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INSIGHTS

Impact on Individuals Operating a Business Directly or Indirectly through a Pass-Through Entity

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*By: **Elizabeth L. McGinley***

A key element of the Tax Cuts and Jobs Act (TCJA) is the reduction in the effective federal income tax rate on certain qualified business income (QBI) earned by individuals either directly or indirectly through pass-through entities, including partnerships and entities treated as partnerships for federal income tax purposes, such as LLCs, and S corporations. This reduction is effected by two provisions of the TCJA: the decrease in the federal income tax rates applicable to individual taxpayers, with a new maximum rate of 37%, and the deduction of up to 20% of an individual taxpayer's QBI (the QBI Deduction).[1] Both the individual rate decrease and the QBI Deduction are scheduled to expire on December 31, 2025.

QBI is taxable income derived from the conduct of certain U.S. trades or businesses. QBI is determined on a business-by-business basis and, in the case of an individual taxpayer engaged in more than one U.S. trade or business directly or indirectly through a pass-through entity, the QBI Deduction is limited to 100% of the individual's combined QBI. Capital gains and losses, dividends, and interest not properly allocable to a trade or business are excluded from the calculation of QBI. Further, QBI excludes compensation for services received by the individual with respect to a U.S. trade or business, including guaranteed payments.

Two limitations may reduce the magnitude of an individual taxpayer's QBI Deduction. Both of these limitations apply if the individual's taxable income for a given year is equal to or greater than (i) $315,000, with a phase-in of the limitation for taxable income up to $415,000, for married individuals filing jointly, or (ii) $157,500, with a phase-in of the limitation for taxable income up to $207,500, for single individuals or married individuals filing separately.

The first limitation is based on the individual taxpayer's share of wages paid, or the tax basis of depreciable property utilized, with respect to the relevant trade or business. This limitation caps the QBI Deduction for any year at the greater of (1) 50% of the individual's allocable share of W-2 wages with respect to the trade or business, or (2) the sum of 25% of the individual's allocable share of W-2 wages with respect to the trade or business, plus 2.5% of the individual's allocable share of the initial tax basis of depreciable property used in the trade or business. For this purpose, depreciable property generally includes real property (other than land), wells and other improvements, and equipment and machinery.

The second limitation eliminates the QBI Deduction for taxable income generated with respect to certain services businesses. Generally, the QBI Deduction is not available for any trade or business involving the performance of certain enumerated professional services such as law, accounting or consulting, or for any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.

Under prior law, an individual taxpayer's QBI would have been fully taxable at the ordinary federal income tax rates applicable to individuals, with a maximum rate of 39.6%. Under the TCJA, unless limitations apply, the QBI Deduction could reduce the maximum effective federal income tax rate imposed on an individual's QBI to 29.6%. However, the limitations on the QBI Deduction are significant. In the case of high income individuals—generally, those with taxable income in excess of $415,000 (married filing jointly) or $207,500 (single or married filed separately)—the QBI Deduction may be unavailable, causing the QBI to be subject to the maximum federal income tax rate applicable to individuals, which is 37%.

Separately, the TCJA permanently reduces the federal income tax rate applicable to C corporations, or other entities taxed as C corporations, from 35% to 21%. As a result, each dollar of corporate income distributed to shareholders will be subject to an effective federal income tax rate of 36.8%, 21% at the corporate level and an additional 20% upon distribution to shareholders. This rate approximates the highest federal income tax rate applicable to business income earned by an individual taxpayer directly or indirectly through a pass-through entity without application of the QBI Deduction, which is 37%.

The TCJA, therefore, changes the federal income tax analysis for individual taxpayers' choice of business entity. Prior to the TCJA, the effective federal income tax rate on corporate income distributed to shareholders was 48% while the maximum federal income tax rate for individual taxpayers was 39.6%. As a result, individuals typically chose to operate privately-held businesses either directly or indirectly through a pass-through entity. By contrast, under the TCJA, the effective federal income tax rates applicable to income generated by businesses in corporate and non-corporate form are more closely aligned than before, although individuals should continue to prefer the pass-through form if the QBI Deduction is available. However, the reduced federal income tax rates for individuals and the QBI Deduction are scheduled to expire at the end of 2025 and, if not extended, the effective C corporation rate (36.8%) would fall slightly below the maximum individual rate applicable to pass-through income (39.6%).

Going forward, individual taxpayers must consider the long-term tax implications of operating a business directly or indirectly through a pass-through entity, including the availability of the QBI Deduction and the applicable limitations. Individuals now opting to operate their businesses in pass-through form may well consider a conversion to C corporation form later if the new individual rates and QBI Deduction expire following the end of 2025. Finally, individual taxpayers not eligible for the full QBI Deduction could find the corporate form more attractive, particularly if these individuals are willing to delay the distribution of corporate income into the future, thus deferring the shareholder-level tax.

Many privately-held oil and gas businesses are structured as partnerships or LLCs, in part, to take advantage of the lower federal income tax rate applicable to individual owners of pass-through entities and the pass-through of business losses to partners or members. We expect that these businesses will continue to operate as pass-through entities, particularly if individual owners qualify for the QBI Deduction.

However, many oil and gas partnerships and LLCs do not pay significant W-2 wages. Often, their service providers are partners or independent contractors, neither of which receive W-2 wages, and therefore the individual owners of these partnerships and LLCs could see their QBI Deduction reduced by the wage limitation described above. To bolster W-2 wages, taxpayers could engage service providers as employees rather than independent contractors, although this would impose additional costs in the form of employer payroll taxes and employee benefits. In addition, if service providers currently are partners, a subsidiary partnership could be formed to employ these service providers with W-2 wages paid at such subsidiary level.

Upstream, midstream or downstream oil and gas businesses are not listed among the enumerated businesses that may be ineligible for the QBI Deduction. However, the QBI Deduction also would be limited if the principal asset of a business is the reputation or skill of an employee or owner, and it is presently unclear whether this could be interpreted to include certain oil and gas services companies.

Under the TCJA, individual taxpayers owning interests in master limited partnerships (MLPs) should expect the full benefit of the QBI Deduction as the wage limitation does not apply to MLPs under the TCJA. Accordingly, an individual owner of an MLP interest should expect to take a QBI Deduction equal to a full 20% of the owner's allocable share of QBI generated by the MLP, including any ordinary income arising in connection with the sale of an MLP interest, and therefore expect a maximum effective federal income tax rate of 29.6% on MLP income.

Going forward, an MLP structure should be more attractive than a C corporation structure for publicly-traded businesses expecting to generate sufficient qualifying income. However, as noted above, the new individual rates and the QBI Deduction are scheduled to expire in 2026 and, if not extended, the maximum federal income tax rate applicable to individual owners of MLPs (39.6%) would be slightly higher than the effective federal income tax rate on distributed corporate income (36.8%), which could cause owners of MLPs to consider whether the conversion to corporate form would be more tax efficient.

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1 All income tax rates provided herein are exclusive of the Medicare tax on unearned income.