)(3) and (8)." This mirrors, in part, the language in Section 199(b) as it existed prior to the Tax Cuts and Jobs Act relating to the Domestic Production Activities deduction. Guidance on wage issues had been issued under prior Section 199 in Revenue Procedure 2006-22 and in Section 199 regulations.

Note that Form W-2 wages could have included references to Federal Income wages (Box 1), Social Security (Box 3), Medicare (Box 5), or even state wages (Box 16), as reported on Form W-2. However, the preceding Section 199A statutory reference is to wages for Federal income tax *withholding* purposes, Section 3401(a), *plus* "the total amount of elective deferrals (within the meaning of Section 402(g)(3) and compensation deferred under Section 457, including the amount of designated Roth contributions (as defined in Section 402A))."

Unfortunately, this special definition of Form W-2 wages is *not actually included on the Form W-2 at all*. Box 1 included *all* wages, not just those subject to withholding. Box 2 shows the actual Federal Income tax withheld, but not the wages which were subject to the withholding. The total wages subject to withholding should be accounted for by the payroll system so that the payroll withholding can take place, and that number certainly is obtainable with the proper co-ordination with payroll. To the base withholding number would be added the total Section 402(g) and Section 457 deferrals as defined in Section 6501(a)(8), also a number that could be obtained from the payroll department. Rev. Proc. 2006-22 provided three safe harbors for determining the definition of wages for purposes of old Section 199: (1) The unmodified box method which uses the lesser of Box 1 or Box 5; (2) the Modified Box 1 method which adds a modified Box 1 amount subtracting amounts not subject to Federal Income tax withholding, added to the deferrals reported in Box 12; and (3) the Tracking Method where the amounts subject to Federal Income tax withholding are tracked, deferrals are added, and other modifications made.

Section 199A Wages do not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60<sup>th</sup> day after the due date including extensions for such return. Thus, good compliance with the reporting rules is necessary to get credit for the maximum amount of Form W-2 wages.

Section 199A(f)(1)(C) provides special rules for trades or business in Puerto Rico including that wages are determined without regard to any exclusion under Section 3401(a)(8) for remuneration for services in Puerto Rico.

The wages are those reported in the calendar year ending during the taxable year of the taxpayer. The statute requires the Secretary to prescribe rules regarding acquisition, dispositions, and short taxable years where the taxpayer acquires or disposes of the major portion of a trade or business of the major portion of a separate unit of a trade or business during the taxable year.

Careful analysis must be made of the actual substantive employment situation rather than simply using the wages reported on a Form W-2 by the trade or business. Important to note is that a qualified trade or business may have Form W-2 wages for purposes of Section 199A, but may not be actually issuing the Forms W-2, because a third party has assumed that responsibility including where employees are leased to the trade or business but are still common-law employees of the trade or business. On the flip side, the trade or business may issue Form W-2s to employees that are actually providing services to another and separate trade or business.

Rev. Proc. 2006-22 and the Section 199 regulations provides guidance on the wage issues described above albeit as applied to Section 199, not Section 199A. Although Rev. Proc. 2006-22 is not authority for Section 199A, it provides some insight in to how issues were interpreted with respect to similar wage determination issues.

## Rules for Allocating Form W-2 Wages to the Taxpayer

If there are multiple owners of the qualifying trade or business, then each owner only gets an allocable share of the Form W-2 wages. For example, three equal owners of either an S Corporation or LLC/partnership would generally only get 33.3% of the allocation of a \$100 million payroll rather than all of it. In contrast, sole proprietorships or single member disregarded entities of a single trade or business would get 100% of any payroll Form W-2 wages for Section 199A purposes.

Secondly, only the wages attributable to the employees of the trade or business may be used for purposes of each calculation for the taxpayer's Qualified Business Income. In other words, it appears that the maximum 20% deduction for each trade or business must have the Form W-2 Limit applied separately before the totals are aggregated as part of the final calculation. This puts stress on determining what is a separate trade or business and which wages belong to such separate trade or business. For example, an S Corporation or Partnership may have several different qualifying trade or businesses, as well investment activities resulting in capital gains and losses. In this example, there may be

employees that work separately for each activity, as well as overhead employees which provide services to the trades or businesses and the investment activities. It may be that there are gains in one of the activities and losses in others. Exactly how these allocations of wages will be made is uncertain, but what is certain is that there must in fact be an allocation. Section 199A(f)(1)(A) provides that in the case of an entity taxable as a partnership, the allocation must follow the allocation of the expenses to the partners related to wages. In the case of an S corporation, the allocation must be in proportion to the percentage of stock ownership of each shareholder. Section 199A(f)(1)(B) provides that Trusts and Estates will follow the old Section 199(d)(1)(B)(i) for rules for the apportionment of wages.

There would also need to be an allocation of wages with respect to “tiered entities”, that is pass-through entities owned in whole or in part by the immediately owned pass-through entity.

Regulations issued under Section 199 provided extensive guidance on methods which are permitted for the purpose of allocating wages. It is possible these rules may be referred to in part by subsequent guidance for purposes of Section 199A also.

### **Reasonable Compensation Reduces Qualified Business Income**

The statute provides that both guaranteed payments and Form W-2 compensation of the taxpayer reduce the Qualified Business Income eligible for deduction. This leads to the conundrum of entertaining the restructuring of a trade or business, which does not have any other wages or depreciable property, to one that pays the taxpayer a Form W-2 wage so that the Form W-2 limit is satisfied, yet at the same time leave some Qualified Business Income on which to apply the 20%. Of course there is no concern where the taxpayer’s total

taxable income is below the threshold amounts because in that case the Form W-2 limit does not apply.

This is where algebra comes in handy. For example, a taxpayer engages in a non-specified business earns \$1,000,000, after all expenses, and operates as a sole proprietorship or disregarded entity LLC with no employees and no depreciable assets. In that type of structure, the taxpayer would have “0” Section 199A deduction because of the Form W-2 Limit applicable to high income taxpayers. If the trade or business is formed as an S-Corporation and wages are paid to the taxpayer, a Section 199A deduction may be had. However, as the wage is paid to the taxpayer, the amount of Qualified Business Income is reduced. The algebraic formula for obtaining the maximum deduction in this example is  $20\% (Y - X) = 50\% X$ , with Y as the income prior to payment of wages and X the wages. The result is .2857 of income should be paid as wages to maximize the deduction, which in this example would be \$285,714 of wages and Section 199A deduction of \$142,857.145.

### **Conclusion**

Form W-2 wages are relevant for purposes of determining the amount of Qualified Business Income which can be deducted from a taxpayer’s income where the taxpayer has taxable income over the applicable threshold amount. An exceptions to this is where 2.5% of qualified depreciable business property is already equal to the maximum 20% of the trade or business income and therefor wages are not needed to support the deduction. Another exception is where the trade or business is a specified service business and no deduction can be had at all because the taxpayer’s income is over the threshold plus the phase-out amount. For all other taxpayers that need the Form W-2 Wage number in order to take advantage of the new Section 199A deductions, systems should be put in place as soon as possible to track the special definition and allocation of wages used for that purpose.