The New 20% Deduction in Crowdfunding Transactions

Blog Post

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The new tax law added section 199A to the Internal Revenue Code, providing for a 20% deduction against some kinds of business income. Section 199A immediately assumes a place among the most complicated provisions in the Code, which is saying something.

Im going to summarize just one piece of section 199A: how the deduction works for income recognized through a limited liability company or other pass-through entity. That means Im not going to talk about lots of important things, including:

- Dividends from REITS
- Income from service businesses
- Dividends from certain publicly-traded partnerships
- Dividends from certain cooperatives
- Non-U.S. income
- Short taxable years
- Limitations based on net capital gains

Where the Deduction Does and Doesnt Help

Section 199A allows a deduction against an individual investors share of the taxable income generated by the entity. The calculation is done on an entity-by-entity basis.

That means you cant use a deduction from one entity against income from a different entity. It also means that the deduction is valuable only if the entity itself is generating taxable income.

Thats important because most Crowdfunding investments and ICOs, whether for real estate projects or startups, dont generate taxable income. Most real estate projects produce losses in the early years because of depreciation deductions, while most startups generate losses in the early years because, well, because theyre startups.

The section 199A deduction also doesnt apply to income from capital gains, interest income, or dividends income. It applies only to ordinary business income, including rental income*. Thus, when the real estate project is sold or the startup achieves its exit, section 199A doesnt provide any relief.

Finally, the deduction is available only to individuals and other pass-through entities, not to C corporations.

*Earlier drafts of section 199A didnt include rental income. At the last minute rental income was included and Senator Bob Corker, who happens to own a lot of rental property, switched his vote from No to Yes. Go figure.

The Calculation

General Rule

The general rule is that the investor is entitled to deduct 20% of his income from the pass-through entity. Simple.

Deduction Limits

Alas, the 20% deduction is subject to limitations, which I refer to as the Deduction Limits. Specifically, the investors nominal 20% deduction cannot exceed the *greater of*:

- The investors share of 50% of the wages paid by the entity; or
- The sum of:
- - The investors share of 25% of the wages paid by the entity; plus
- - The investors share of 2.5% of the cost of the entitys depreciable property.

Each of those clauses is subject to special rules and defined terms. For purposes of this summary, Ill point out three things:

- The term wages means W-2 wages, to employees. It doesnt include amounts paid to independent contractors and reported on a Form 1099.
- The cost of the entitys depreciable property means just that: the cost of the property, not its tax basis, which is reduced by depreciation deductions.
- Land is not depreciable property.
- Once an asset reaches the end of its depreciable useful life or 10 years, whichever is later, you stop counting it. That means the regular useful life, not the accelerated life used to actually depreciate it.

Exception Based on Income

The nominal deduction and the Deduction Limits are not the end of the story.

If the investors *personal taxable income* is less than $157,500 ($315,000 for a married couple filing a joint return), then the Deduction Limits dont apply and he can just deduct the flat 20%. And if his personal taxable income is less than $207,500 ($415,000 on a joint return) then the Deduction Limits are, in effect, phased out, depending on where in the spectrum his taxable income falls.

Those dollar limits are indexed for inflation.

ABC, LLC and XYZ, LLC

Bill Smith owns equity interests in two limited liability companies: a 3% interest in ABC, LLC; and a 2% interest in XYZ, LLC. Both generate taxable income. Bills share of the taxable income of ABC is $100 and his share of the taxable income of XYZ is $150.

ABC owns an older apartment building, while XYZ owns a string of restaurants.

Like most real estate companies, ABC doesnt pay any wages as such. Instead, it pays a related management company, Manager, LLC, $500 per year as an independent contractor. All of its personal property has been fully depreciated. Its depreciable real estate, including all the additions and renovations over the years, cost $20,000.

Restaurants pay lots of wages but dont have much in the way of depreciable assets (Im assuming XYZ leases its premises). XYZ paid $3,000 of wages and has $1,000 of depreciable assets, but half those assets are older than 10 years and beyond their depreciable useful life, leaving only $500.

Bill and his wife file a joint return and have taxable income of $365,000.

Bills Deductions

Calculation With Deduction Limits

Bills income from ABC was $100, so his maximum possible deduction is $20. The Deduction Limit is the *greater of*:

- 3% of 50% of $0 = $0

OR

- The sum of:
  - 3% of 25% of $0 = 0; plus
  - 3% of 2.5% of $20,000 = $15 = $15

Thus, ignoring his personal taxable income for the moment, Bill may deduct $15, not $20, against his $100 of income from ABC.

NOTE: If ABC ditches the management agreement and pays its own employees directly, it increases Bills deduction by 3% of 25% of $500, or $3.75.

Bills income from XYZ was $150, so his maximum possible deduction is $30. The Deduction Limit is the *greater of*:

- 2% of 50% of $3,000 = $30

OR

- The sum of:
- - 2% of 25% of $3,000 = 15; plus
- - 2% of 2.5% of $500 = $0.25 = $15.25

Thus, even ignoring his personal taxable income, Bill may deduct the whole $30 against his $150 of income from XYZ.

Calculation Based on Personal Taxable Income

Bills personal taxable income doesnt affect the calculation for XYZ, because he was allowed the full 20% deduction even taking the Deduction Limits into account.

For ABC, Bills nominal 20% deduction was $20, but under the Deduction Limits it was reduced by $5, to $15.

If Bill and his wife had taxable income of $315,000 or less, they could ignore the Deduction Limits entirely and deduct the full $20. If they had taxable income of $415,000 or more, they would be limited to the $15. Because their taxable income is $365,000, halfway between $315,000 and $415,000, they are subject, in effect, to half the Deduction Limits, and can deduct $17.50 (and if their income were a quarter of the way they would be subject to a quarter of the Deduction Limits, etc.).

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Because most real estate projects and startups generate losses in the early years, the effect of section 199A on the Crowdfunding and ICO markets might be muted. Nevertheless, I expect some changes:

- Many real estate sponsors will at least explore doing away with management agreements in favor of employing staff on a project-by-project basis.
- Every company anticipating taxable income should analyze whether investors will be entitled to a deduction.
- Because lower-income investors arent subject to the Deduction Limits, maybe Title III offerings and Regulation A offerings to non-accredited investors become more attractive, relatively speaking.
- I expect platforms and issuers to advertise Eligible for 20% Deduction! Maybe even with numbers.
- The allocation of total cost between building and land, already important for depreciation, is now even more important, increasing employment for appraisers.
- Now every business needs to keep track of wages and the cost of property, and report each investors share on Form K-1. So the cost of accounting will go up.

As for filing your tax return on a postcard? It better be a really big postcard.

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ATTORNEYS MENTIONED

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