

New Passthrough Deduction Creates Tax Benefit for Self-Employed

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In this article, the authors discuss the application of the new section 199A deduction to independent contractors.

When the new tax deduction for passthrough entities was first proposed, there was speculation about whether it would be available to independent contractors. The enactment of the Tax Cuts and Jobs Act (P.L. 115-97) makes clear that the answer is yes; the deduction is available to independent contractors and it could provide them with significant tax savings.

The relevant provisions are contained in new section 199A, which was enacted as a temporary measure. It is effective only for tax years beginning after December 31, 2017, and before January 1, 2026.

The new deduction is available to an individual taxpayer for business income from a partnership, S corporation, or sole proprietorship, in connection with real estate investment trust dividends, qualified cooperative dividends, and qualified publicly traded partnership income. Section 199A also includes special rules for specified agricultural or horticultural cooperatives. Because independent contractors operate sole proprietorships, they are eligible to claim the deduction.

The new section 199A deduction offers a possible solution to one dimension of the "gig economy" issue. Currently, gig economy workers treated as independent contractors are required to pay 100 percent of their Social Security and Medicare contributions, while employees pay only 50 percent. This new deduction, which is

available only to independent contractors but not employees, helps eliminate the financial consequences of this disparate treatment.¹

For taxpayers with taxable income not exceeding a specified threshold amount, the new deduction rules are relatively straightforward. For those with taxable income over the threshold amount, the rules (discussed in Section II) are more complicated.

I. Income Not Exceeding Threshold Amount

For an independent contractor whose taxable income for the tax year does not exceed the threshold amount, defined as \$157,500 per year (or \$315,000 if filing a joint tax return), the section 199A calculation is not subject to any special rules or limitations. The threshold amount will be indexed for inflation.

A. General Calculation

For these taxpayers, the deduction for a tax year is the sum of:

- (i) the lesser of:
 - a. the taxpayer's combined qualified business income amount, or
 - b. 20 percent of the taxpayer's taxable income (reduced by net capital gains and qualified cooperative dividends);

plus (ii) the lesser of:

- a. 20 percent of the taxpayer's qualified cooperative dividends, or

¹One concern this new deduction creates is that it could lead to greater IRS scrutiny regarding whether individuals who claim to be independent contractors qualify as such for federal tax purposes.

b. the taxpayer's taxable income (reduced by net capital gain).

The sum of (i) + (ii) may not exceed the taxpayer's taxable income for the tax year (reduced by net capital gain).

A taxpayer's combined qualified business income amount is calculated as the sum of: (i) the deductible amounts for each qualified trade or business carried on by the taxpayer, plus (ii) 20 percent of the sum of any qualified REIT dividends plus qualified publicly traded partnership income.

The term "qualified trade or business" means any type of business other than the trade or business of performing services as an employee.²

B. Deductible Amount

The deductible amount for a qualified trade or business is defined as 20 percent of the qualified business income³ of the qualified trade or business (the 20 percent of qualified business income limit).

C. Calculation by Typical Independent Contractor

For an independent contractor whose taxable income does not exceed \$157,500 for the year (or \$315,000 if filing a joint tax return) and who has no qualified cooperative dividends, qualified REIT dividends, or qualified publicly traded partnership income, the section 199A deduction will be an amount equal to 20 percent of the individual's net earnings from independent-contractor activities, capped at 20 percent of the taxpayer's taxable income (reduced by net capital gains).

II. Income Exceeding Threshold Amount

For an independent contractor with taxable income above the threshold amount of \$157,500

(or \$315,000 if filing a joint tax return), the calculation is more complicated.

For these taxpayers, the same general calculation discussed in Section I.A is made, but two special rules apply. First, an additional limitation is imposed on the deductible amount for a qualified trade or business. Second, if the taxpayer operates a specified service trade or business, special limitations apply.

A. Additional Limitation on Deductible Amount

If a taxpayer's taxable income for the tax year exceeds the threshold amount, the deductible amount for a qualified trade or business is defined as the lesser of:

1. 20 percent of the qualified business income⁴ regarding the qualified trade or business (the 20 percent of qualified business income limit); or
2. the greater of (i) or (ii) (the wage and property limit), where (i) = 50 percent of W-2 wages⁵ regarding the qualified trade or business, and (ii) = the sum of 25 percent of W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property (defined generally as tangible depreciable property).

As the foregoing reveals, for taxpayers with taxable income for the tax year that exceeds the threshold amount, the deductible amount for a qualified trade or business is limited by the wages paid by the business and by the amount of qualified property used in the business.

If a taxpayer's taxable income exceeds the threshold amount, but by no more than \$50,000 — that is, \$207,500⁶ (or by no more than \$100,000 if filing a joint return, that is, \$415,000⁷) — the effect of the wage and property limit is gradually phased in. For these taxpayers, if the wage and property limit for a qualified trade or business is less than the corresponding 20 percent of

²For taxpayers with taxable income over the threshold amount, the term "qualified trade or business" is subject to additional limitations.

³The term "qualified business income" is defined generally to mean, for any tax year, the net amount of items of income, gain, deduction, and loss regarding any qualified trade or business of the taxpayer, to the extent such items are effectively connected with the conduct of a trade or business within the United States — but does not include any qualified REIT dividends, qualified cooperative dividends, qualified publicly traded partnership income, or specified investment-related items. Special rules govern the treatment of loss carryovers.

⁴See *supra* note 2.

⁵Special rules defining the term "wages" for these purposes are in new section 199A(b)(4).

⁶\$207,500 = \$157,500 + \$50,000.

⁷\$415,000 = \$315,000 + \$100,000.

Formula 1

$$\frac{(\text{taxable income}) - (\$157,500 \text{ [\$315,000, if filing a joint return]})}{(\$50,000 \text{ [\$100,000, if filing a joint return]})} \times (20\% \text{ of QBI Limit - Wage and Property Limit})$$

qualified business income limit, then for that qualified trade or business, the wage and property limit is disregarded and the 20 percent of qualified business income limit is subject to a further reduction. The effect of this provision is to provide these taxpayers with some relief from the wage and property limit. It does so by further reducing the applicable 20 percent of qualified business income limit by an amount representing a portion of the difference between the higher 20 percent of qualified business income limit and the wage and property limit that increases as the taxpayer's taxable income amount moves from the threshold amount of \$157,500 (\$315,000 if filing a joint return) to \$207,500 (\$415,000 if filing a joint return).

The calculation of this additional reduction amount is best explained by Formula 1.

The higher 20 percent of qualified business income limit for the qualified trade or business is reduced by the calculated amount.

As noted, only taxpayers with taxable income between \$157,500 (\$315,000 if filing a joint return) and \$207,500 (\$415,000 if filing a joint return) are eligible for this relief provision.

B. Specified Service Trade or Business

If a taxpayer's taxable income exceeds the threshold amount of \$157,500 (or \$315,000 if filing a joint tax return), the term "qualified trade or business" is defined more narrowly. It includes any type of business other than (A) the trade or business of performing services as an employee, or (B) a specified service trade or business.

A specified service trade or business is defined as any trade or business (A) involving the performance of services in the fields of health, law, accounting, actuarial service, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business in which the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners, or (B) involving the

performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. (Note: The category described as a trade or business, of which the principal asset is the reputation or skill of one or more of its employees or owners, is broad and could include many independent contractors — to the extent that their own reputation or skill is the principal asset of their business.)

If a taxpayer with taxable income that exceeds the threshold amount operates a specified service trade or business, the business will not constitute a qualified trade or business and the section 199A deduction will not be available for that business, unless the taxpayer's taxable income for the tax year is less than \$207,500⁸ (\$415,000⁹ if filing a joint return).

For these taxpayers, the deductible amount for a specified service trade or business is phased out as the taxpayer's taxable income amount moves from the threshold amount to \$207,500 (\$415,000, if filing a joint return). The phaseout is accomplished by only taking into account the applicable percentage of the qualified items of income, gain, deduction, or loss — and the W-2 wages and qualified property — in calculating the deductible amount. The applicable percentage is reflected by the following formula:

⁸ See *supra* note 6.

⁹ See *supra* note 7.

Formula 2

$$\text{Applicable percentage} = 100\% - \frac{(\text{taxable income}) - (\$157,500 \text{ [\$315,000, if filing a joint return]})}{(\$50,000 \text{ [\$100,000, if filing a joint return]})}$$

The formula shows that if a single taxpayer has taxable income of \$207,500 (the phaseout amount), the applicable percentage is zero, which means that the phaseout is complete and the section 199A deduction for that trade or business is zero:

Formula 3

$$100\% - \frac{\$207,500 - \$157,500}{\$50,000} = 100\% - \frac{\$50,000}{\$50,000} = 100\% - 100\% = \text{zero}$$

III. Example

To illustrate the section 199A calculation, consider an independent contractor who does not file a joint tax return and has taxable income for the year of \$200,000 (that includes \$180,000 of income from an accounting sole proprietorship) after paying \$50,000 in wages.

In this case, the independent contractor’s accounting business is a specified service trade or business, and taxable income of \$200,000 is above the threshold amount of \$157,500 but not over \$207,500. It follows that (1) the independent contractor’s business constitutes a qualified trade or business, but only to the extent of the applicable percentage, and (2) the independent contractor is eligible for a phase-in of the wage and property limit, if that limit is lower than the 20 percent of qualified business income limit.

The applicable percentage is calculated as:

Formula 4

$$100\% - \frac{\$200,000 - \$157,500}{\$50,000} = 100\% - 85\% = 15\%.$$

The next step is to apply the applicable percentage:

$$\begin{aligned} &15 \text{ percent of qualified business income} = \\ &15 \text{ percent} \times \$180,000 = \$27,000 \end{aligned}$$

$$15 \text{ percent of W-2 wages} = 15 \text{ percent} \times \$50,000 = \$7,500$$

The next step is to perform the general calculation:

The deductible amount is calculated as follows:

$$\begin{aligned} &20 \text{ percent of qualified business income limit} = 20 \text{ percent of qualified business income amount} = 20 \text{ percent} \times \$27,000 = \\ &\$5,400 \end{aligned}$$

Wage and property limit = greater of (i) or (ii):

$$(i) 50 \text{ percent of W-2 wages} = 50 \text{ percent} \times \$7,500 = \$3,750$$

$$(ii) 25 \text{ percent of W-2 wages plus } 2.5 \text{ percent of tangible property} = 25 \text{ percent} \times \$7,500 + 2.5 \text{ percent} \times \text{zero} = \$1,875$$

Since the wage and property limit and the independent contractor’s taxable income is no more than \$207,500, the contractor is eligible for a phased-in wage and property limit. The reduction amount is calculated as:

Formula 5

$$\frac{\$200,000 - \$157,500}{\$50,000} \times (\$5,400 - \$3,750) = 85\% \times \$1,650 = \$1,402.5$$

Therefore, the 20 percent of qualified business income limit of \$5,400 is reduced by \$1,402.50 = \$3,997.50, which is the deductible amount for the taxpayer’s trade or business.

Because the taxpayer has no qualified REIT dividends or qualified publicly traded partnership income, the taxpayer’s combined qualified business income amount is \$3,997.50.

The final step is to apply the cap of 20 percent of the taxpayer’s taxable income (reduced by net capital gains and qualified cooperative dividends):

20 percent of taxable income (\$200,000) =
\$40,000

Since \$3,997.50 < \$40,000, the independent contractor's section 199A deduction amount for the tax year is \$3,997.50.

IV. Miscellaneous

The section 199A deduction is available to taxpayers who claim itemized deductions and also to those who do not. However, the deduction does not reduce a taxpayer's adjusted gross income; it only reduces a taxpayer's taxable income. Special rules apply to partnerships, S corporations, trusts, and estates, and to specified agricultural or horticultural cooperatives. ■

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