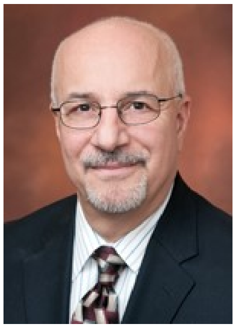
IRS Provides Guidance on 20% Pass-Through Deduction (Section 199A)
How it might affect the Transportation Industry

Co-Authors: Kent L. Schwarz, Esq. & Jay Soojian, CPA

Kent L. Schwarz, Esq.
Tax & M&A Groups, Chair
kschwarz@becker.legal



Jay Soojian, CPA
Cullari Carrico, LLC
jsoojian@cullaricarrico.com

Many companies are continually facing challenges in their industries as influences outside of their control may have negative effects on their profitability. In the trucking and transportation sectors this is especially true. For example, a shortage of qualified drivers is driving the cost of labor upwards. Increases in other costs such as fuel also increases expenses. As interest rates move upward, the cost of trucks and other equipment increases for those financing equipment purchases. Trade wars are also increasing equipment costs and even replacement parts.

Facing these challenges, it is especially important for those in the transportation industry to scrutinize costs and take advantage of laws, rules, and/or regulations that may apply to them so as to increase profitability to offset rising costs. Once such opportunity may be found in the new IRS Section 199A Pass-Through Deductions.

Effective for tax years beginning after December 31, 2017 and before January 1, 2026, a taxpayer other than a "C" corporation is entitled to a deduction equal to 20% of the taxpayer's **"qualified business income (QBI)"** earned in a **"qualified trade or business."** The IRS recently released 184 pages of highly anticipated regulations which aim to clear up uncertainties in the law.

What is a "qualified trade or business?" It is designed to include all businesses other than those of an employee and a so called "specified service business" ("SSB"). Therefore an employee is not allowed the 20% deduction against wage income.

The second category of income from a SSB is designed to prevent the conversion of personal service income into qualified business income. The code defines a specified service business as:

"…any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, securities brokerage services, or 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."

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And "…any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities."

Thus, a trucking company, freight broker, logistics company, warehousing business, limousine or busing company would be considered a "qualified trade or business".

What is qualified business income? Once a taxpayer established they are a qualified trade or business, they must determine the qualified business income for each separate business.

Qualified business income is defined as the net amount of qualified items of income, gain, deduction and loss with respect to a qualified trade or business that is effectively connected with the conduct of a business within the United States. Qualified business does not include, however, certain investment related income such as for example, with some exceptions:

- Short or long-term capital gain or loss
- Dividend income
- Interest income
- Net gain from foreign currency transactions

In addition, qualified business income does not include:

- Reasonable compensation paid to an "S" corporation owner
- Guaranteed payments paid to a partner

The decision to exclude wages paid to a shareholder and guaranteed payments to a partner from qualified business income put these entity types at a disadvantage relative to sole proprietors at certain income levels. Since guaranteed payments are not considered wages, an S-corporation may allow for a higher wage limit (described below) than a similarly situated partnership or LLC.

Determining the 20% Pass-Through Deduction
W-2 and Qualified Property-Based Limitations Based on Taxable Income
A taxpayer other than a "C" corporation is entitled to a deduction equal to 20% of the taxpayer's "qualified business income" earned in a "qualified trade or business."

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The deduction is limited for taxpayers with income in excess of a threshold ($315,000 for married and $157,500 for all others), however, to the greater of:

- 50% of the W-2 wages or
- The sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property. Note that fully deprecated assets in some cases can be counted. Land is not considered qualified property.

The resulting deduction is then subject to a **second limitation** equal to 20% of the excess of:

- The taxable income for the year, over
- The sum of net capital gain

The purpose of this overall limitation is to ensure that the 20% deduction is not taken against income taxed at preferential rates.

*Example: In 2018, Taxpayer A generates $400,000 from his trucking business. Taxpayer A and his wife file joint returns. In addition to the $400,000 of qualified business income from his trucking business, the married couple have $100,000 of long-term capital gain and $30,000 of deductions, resulting in taxable income of $470,000. The Section 199A deduction is limited to the **lesser** of $80,000 (20% of $400,000) or $74,000 (20% of $370,000, the excess of taxable income over net capital gain of $100,000).*

EXCEPTION to W-2 and Qualified Property-Based Limitations Based on Taxable Income

The above limitations do not apply when taxpayer has taxable income for the year of less than $315,000 (if married filing jointly, $157,500 for all other taxpayers).

The deduction for taxable incomes below these thresholds is **only subject to the second limitation** noted above.

Taxpayers in a Specified Service Business

These SSB taxpayers can only take a full deduction if taxable income is less than the thresholds. A partial deduction is allowed when the thresholds are exceeded and will be completely phased out when taxable income reaches $415,000 if married filing jointly and $207,500 for all other taxpayers. Once the phase-out is reached no deduction is allowed for SSB's.

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Considerations for the Transportation Industry

- Entity type, "S" corporation, partnership or sole proprietor. Each decision must not be made in a vacuum. One must consider income levels, shareholder and employee wages paid, guaranteed payments and the unadjusted basis of property to name a few of the important variables.
- The importance of the 50% of wages in the deduction calculation warrants that we take a look at the issue of independent contractor versus employee status.
- Since wages are not considered QBI, some employees may think they can switch to and be paid as an independent contractor in order to avail themselves of the deduction. However, there are anti-abuse regulations aimed at preventing this tactic.
- Payments to employee leasing companies contain a wage component as well as other charges. The wage piece can be counted when calculating the pass-through deduction.

Takeaway

As one can plainly see, the regulations are complex and will require careful planning. We have not attempted to dive deep in this article and cover all 184 pages of the proposed regulations, instead however, we hope we have popped the hood and ask that you look inside with us.

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