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Federal Tax ADVISORY ■

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Certain Banks Qualify for the 20% Pass-Through Deduction

This month brought good news for owners of small banks. On August 8, 2018, the IRS issued new Proposed Treasury Regulation §§ 1.199A-1 through 1.199A-6 (the "199A Regulations") specifically including banking in the list of businesses eligible for the 20% deduction for the qualified business income (QBI) of pass-through entities.

The Tax Cuts and Jobs Act, which took effect on January 1 of this year, famously slashed the tax rate on C corporations, which pay corporate income tax, from 35% to 21%. By itself, this may have been seen as unfair to small businesses, most of which are set up not as C corporations but rather as LLCs, partnerships, and S corporations whose income passes through to be taxed at the level of their individual owners. To ensure that non-C corporations also benefited, the Act included Section 199A, which allows owners of sole proprietorships and pass-through entities a deduction of up to 20% of their QBI.

The 20% pass-through deduction was meant to benefit income derived from a business's deployment of capital. Therefore, owners of specified service businesses (including law and accounting firms) with income over a low threshold were excluded from qualification. Confusingly, specified service businesses also included financial services businesses. This inclusion left owners of banks organized as S corporations wondering whether they could benefit from the deduction or whether they ought to convert to C corporations. Fortunately, the 199A Regulations specifically exclude banking from the definition of specified financial services, meaning that owners of banks organized as S corporations will qualify for the 20% deduction.

To ensure that the 20% deduction is only used to benefit productive businesses, Section 199A contains a limitation based on the amount of a qualified business's wages and depreciable property. For an owner with income over a low threshold, the 20% deduction is limited to the greater of (1) 50% of a qualified business's W-2 wages; or (2) the sum of 25% of its W-2 wages and 2.5% of the original basis of all of its depreciable property. Reasonable compensation paid to S corporation shareholder-employees is included as W-2 wages and excluded from QBI.

The 199A Regulations also contain aggregation rules so that owners of multiple qualified businesses can potentially aggregate their QBI, W-2 wages, and basis for purposes of the thresholds. W-2 wages paid by a management company may also be allocated to commonly controlled operating companies to satisfy the wage limitations. If certain businesses have negative QBI and others positive, the losses may be allocated to the businesses with positive QBI. Net QBI losses may be carried forward to future years.

The 199A Regulations further clarify that businesses with fiscal year ends other than December 31 may take the full amount of their QBI, W-2 wages, and basis into account even though some might have been earned or incurred before 2018.

The 199A Regulations also create a series of anti-abuse rules meant to prevent otherwise ineligible businesses from taking advantage of the 20% deduction. Before the issuance of the regulations, business owners and advisers considered whether it would be advantageous to convert employees into independent contractors so that they could each claim the 20% deduction, or to engage in "cracking," whereby a service business is split into two separate businesses with the qualified business paying a fee to the service business. The 199A Regulations specifically crack down on these types of transactions to curtail abuse of the deduction.

For more information, please contact Michael Senger at 404.881.4988 or Brian Harvel at 404.881.4491.

Join our tax attorneys at a reception being held at the Capital City Club in Atlanta on October 4 alongside the ABA 2018 Joint Fall CLE Meeting. Register here.

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