
## NAPEO Legislative Update: Tax Reform, Pass-Through Entities, and the Impact on the PEO Industry

***NOTE****: This alert is to provide you/your PEO information on a current public policy issue. Nothing in this alert should be construed as legal or accounting advice. Please consult a tax attorney and/or a Certified Public Accountant before taking any action on this matter.*

**Overview of the Issue**

The tax reform bill signed by President Trump creates a new income tax deduction for certain types of business owners as a means of providing an even lower effective individual income tax rate. Specifically, this allows taxpayers to deduct, solely for federal income tax purposes, the “combined qualified business income amount” from a pass-through entity in an amount up to 20 percent of the taxpayer’s taxable income, after the deduction of any net capital gain.

**PEO Impact**

Because of the wording of the new law, some accountants have indicated to their clients that are pass-through entities that a PEO relationship might conceivably jeopardize the client’s eligibility for this new 20 percent tax deduction. Specifically the accountants are saying that, because they use a PEO, the client reports no W-2 wages. Because the new tax deduction is limited by the amount of W-2 wages paid, their concern/argument is that the only way the client can be certain of this deduction may be to end the PEO relationship and have the W-2 wages reported under the client’s tax identification number.

**Background**

Beginning in 2018 (and ending after 2025), the tax reform bill allows taxpayers to deduct (solely for federal income tax purposes) the “combined qualified business income amount” from a pass-through entity in an amount up to 20 percent of the taxpayer’s taxable income (after the deduction of any net capital gain). The qualified business income amount of each particular qualified trade or business is generally 20 percent of the taxpayer’s income attributable to that trade or business (subject to several limitations), but it generally cannot exceed the greater of (1) 50 percent of the W-2 wages paid with respect to the trade or business or (2) the sum of 25 percent of such W-2 wages and 2.5 percent of the unadjusted basis at acquisition of the business’s “qualified property”(defined as tangible depreciable property). For this purpose, W-2 wages means, with respect to any person, the wages, elective deferrals, and section 457 deferred compensation that are paid by the person with respect to non-owner employees.

**Challenge for PEOs**

The new business income deduction for pass-through entities could be advantageous for many PEO clients that are organized as pass-through entities. However, for those PEO clients, there is potential uncertainty about the proper allocation between the client and the PEO with respect to the W-2 wages paid under the PEO's EIN to work site employees. The new tax law, in new Internal Revenue Code (IRC) section 199A, provides that for this purpose "W-2 wages" means "with respect to any person for any taxable year of such person, the [total wages, elective deferrals, and section 457 deferred compensation] paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year." That language, as is often the case, fails to adequately address tri-party employment relationships involving a PEO, but it also uses the phrase "paid by such person," which does not directly link the definition to the entity filing the W-2.

**Suggested Talking Points for Clients and Accountants**

- It has always been the position of NAPEO that a PEO relationship should neither advantage nor disadvantage the client.

- If a client – absent a PEO – is eligible for a tax benefit (e.g., a credit or deduction), the PEO relationship should not prevent the client from taking advantage of that tax benefit.

- There is no IRS guidance that says clients will be denied the deduction because they are in a PEO relationship.

- There is also no IRS guidance that says clients may take the deduction even if they are in a PEO relationship.

- And, in the near term, it is unlikely that the IRS will provide PEO-specific guidance on the use of this tax deduction by PEO clients.

- With that said, fortunately, there is some directly analogous IRS guidance that may provide some insight into the proper application of the new business income deduction in the PEO context.

- The IRC section 199 domestic manufacturing deduction (which was repealed by tax reform) was also limited based on wages paid, <u>using for all relevant purposes the same definition of "W-2 wages" as the pass through tax deduction</u>.
    - Regulations under IRC section 199 subsequently clarified that taxpayers "may take into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer."

    - In other words, the fact that a particular entity pays the wages and reports those wages on its W-2 is not necessarily dispositive of which entity should take those wages into account in claiming the deduction.

    - Many PEO clients have, for many years - without IRS complaint - counted W-2 wages paid by the PEO to work site employees to calculate the section 199 deduction claimed by the client.

    - In addition, the IRS has - in regulations under IRC section 3504 - made clear that both the PEO and the client may have responsibility for the payment of wages by a PEO in a traditional PEO co-employment relationship.

- Finally, it is highly unlikely that the IRS would deny the client taking the deduction, or that the IRS would find the PEO (and not the client) the employer for purposes of taking the deduction.

## Summary

Until guidance is issued by the IRS, it is ultimately up to the client - and his/her accountant - whether or not to take the PEO-reported W-2 wages into account in claiming the deduction. Given (1) that there is no guidance from the IRS; (2) that the client would be eligible for the deduction absent the PEO relationship; and (3) past IRS guidance on an almost identical provision allowing the client to take a tax deduction based on PEO-reported W-2 wages; there is a very strong case that a PEO client should feel comfortable taking PEO-paid W-2 wages into account in calculating eligibility for the new 20 percent tax deduction.

For more information please contact Thom Stohler.

**The National Association of Professional Employer Organizations**

**707 North Saint Asaph Street • Alexandria, Virginia 22314**