UNDERSTANDING WHAT THE 2017 TAX REFORM MEANS FOR YOUR FIRM

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Internal Revenue Code 199A

- The Tax Cuts and Jobs Act of 2017 included a 20% deduction for “pass-through” businesses.
- Section 199A is an interesting maze of rules, definitions, and limitations.
- Section 199A contains specific limitations with respect to service professionals.
- Most businesses, including lawyers, should revisit tax status and entity structure.

IRC 199A – The Deduction Generally

- Deduction is available to individual taxpayers and trusts who own pass-through trades or businesses.
- Deduction is from Taxable Income (not from adjusted gross income).
- Taxable Income is calculated without regard to the deduction.
- Deduction has the effect of taxing flow-through income at a 29.6% rate for taxpayers being taxed at the highest rate.
  - 80% of highest bracket of 37% = 29.6%
  - Additional 3.8% net investment income tax may apply in some instances.

THE DEDUCTION GENERALLY – CONT'D

- Deduction is equal to the sum of:
  - The lesser of: (Part 1)
    - Combined qualified business income amount of the taxpayer, or
    - The amount equal to 20% of the excess of
      - The Taxable Income of the taxpayer for the taxable year, over
      - Net capital gain
  - The lesser of: (Part 2)
    - 20% of the aggregate amount of qualified cooperative dividends.
    - Taxable Income (reduced by net capital gain) of the taxpayer.

COMPONENTS OF QUALIFIED BUSINESS INCOME AMOUNT

- Qualified Business Income
  - May be limited by Specified Services Limitation

- Qualified Business Income Amount
  - Determined with respect to each business

"AMOUNT" has become a DEFINED TERM

EXAMPLE OF PART 1

- Married Taxpayer has Taxable Income of $300,000.
  - $150,000 of Qualified Business Income
  - $200,000 of Capital Gains
  - Itemized Deductions $50,000
  - Taxable Income = ($150,000 + $200,000) - $50,000 = $300,000
- Deduction Based on Qualified Business Income = $30,000
  - $150,000 * .20
- Deduction Based on Taxable Income less Net Capital Gains = $20,000
  - ($300,000 - $200,000) * .20 = $20,000
- Part 1 Deduction is $20,000

EXAMPLE OF PART 2

- Qualified Cooperative Dividends = 0
- Taxable Income Less Net Capital Gains = $100,000
- Part II Amount (lesser of the above two amounts) = 0

SUM OF PART 1 AND PART 2

- PART 1 = $20,000
- PART 2 = $0
- THE DEDUCTION = $20,000 ($20,000 +0)

MAXIMUM DEDUCTION

- UNDER NO CIRCUMSTANCE CAN THE AMOUNT OF THE DEDUCTION EXCEED THE EXCESS OF THE TAXPAYER'S TAXABLE INCOME OVER NET CAPITAL GAINS.
- Same Taxpayer but Capital Gains are $300,000 and Itemized Deductions are $150,000.
- Taxable Income is $300,000. Capital Gains are $300,000.
- No Deduction.

COMBINED QUALIFIED BUSINESS INCOME AMOUNT

- Part 1 of the calculation of the deduction refers to Combined Qualified Business Amounts
  - The amounts of each qualified business of the taxpayer are combined
  - PLUS 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income

STEP 1

- IDENTIFY QUALIFIED TRADES OR BUSINESSES FOR PURPOSES OF THE DEDUCTION

WHAT IS A QUALIFIED TRADE OR BUSINESS?

- Pass-through businesses are eligible.
- Includes partnerships, S corporations, disregarded entities, sole proprietorships.
- If an LLC elects C corporation tax status, such entity will not be a qualified trade or business.
- Remember that while an amount is calculated with respect to each pass through business, the deduction is at the individual level.
- Consider distinction between legal status of entity and tax status.

WHAT IS A QUALIFIED TRADE OR BUSINESS?

- Some LLC's and some Limited Partnerships may be taxed as C corporations.

- Consider any agreements that might result in an entity being treated as a C corporation.

- Limitations Apply to "Specified Service Trade or Business"
  - Deduction is phased out for taxpayers with specified service trade or business.
  - If Taxable Income exceeds a certain amount, then trade or business is not a Qualified Trade or Business with respect such a Taxpayer.

Specified Service Trade or Business

- 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. (IRC 1202(e)(3)(A))
  - Architects and engineers are specifically excluded from definition in 199A even though they are included in 1202(e)(3)(A). Should we become architects of law or hire a better lobbyist?

- Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.
  - What if we rely on robots? Or Artificial Intelligence? Provide online services?

When Service Business is a Qualified Trade or Business

- Law Firm (or other service business) will BE a Qualified Trade or Business
  - If Taxable Income of single taxpayer is less than $157,500 ("Single Threshold Amount").
  - If Taxable Income of married taxpayer is less than $315,000 ("Married Threshold Amount").

- It is unclear how this works for married filing separate or head of household.
  - Statute reads $315,000 for married filing joint.
  - Assumption is $157,500 applies to married filing separate and head of household.

Phase-out For Specified Service Trade or Business

- If taxable income of single taxpayer is greater than $157,500 but less than $207,500, a phase-out of the deduction shall apply ($157,500 threshold plus $50,000)

- If taxable income of married taxpayer is greater than $315,000 but less than $415,000, a phase-out shall apply ($315,000 threshold plus $100,000)

EXAMPLE OF PHASE-OUT FOR SERVICE BUSINESS

- Married Lawyer has $360,000 of Taxable Income
- $200,000 of Taxable Income is from her law practice
- Calculate Excess of Taxable Income over Threshold
  - $360,000 - $315,000 = $45,000 (“Excess Amount”)
  - $45,000/$100,000 = 45% (“Excess Amount divided by Phase-Out Amount)
  - 1 – 45% = 55% (Applicable Percentage to determine QBI)
  - .55 * $200,000 = $110,000 (QBI from Service Business)
  - $110,000 * .20 = $22,000
  - Deduction without limitation, deduction would have been $40,000

When Service Business is NOT a Qualified Trade or Business

- No Deduction is Available (Service Business is not a Qualified Trade or Business)
  - If Married Taxpayer Taxable Income exceeds $415,000
  - If Single Taxpayer Taxable Income exceeds $207,500

STEP 2

- DETERMINE THE QUALIFIED BUSINESS INCOME AMOUNT FOR EACH BUSINESS

QUALIFIED BUSINESS INCOME

- QUALIFIED BUSINESS INCOME = QUALIFIED ITEMS OF INCOME, GAIN, DEDUCTION AND LOSS

- ITEMS THAT ARE EXCLUDED FROM QUALIFIED ITEMS
  - CAPITAL GAINS AND LOSSES
  - DIVIDENDS
  - INVESTMENT INTEREST
  - CERTAIN ITEMS DESCRIBED IN IRC 954 – FOREIGN PERSONAL HOLDING COMPANY INCOME
  - AMOUNTS FROM AN ANNUITY NOT CONNECTED WITH TRADE OR BUSINESS
  - ITEMS OF DEDUCTION OR LOSS ALLOCABLE TO ABOVE REFERENCED INCOME ITEMS EFFECTIVELY CONNECTED WITH US TRADE OR BUSINESS

- MUST BE EFFECTIVELY CONNECTED WITH US TRADE OR BUSINESS

Determination of Qualified Business Income Amount for Each Trade or Business

- **Lesser Of:**
  - 20% of taxpayer's qualified business income with respect to the qualified trade or business **(Part A)**
  - **The Greater Of: (Part B) – comes into play at certain Taxable Income levels**
    - 50% of W-2 wages with respect to the qualified trade or business, or
    - The sum of 25% of W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis of all qualified property.

STEP 3

- DETERMINE WHETHER W-2 AND QUALIFIED PROPERTY ANALYSIS APPLIES – LIMITATION OF DEDUCTION BASED ON TAXABLE INCOME

Limitation Based on Taxable Income

- Even if business is a qualified trade or business (and not a specified service trade or business), various limitations apply if taxpayer income exceeds $157,500 for a single taxpayer and $315,000 for a married taxpayer.
- When income exceeds the threshold amounts, limitations apply based on the amount of W-2 wages paid from and the amount of qualified property owned by a qualified trade or business.
- **This will only affect law firms who are within the phase-out rules for specified service trade or businesses.**

PART B of Qualified Business Income Amount Calculation

- **The Greater Of:**
  - 50% of W-2 wages with respect to the qualified trade or business, or
  - The sum of 25% of W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis of all qualified property.

Wages

- Wages must be W-2 wages.
- Independent contractor payments do not count.
- Guaranteed payments to partners are not W-2 wages.
  - Should partnerships elect S status?

Qualified Property Test

- Tangible property subject to depreciation under IRC Section 167.

- Must be held by and available for use by close of taxable year.

- Must be used during the taxable year for the production of qualified business income.
  - Note: If income is not qualified business income because it is excluded at the level of the individual taxpayer under the specified trade or services rules, can the property be considered to be used in a qualified trade or business?

- Depreciable period for the property cannot have ended by the close of the tax year.
  - Note: Depreciable period used for calculating 199A deduction is not always equal to the property's depreciable life used to calculate deprecation deduction for tax purposes. Later of (i) ten years, or (ii) period that would apply under 168.

Determine Whether Income Limitations will Result in Applying W-2 and Qualified Property Tests

- Specified Service Business Limitation is separate limitation from income limitation that results in application of W-2 and qualified property tests.
  - Specified Service Business Limitation applies to calculation of Qualified Business Income of a service business

- Separate income limitation impacts calculation of Qualified Business Income "Amount" rather than Qualified Business Income.

Calculating Deduction – Determine Deductible Amount for Each Trade or Business

- **Lesser Of**:
  - 20 percent of taxpayer's qualified business income with respect to qualified trade or business, OR
  - Greater Of: (only if income limitations apply)
    - 50% of W-2 wages with respect to qualified trade or business, or
    - Sum of 25% of the W-2 wages with respect to qualified trade or business plus 2.5% of unadjusted basis of all qualified property immediately after acquisition.
  - W-2 & Qualified Property Test will apply
    - if 50% of wages is less than 20% of qualified business income, then phase-out of deduction applies
    - If 50% of wages is more than 20% of qualified business income, then there is no phase-out

Phase-out With Respect to Income Limitation

- If income of single taxpayer is greater than $157,500 but less than $207,500 or income of married taxpayer is greater than $315,000 but less than $415,000, phase-out of 20% deduction applies.

- Phase-out is calculated by a fraction
  - Amount by which taxpayer taxable income exceeds threshold ($157,500 or $315,000)
  - $50,000/$100,000 (Phase-out Amounts)

Example No Deduction Due to Income Limitation

- Married Taxpayer Has $1,000,000 of Qualified Business Income
- Qualifying Business Pays NO W-2 wages
- Qualifying Business has NO Qualified Property
- Taxpayer Has NO deduction

Example Combined Limitations

- Single lawyer has $180,000 of flow through income from law firm and taxable income of $180,000.
- Lawyer has no other flow through income. No W-2 wages paid.
- SERVICES LIMITATION CALCULATION – Lawyer is in Specified Services Phase-out
  - $180,000 – $157,500 = $22,500 (Taxable Income less Threshold Amount = Excess)
  - $22,500/$50,000 = .45 (Excess Divided By Threshold)
  - 1-.45 = .55 (Calculation of Applicable Percentage)
  - .55 * $180,000 = $99,000 (Qualified Business Income After Services Limitation).
  - 20% * $99,000 = $19,800 (20% after Services Limitation)

Example Combined Limitations

- INCOME LIMITATION PHASE-OUT
  - Starting Point $19,800
  - $180,000 – $157,500 = $22,500 (Taxable Income less Threshold Amount = Excess)
  - $22,500/$50,000 = .45 (Excess Divided By Threshold)
  - 1-.45 = .55 (Calculation of Applicable Percentage)
  - .55 * $19,800 = $10,980 Deduction After Combined Limitations

EXAMPLE COMBINED LIMITATIONS W-2 AND QP APPLIES

- Same facts as previous example, but lawyer pays paralegal $30,000 in W-2 wages and has qualified property of $50,000.
- The applicable percentage is applied to the QBI, W-2 wages and qualified property first.
  - QBI is $99,000 (.55 * $180,000); W-2 wages is $16,500 (.55 * $30,000); Qualified property is $27,500 (.55 * $50,000).
  - 20% of QBI is $19,800; 50% of W-2 wages is $8,250; 25% of W-2 wages ($4,125) plus 2.5% of qualified property ($687.50) is $4,812.50.

EXAMPLE COMBINED LIMITATIONS W-2 AND QP APPLIES

- Excess amount is the excess of QBI over the greater of (i) W-2 wages or (ii) 25% of W-2 wages plus 2.5% of qualified property, or $11,550 ($19,800-$8,250)
- The amount of the reduction is the same ratio of the excess amount compared to the ratio of the excess of the taxable income over the threshold amount ($22,500/$50,000), or 45%.
- $11,550 * .45 = $5,197.50
- $19,800 - $5,197.50 = $14,602.50 Deduction After Combined Limitations

ADDITIONAL EXAMPLES

- VARIOUS EXAMPLES FOLLOW

Example 1 – Full Deduction

- Married Lawyer has $200,000 of qualified business income from law firm and taxable income of $250,000.
- Lawyer has no other pass through income.
- Lawyer will have a qualified business income deduction of $40,000. Limitation regarding specified trade or service business does not apply because taxable income is below threshold.

Example 2 – No Deduction

- Married lawyer has $425,000 of flow-through income from his law practice.
- Lawyer has taxable income of $450,000.
- Lawyer will receive no pass-through deduction.

Example 3 – No Deduction from Services but Deduction from Other

- Single lawyer has $150,000 of income from his law practice and $100,000 of income from rental real estate flow through operation that has Qualified Property with cost immediately after acquisition of $1,000,000 [2.5% = $25,000].
- Single lawyer has taxable income of $250,000.
- Single lawyer receives no deduction with respect to flow through income from law practice (taxable income is above threshold plus $50,000.)
- W-2 and Qualified Property tests apply to rental real estate flow through. Assume no wages paid.
- Lawyer has deduction of $20,000. (Lesser of 20% of $100,000 or 2.5% of QP)

Example 4 Deduction Limited by Qualified Property Amount

- Same facts as Example 4 but acquisition cost of Qualified Property is $500,000.
- Lawyer has deduction of $12,500. (2.5% of Qualified Property)

A Law Firm Challenge in Dealing with the rules –The Single Penalty

- When applying strategies to seek the benefit of the pass-through deduction, taxable income of each law firm owner must be considered.
- Assume a two partner law firm. One partner is married with a stay at home spouse. The other partner is single.
- Both partners contribute equally to law firm revenues and share expenses.
- Assume income for Year 1 of $450,000 to be split equally.
  - Single partner receives $225,000 and gets no pass-through deduction.
  - Married partner receives $225,000 and receives a $45,000 deduction.

Some Planning Thoughts – Manage Law Firm Income

- Manage the income of your law firm.
  - Consider increased contributions to retirement and benefit plans.
  - Carefully consider the use of Section 179 and bonus depreciation. Consider the level of deduction that will be most beneficial to assist as many partners as possible in being able to take advantage of the pass-through deduction.
  - Avoid taking all the depreciation and expense possible in one year and then having no such deductions for the future. Prepare a five year analysis.

Some Planning Thoughts – The C Corporation

- Elect C corporation tax status. Law firms operated as C corporations will receive the benefit of the 21% tax rate on C corporation income and may elect a fiscal year other than December 31.
  - Keep in mind that most law firms distribute all income. In such case, a C corporation may not have significant benefits.
  - Additionally, if income is retained in the C corporation, such income will be subject to a second tax when distributed (the double taxation realm of C Corporations)
- Elect S status so you can pay wages.

Some Planning Thoughts – Separate Streams of Income

- Move separate income to a C corporation or different pass-through entity.
  - Evaluate the revenue streams of your law firm. To the extent any revenue is generated from something other than a specified service, consider moving that revenue stream to a C corporation or a different pass-through entity.
  - Using a separate C corporation may allow the taxpayer owners to provide other benefits through the C corporation that could not be provided through a flow-through. (Health insurance and other deductions flow through to the owners of S corporations and partnerships and do not reduce income.)
    - You could also establish C Corporation in a state with low or no income taxes.
    - You can use a different fiscal year for a C Corporation.

Planning Thoughts – Evaluate Revenue Streams and move non-service income to another flow-through.

- Move real estate to a separate entity and pay rent to the separate entity.
- Additional example – Perhaps the law firm has developed a web-based product for clients. Such product can likely be treated differently than revenue from traditional legal services.
- Can intellectual property be moved to a separate entity? Can some origination be allocated to that entity? Is there other income from intellectual property?
- Keep in mind that specified services includes in its definition that the principal asset is the reputation or skill of one or more employees. Many law firms are moving away from that model.

Planning Thoughts – Trust Ownership

- Trusts get their own pass-through deduction.
- Can any part of law firm ownership be transferred to a trust?