Pass-through Deduction-Code Section 199A

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SECTION 199A

- **What's the point of the S199A deduction?**
  - Under pre-2018 law, the double taxation rate on owners of C corporations was 50.47%
  - Under pre-2018 law, the top rate on Schedule C/S corp/partnership income was 39.6% (really 40.8% when factoring in the PEASE limitation on itemized deductions)
  - Under 2018 law, the double taxation rate on owners of C corporation is down to 39.8% (21% corporate rate; 23.8% dividend tax)
- **As a result, the advantage flow-through owners enjoyed relative to C corporations would have shrunk from 11% down to 0.2%.**
- **To preserve the competitive advantage, allowing a 20% deduction will reduce the effective top rate on non-corporate business income to 29.6%.**
- **This way, these business owners keep a 10% advantage over C corporation shareholders.**

Section 199A, In General

- **Section 199A provides a deduction of up to 20% of "qualified business income" from a domestic business operated as a:**
  - Sole proprietorship
  - Partnership
  - S corporation
  - Trust, or
  - Estate
- **Two additional limitations apply if the taxable income of the business exceeds a threshold amount:**
  - Limitation 1: Limitation on deduction for owners of a "specified service trade or business"
  - Limitation 2: Deduction is limited to amounts based on W-2 wages paid by and property held by the business.

SECTION 199A, IN GENERAL

- This deduction is then added to a second deduction equal to 20% of the sum of:
  - Qualified REIT dividends, and
  - PTP Income.
- The combined deduction is then subject to an overall limitation equal to 20% of the excess of:
  - Taxable income, over
  - Net capital gain as determined under S1(h).
- By imposing this overall limitation, Section 199A ensures that the 20% deduction is not taken against income that is taxed at preferential tax rates.

Example: *In 2018, A, a married taxpayer, has $100,000 of qualified business income, $100,000 of long-term capital gain, and $30,000 of itemized deductions in 2018, for total taxable income of $170,000. A's tentative Section 199A deduction is $20,000 (20% * $100,000). The deduction is limited, however, to 20% of taxable income ($170,000) in excess of net capital gain ($100,000), or $70,000. Thus, A's deduction for 2018 is reduced to $14,000.*

Key Definitions

- Threshold amount: this is the <u>dividing line</u>, below which:
  - S199A will be easy to administer, but above which
  - S199A will be nightmare.
- The prohibition on specified service businesses and the W-2 and property-based limitations do not apply when the owner's taxable income (before the S199A deduction) is less than:
    - $315,000 in the case of MFJ
    - $157,500 for all other taxpayers
- Phase-in range:
  - The prohibition on specified service business and the W-2 and property based limitations are phased in over the next:
    - $100,000 in the case of MFJ
    - $50,000 for all other taxpayers.
- Thus, the prohibition and limitations <u>apply in full</u> once taxable income exceeds:
  - $415,000 in the case of MFJ
  - $207,500 for all other taxpayers.

KEY ACRONYMS

- **QBI:** Qualified Business Income.
- **RPE:** Relevant Passthrough Entity.
  A partnership (other than a PTP), S corporation, trust or estate in which an individual is an owner.
- **SSTB:** Specialized Service Trade or Business.
- **TorB:** A Section 162 Trade or Business.
- **UBIA:** Unadjusted Basis Immediately after Acquisition of qualified property.

KEY DEFINITIONS

- Trade or business:
  - Means a S162 trade or business, other than the trade or business of performing services as an employee.
  - In addition, renting or licensing tangible or intangible property to a commonly controlled business will be treated as a S162 trade or business.
    - *Common control: same person or persons own 50% or more of both businesses.*
    - *Commonly controlled business can be an RPE or a C corporation.*
  - This cuts both ways, because as we'll see later, if you rent property to a commonly controlled specialized SSTB, the rental income is not eligible for the S199A deduction.

WHAT IS A TRADE OR BUSINESS?

- *Groetzinger v Comm:*

"We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity <u>with continuity and regularity</u> and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify."

STEPS TO COMPUTING THE SECTION 199A DEDUCTION

- Step 1: Compute Qualified Business Income
- Step 2: **Keep it Simple**. If the owner's taxable income is < $315K (if MFJ, $157.5K for everyone else), deduction is equal to 20% of qualified business income, limited to 20% of the excess of
  - Taxable income, less
  - Net capital gain (this includes qualified dividends).

STEPS TO COMPUTING THE SECTION 199A DEDUCTION

- Step 3: If the owner's taxable income is > $315K (if MFJ, $157.5K for everyone else), strap in:
  - First, ID if the business is a specified service business.
  - Next, consider the election to aggregate trades or businesses.
  - Then, apply netting rules.
  - Next, apply W-2 and property-based limitations.
  - Finally, apply overall limitation based on taxable income.

Qualified Business Income

- What is "qualified business income?" Reg. S1.199A-3
- Items of gross income, deduction, gain and loss to the extent the items are:
  - Effectively connected with the conduct of a TorB within the U.S.
  - Included or allowed in determining taxable income for the tax year (Section 280E?)
- Does not include:
  - Non-trade or business interest income (interest on investment of working capital reserves, etc…is QBI)
  - Dividend income
  - Long-term capital gain
  - Short-term capital gain
  - Income from an annuity not connected with a TorB.
  - Income that is not effectively connected with a U.S. trade or business

QUALIFIED BUSINESS INCOME

- QBI also does not include:
  - Qualified REIT dividends or PTP income
  - Reasonable compensation received (or that should have been received) by an S corporation shareholder.
  - Guaranteed payments under S707(a) or 707(c) (received by the partner. The partnership deduction generally reduces the QBI of the partnership, and by extension, the partners).
- Special items:
  - S751 hot asset ordinary income = IS QBI. By extension then, any Section 1245 ordinary income recapture should be QBI.
  - S481 adjustments related to a business: = IS QBI for adjustments created for tax years ending after 12.31.2017.
  - Net operating losses = Do NOT reduce QBI, except for the piece of the NOL attributable to a suspended excess business loss under new Section 461(l). This particular carryover is specific to a TorB.

Qualified Business Income

- Complications: The regs are woefully lacking in guidance as to what really is QBI in practice.
  What do we do with?
  - ½ of self-employment tax?
  - Unreimbursed out of pocket expenses by a partner in a partnership?
  - Pension contributions?
  - Heath insurance premiums?
  - Nondeductible expenses?
  - Other separately stated items?

Computing the Deduction When the Taxpayer is Under the Threshold

- Keep it simple. When the owner's taxable income is below:
  - $315,000 for MFJ;
  - $157,500 for everyone else

  We don't care about the SSTB rules or the W-2 and property-based limitations.

- The deduction is 20% of QBI (even from an SSTB), limited to the excess of:
  - Taxable income (before the S199A deduction but after an NOL), over
  - Net capital gain.

Computing the Deduction When the Taxpayer is Under the Threshold

- Only other things you have to consider when taxable income is below the threshold: the netting of QBI and QBI losses.
- If the taxpayer has one business with income and one with a loss, net the QBI together before determining the deduction.
- If the businesses combine to a net loss, there is no deduction, and the net loss is treated as negative QBI from a separate business in the next year.
- If the taxpayer also has REIT dividends/PTP income, that is grouped separately.
  - Any income is subject to its own 20% deduction before the sum of the two deductions are subject to the overall limitation.
  - Any net loss from REIT dividends/PTP income does NOT reduce QBI, but rather carries forward to be used in future years to offset REIT/PTP income.

Computing the Deduction When the Taxpayer is Under the Threshold

Ex. *A operates a computer repair shop as a sole proprietor. Income from the business is $100,000 in 2018. A also has $7,000 of long-term capital gain, and net taxable income of $74,000. A's deduction is equal to the lesser of $20,000 (20% of QBI of $100,000) or $13,400 (20% of the excess of taxable income ($74,000) over net capital gain ($7,000)).*

- A operates two businesses. An S corporation allocates $100,000 to A, while an LLC allocates a $60,000 loss. A's net taxable income is $200,000, and A has no net capital gain. A's deduction is $8,000, (20% of net QBI of $40,000), limited to $40,000 (20% of taxable income of $200,000).
- Same facts as in the previous example, except the LLC allocates to A a loss of $120,000. Because A has a net QBI loss of $20,000, A gets no deduction, and must carry the $20,000 loss to 2019, where it will reduce QBI.

Computing the Deduction When the Taxpayer is Under the Threshold

Ex. A and B are married. B is allocated $100,000 in QBI from an S corporation and $10,000 in REIT dividends and $2,000 in PTP income. Taxable income for the couple is $270,000.

- The deduction is equal to:
  - The QBI deduction of $20,000 (20% of $100,000), plus
  - The deduction for 20% of REIT dividends and PT income (20% * $12,000), or $2,400.
- For a total deduction of $22,400.
- The total deduction is then limited to $54,000, the excess of taxable income ($270,000) over capital gains ($0).
- Thus, A and B are entitled to a deduction of $22,400.

Computing the Deduction When the Taxpayer is OVER the Threshold

- When the owner's taxable income is over:
  - $315,000 for MFJ;
  - $157,500 for everyone else

  We have to care about the SSTB rules and the W-2 and property-based limitations.
- At these income levels, the deduction of 20% of QBI is limited to the greater of:
  - 50% of the taxpayer's allocable share of the W-2 wages paid by the business, or
  - 25% of the taxpayer's allocable share of the W-2 wages paid by the business, plus 2.5% of the taxpayer's allocable share of the unadjusted basis immediately after acquisition of qualified property (UBIA).
- As a general rule, the deduction is determined separately for each separate business. See, however, netting and aggregation rules.

Qualified Businesses

- S199A(d) – A qualified business is any trade or business other than:
  - A specified service business, or
  - The trade or business of performing services as an employee.
- What's the point of these two rules?
  - Income received in exchange for personal services should be taxed at regular rates with no preference, whether as wages or an allocation of business income.

Trade or Business of Being an Employee

- Trade or business of performing services as an employee:
  - Doesn’t matter if the employer treats a service provider as an independent contractor, if the IRS determines that the service provider is an employee using established factors, no S199A deduction is available.
  - **Solely for purposes of S199A:** if an individual who was an employee is subsequently treated as an independent contractor, but continues to render substantially the same services to the former employer, the individual is presumed to still be an employee; thus, no S199A deduction.
  - This presumption may be rebutted by showing that under federal tax law, regulations, and principles, the individual is no longer an employee.

Trade or Business of Being an Employee

Ex. *E is an engineer at an engineering firm, a partnership. After 10 years, E is promoted to partner, and begins to receive a Schedule K-1 from the partnership instead of a W-2.*

- Because E provides the same services he did as an employee, the presumption is that E is still an employee, and thus his distributive share of income on Schedule K-1 is not QBI.
- E may rebut the presumption, however, by showing that he converted from employee to partner by virtue of firm policy and a career milestone.

Specified Service Trade or Business

- If the business owner's taxable income exceeds the threshold plus the phase-in range, no deduction is available against income from an SSTB.

- An SSTB is: *"Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners."*

- Also includes investing and investing management, trading, or dealing in securities, partnership interests, or commodities.

Specified Service Trade or Business

- The determination of whether a business is an SSTB is made at the business level. Reg. S1.199A-6(b)(3): an RPE must separately identify and report on the Schedule K-1 issued to its owners whether any business engaged in directly by the RPE is an SSTB.

- This is very important. Consider the following example:

A is a CPA. A works for an engineering firm S corporation, but performs all accounting functions, which IS an SSTB. The determination of the nature of the business is done at the S corporation level. Because engineering is not an SSTB, on the K-1 the S corporation provides A, it will not designate the business as an SSTB. Thus, A should not be prohibited from claiming the S199A deduction.

Field of Health

- Disqualified:
  - Doctors, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologist, and other similar healthcare professionals who provide medical services "directly to a patient."
- Not disqualified:
  - Health clubs, health spas, personal trainers, Pilates instructors, etc., or research, testing and manufacturing and/or sales of pharmaceuticals and medical devices.
- Unanswered questions:
  - Those who are skilled medical professionals but who might not treat patients directly: radiologist?
  - Those who treat patients directly but have varying licensing requirements: chiropractors, naturopaths, acupuncturists, massage therapists, etc.

Field of Law

- Disqualified:
  - Lawyers, paralegals, legal arbitrators, mediators, judges, anyone with skills unique to the field of law.
- Not disqualified:
  - Stenographers, printers.
- Unanswered questions:
  - Stanley case: Lawyer owns 5% of a property management LLC, does mostly property management, but also acts as in-house counsel. Shouldn't be in field of law. Should be in field of property management.

Field of Performing Arts

- Disqualified:
  - Those who “create” art, like actors, singers, musicians, entertainers, directors.
- Not disqualified:
  - Those who broadcast or otherwise disseminate video or audio of performing arts to the public.
- Unanswered questions:
  - What is Howard Stern?
  - Famous DJ that only plays other peoples’ music?
  - Authors? Seems OK to me.
  - Stunt men? Body doubles?

Field of Consulting

- Disqualified:
  - Those who provide professional advice and counsel to clients to assist the client in achieving goals and solving problems. Includes lobbyists.
- Not disqualified:
  - Does not include consulting that is embedded into the sale of goods or services that is not separately billed for.
- Unanswered questions:
  - Could a tax preparer charge $5,000 for a “copy of Form 1040” and then “throw in the tax prep consulting for free?” to avoid an SSTB. Of course not for many reasons, not the least of which is that the tax prep work, even though not separately charged for, is an SSTB.

Field of Consulting

Ex. *D is in the business of licensing software to customers. D discusses and evaluates the customer's software needs with the customer. The taxpayer advises the customer on the particular software product it licenses. D is paid a flat price for the software license. After the software is sold, D helps to implement the software for no extra fee. D is engaged in the trade or business of licensing software; not consulting. This is not an SSTB.*

Field of Financial Services and Investment Management

- Disqualified:
  - Financial advisors, investment bankers, wealth planners, retirement advisors.
- Not disqualified:
  - Banks!
- Disqualified:
  - Receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments.
- Not disqualified:
  - Property management!

Field of Brokerage Services

- Disqualified:
  - A person who arranges transactions between a buyer and seller <u>with respect to securities as defined in S475</u> for a commission or fee.
- Not disqualified:
  - Real estate brokers.
- Unanswered questions:
  - Sounds like insurance brokers and the like are OK.

The Catch-All

- An SSTB includes: *"Any trade or business where the principal assets of such trade or business is the reputation or skill of one or more of its employees or owners."*
- This was very concerning prior to the proposed regulations.
- The proposed regulations, however, interpret this VERY narrowly.

The Catch-All

- A business will only be a *"trade or business where the principal assets of such trade or business is the reputation or skill of one or more of its employees or owners"* if:
  - A person receives fees, compensation, or other income for endorsing products or services,
  - A person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or other symbols associated with the individual's identity, or
  - A person receives fees, compensation, or other income for appearing at an event on radio, television, or another media format.

THE CATCH-ALL

Ex. *H is a well known chef and the sole owner of many restaurants. H is so well known, H receives $500,000 in endorsement income for the use of his name on a line of cookware.*

- Proposed regs: The business of endorsements is an SSTB. The restaurants, however, are not an SSTB, even though the chef is extremely skilled and famous. This is great news.

- But query: What if the endorsement income is collected by an entity that owns one of the restaurants? Is the endorsement treated as a separate business, so that only it is treated as SSTB income, and the income from the restaurant is preserved as non-SSTB income? Can we use the de minimis rule (discussed shortly) to make the endorsement income non-SSTB income?

De Minimis Rule

- A business will not be an SSTB if:
  - Gross receipts are less than $25M for the year,
  - Less than 10% of the gross receipts are attributable to the performance of services in one of the disqualified fields.

Ex. *S Co., an S corporation, earns $20M in 2018 from the sales of computer software. It also earns $2M from separately-billed consulting revenue from helping the clients implement the software. While the consulting work is an SSTB (it was separately charged for), because the revenue from the work is less than 10% of the total revenue, it is ignored and none of the business is from an SSTB.*

De Minimis Rule

- A business will not be an SSTB if:
  - Gross receipts are greater than $25M for the year,
  - Less than 5% of the gross receipts are attributable to the performance of services in one of the disqualified fields.

Ex. *S Co., an S corporation, earns $50M in 2018 from the sales of computer software. It also earns $2M from separately-billed consulting revenue from helping the clients implement the software. While the consulting work is an SSTB, because the revenue from the work is less than 5% of the total revenue, it is ignored and none of the business is from an SSTB.*

De Minimis Rule

- Do we read the de minimis exception in the opposite? If a business has more than a de minimis amount of SSTB revenue, does:
  - The ENTIRE business become treated as an SSTB, or
  - Is that SSTB revenue significant enough that the business may qualify as its own trade or business for purposes of S199A? The -2 and -3 regs state that an RPE can have more than one trade or business for S199A purposes.

Ex: *AB LLC generates $10M in revenue from the sales of software in 2018, and $5M from consulting related to that software. Because the prohibited consulting services comprise 33% of the total revenue, the de minimis exception is exceeded. Does that make the entire business an SSTB, or does the LLC now have two different trades or businesses, only one of which is an SSTB?*

- There is support that it should be treated as two separate trades or businesses in the example at Reg. S1.199A-5(c)(3), where a dermatologist also sold skin care products out of the same LLC. They were treated as separate trades or businesses in that example, even though the skin care line was less than 5% of the dermatology revenue.

De Minimis Rule

- In an informal statement, an IRS official explained that the de minimis rule IS intended to have a cliff effect; in other words, if SSTB revenue is not de minimis, the entire business is tainted.

Ex: AB LLC generates $10M in revenue from the sales of software in 2018, and $5M from consulting related to that software. Because the prohibited consulting services comprise 33% of the total revenue, the de minimis exception is exceeded. None of the $15M in revenue is eligible for the S199A deduction.

- That same official seemed to leave some wiggle room, however, stating that the SSTB business COULD rise to the level of its own "Section 162 trade or business," but that determination would be based on "all the facts and circumstances."
- So we're back where we started!!

AGGREGATION

- General rule: the S199A deduction is determined separately for each TorB, using separate W-2 wages and UBIA.

Ex: A, a single taxpayer, owns a 30% interest in LLC, 20% of the stock of S Co., and a sole proprietorship. As a general rule, A must determine the QBI, W-2 wages, and UBIA of qualified property, as well as the resulting Section 199A deduction, for each separate business.

- Proposed Reg. S1.199A-4, however, provides for an aggregation regime, whereby a taxpayer can elect (but is not required to elect) to aggregate certain businesses.
- If aggregation is elected, the taxpayer determines the S199A deduction for the aggregated businesses by using the combined:
  - QBI
  - W-2 Wages
  - UBIA of qualifying property.

AGGREGATION

- Before a business can be considered for aggregation, it must rise to the level of a TorB. However, See. Reg. S1.199A-1(b)(13), which provides that an activity that rents or provides services to a commonly controlled TorB is treated as a TorB for these purposes, and may be aggregated.
- Businesses must be under "common control." This is the case when the same person OR GROUP OF PERSONS own 50% or more of the:
  - Capital or profits interest in the case of a partnership, or
  - Outstanding stock in an S corporation.
- This control must exist for a "majority" of the tax year. What is a majority?
- The businesses must be on the same tax year.
- You CANNOT aggregate an SSTB.

Aggregation

- In order to aggregate, all of the businesses to be aggregated must satisfy 2 of the following 3 factors:
  - They must provide products and services that are the same or customarily offered together,
  - They share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
  - They are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain dependencies).

W-2 Wage Limitation

- Determining wages is a four step process:
  - Step 1: Identify W-2 wages for the year
  - Step 2: If a taxpayer has multiple TorBs, you must allocate wages among the TorBs,
  - Step 3: Determine the amount of wages allocated to each business that are allocable to QBI of the business
  - Step 4: allocate the amount from Step 3 among partners or shareholders.

W-2 WAGES

- Step 1: Identify W-2 wages for the year
  - W-2 wages are wages paid to an employee, plus Section 401(k) deferrals, deferred compensation, and designated Roth contributions.
  - Have to be wages reported on a payroll tax return.
  - Notice 2018-64 offers three methods for determining W-2 wages.

W-2 Wages

- Step 1: Identify W-2 wages for the year
  - *Unmodified box method.* This method is the lesser of the total entries in box 1 of all forms W-2 filed with the Social Security Administration (SSA) by you with respect to your employees OR the total entries in box 5 of all forms W-2 filed with SSA by you with respect to your employees.
  - *Modified box 1 method.* To use this method, total the amounts in of all forms W-2 filed with the SSA by you with respect to your employees. Next, subtract any amounts included in box 1 of forms W-2 that are *not* wages for federal income tax withholding purposes. Now, add to that the total amounts reported in box 12 of forms W-2 with respect to your employees that are properly coded D, E, F, G, and S.
  - *Tracking wages method*. To use this method, total the amounts of wages subject to federal income tax withholding that are paid to your employees and that are reported on forms W-2 that you filed with SSA for the calendar year, and add the amounts reported in box 12 of forms W-2 with respect to your employees that are properly coded D, E, F, G, and S.

W-2 WAGES

- Step 1: Identify W-2 wages for the year
  - Allocation to common-law employer: many businesses either use a centralized payroll company or even leased employees.
  - Proposed regulations allow a taxpayer to take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person listed in Box c of the Forms W-2, provided that the wages were paid to common law employees or officers of the taxpayer.

Ex. S Co. uses a professional employer organization for its staffing needs, which issues W-2s - indicating the PEO as the employer - for S Co.'s common law employees totaling $300,000 in 2018. Even though S Co. does not report the wages on its own Forms W-2, because it is the common law employer of the employees, S Co. may be allocated the $300,000 of W-2 wages from the PEO.

- Step 2: Allocating W-2 wages among multiple trades or businesses
  - Any business that pays wages and has more than one trade or business must allocate the W-2 wages among the businesses.
  - W-2 wages must be allocated to the trade or business that generated those wages.
  - If wages are allocable to more than one business, the portion of the W-2 wages allocable to each business is determined using any reasonable method, provided that it is the same way that wages (as part of total QBI) are allocated among multiple trades or businesses for purpose of Reg. S1.199A-3(b)(5).

W-2 Wages

- Step 3: Allocating W-2 wages to QBI
  - Only wages allocable to QBI are allowed.
  - Wages are only allocable to QBI if the expense is taken into account in computing QBI.

W-2 Wages

- Step 4: Allocating W-2 wages among partners and shareholders
  - Partners: W-2 wages are allocated to partners in accordance with the percentage of the wage expense of the partnership they are allocated under the partnership agreement.
  - Shareholders: W-2 wages are allocated on a per-share/per-day, pro-rata basis.

UBIA of Qualifying Property

- Qualified property:
  - Tangible property subject to depreciation
  - Held by the TorB at the end of the tax year (what if you sell and liquidate on the same day?)
  - Used by the business at any point during the tax year by the TorB in the production of QBI
  - The "depreciable period" can not have ended before the end of the tax year of the TorB.
  - Basis adjustments to partnerships under Sections 743 and 734 are not qualified property.
  - Does not include any property acquired within 60 days of year end and disposed of within 120 days unless used for 45 days.

UBIA of Qualifying Property

- Meaning of "unadjusted basis immediately after acquisition"
  - The basis on the date the property is <u>placed in service</u> by the business as determined by general tax principles, unreduced by further depreciation.
  - Acquired by purchase – cost under S1012.
  - Acquired by contribution to a corporation – c/o basis under S362.
  - Acquired by distribution from a corporation – FMV under S301.
  - Acquired by contribution to a partnership – c/o basis under S723.
  - Acquired by distribution from a partnership – c/o basis under S731.

Ex. *In 2012, A purchases a building for $1M and places it in service in A's trade or business. A's basis under Section 1012 is $1M. This is the basis A will use throughout the depreciable period.*

UBIA of Qualifying Property

- Meaning of "unadjusted basis immediately after acquisition"
- Treatment of special items:
  - UBIA is not reduced by bonus depreciation.
  - UBIA is not reduced by deductions under Sections 179, 179B, or 179C.
  - UBIA is not reduced by credits that otherwise reduce basis.
  - Any improvement to qualified property that has already been placed in service is treated as separate qualified property first placed in service on the date the improvement is placed in service.
  - Query: what happens to improvements deducted immediately under Reg. S1.263(a)-1(f) or 3(h)?
- But remember, the UBIA can be net of depreciation if the property is received in a tax-free, c/o basis transaction.

UBIA of Qualifying Property

- Depreciable Period: Starts on the date the property is placed in service and ends on the later of:
  - 10 years, or
  - The <u>last day</u> of the last <u>full year</u> in the recovery period.

Ex. *S Co. purchases a piece of machinery on November 18, 2014. The machinery is used in the business, and is depreciated over 5 years. Even though the depreciable life of the asset is only 5 years, the owners of S Co. will be able to take the unadjusted basis of $10,000 into consideration for purposes of this second limitation for ten full years, from 2014-2023, because the qualifying period runs for the LONGER of the useful life (5 years) OR 10 years.*

- Consider the same facts, only the asset is a non-residential rental building that is depreciated over 39 years. The shareholders of S Co. will be able to take their share of the building's basis into consideration from 2014-2052, the last full year of the asset's depreciation schedule.

UBIA OF QUALIFYING PROPERTY

- **THE UBIA OF QUALIFYING PROPERTY IS PRESUMED TO BE ZERO IF IT IS NOT DETERMINED AND REPORTED FOR EACH TRADE OR BUSINESS!!!**

- **At the moment, there are no anti-abuse rules to prevent transactions between related parties intended to increase the UBIA of property.**

Putting It All Together: When Taxable Income Exceeds The Threshold

- Follow the steps:
  1. No deduction for an SSTB unless within the phase-out range.
  2. Identify QBI, W-2 wages and UBIA for each separate trade or business.
  3. Decide whether to aggregate.
     a) If you aggregate all businesses together, determine the deduction using combined QBI, W-2 wages and UBIA.
     b) If you don't aggregate all together, apply the netting rules to determine net QBI for each business.
  4. Whether aggregated or separate, the deduction is limited to the greater of
     a) 50% of the taxpayer's share of W-2 wages, or
     b) 25% of the taxpayer's share of W2- wages plus 2.5% of UBIA.
  5. Layer on top 20% of REIT dividends/PTP income.
  6. Apply the overall limitation.

When Taxable Income Exceeds The Threshold

Only one business:

Ex. E, a single taxpayer, owns 30% of LLC. In 2018, the LLC allocates to E:

- *$900,000 of QBI*
- *$300,000 of W-2 Wages*
- *$30,000 of UBIA*

- E's total taxable income for the year is $880,000.
- E's deduction is $180,000, limited to the greater of:
  - $150,000 (50% of W-2 wages), or
  - $75,750 (25% of W-2 wages + 2.5% of UBIA)
- Thus, E's deduction is $150,000, limited to 20% of $880,000 (taxable income less capital gain), or $176,000. Final deduction is $150,000.

WHEN TAXABLE INCOME EXCEEDS THE THRESHOLD

- When income is within the phase-out range, no SSTB

Ex. A and B are married. Taxable income is $375,000.

- *A is a 50% owner of an S corporation:*
  - *A's share of S corporation income: $300,000*
  - *A's share of S corporation W-2 wages: $40,000*

- The S corporation IS NOT an SSTB.

When Taxable Income Exceeds the Threshold

- What is A’s deduction?
- This is where things get complicated, because A is in the phase-out range, with taxable income > $315,000 but < $415,000.
- **Step 1:** We start by asking the following question: what would A's deduction have been if his taxable income was less than $315,000?
  - This is simple: at that level of income, the W-2 limits wouldn't apply, and A would take a deduction of 20% of QBI of $300,000 or $60,000.

WHEN TAXABLE INCOME EXCEEDS THE THRESHOLD

Step 2: How does A's $60,000 deduction compare to what it WOULD have been if the W-2 limits did apply in full? If they applied, A's $60,000 deduction would have been limited to the GREATER OF:

- 50% of $40,000 or $20,000, or
- 25% of $40,000 plus 2.5% of $0, or $10,000.

So if the W-2 limitations HAD applied, A would have been entitled to a deduction of only $20,000. This means that if taxable income had been $315,000 or less, the new law would have given A a break in the form of $40,000 of additional deduction ($60,000 - $20,000).

This is known as the "excess amount" in Section 199A(b)(3)(A)(ii).

Tentative deduction:	$60,000
less: W-2 limit:	($20,000)
Excess Amount	$40,000

WHEN TAXABLE INCOME EXCEEDS THE THRESHOLD

Once your taxable income is above the threshold, however, you start to lose the benefit of this excess amount, bit-by-bit, over the next $100,000 of taxable income ($50,000 if you're not married filing jointly). But by how much?

Step 3: Look at it this way: A gets a **TOTAL RANGE** of $100,000 of taxable income -- from $315,000 to $415,000 -- before his $40,000 "get out of jail free" card is totally eliminated. So it makes sense that the $40,000 benefit should be reduced based on how far you are into that $100,000 range. Start by determining by how much your taxable income exceeds your threshold:

Taxable income:	$375,000
Less: threshold:	($315,000)
Excess taxable income:	**$60,000**

When Taxable Income Exceeds the Threshold

Next, we put it into percentage terms. Here is how much of his "get out of jail free" card of $40,000 A should no longer be entitled to:

Excess taxable income:	$60,000
Divided by: Total phase-in range	$100,000
Percentage of benefit A should lose:	**60%**

When Taxable Income Exceeds the Threshold

Step 4: A started with an "excess amount" of $40,000: a $60,000 deduction when a $20,000 W-2 limit would have otherwise applied.

Now that A has burned through 60% of that phase-in range, he should lose 60% of that $40,000 benefit, or $24,000. Thus, as a final step, we reduce A's $60,000 deduction by the amount of the "get out of jail free" card that he has lost because his income is too high:

20% of QBI deduction:	$60,000
Reduction in $40,000 benefit because income is over $315,000:	($24,000)
Final deduction	**$36,000**

A's deduction is $36,000. As opposed to $60,000 if taxable income had been $315,000 or less. The deduction would be $20,000 (50% of W-2 wages) by the time taxable income gets to $415,000.

When Taxable Income Exceeds the Threshold

Netting of losses.

If the taxpayer has at least one business with a loss, and the businesses are not aggregated, the loss is allocated among any businesses with positive QBI in proportion to their respective amounts of QBI. No amount of the W-2 wages or UBIA of property are brought over to the income-producing businesses.

Ex. F, a single taxpayer, owns 100% of X, Y, and Z. None have UBIA, but each have QBI and wages as follows:

- *X – QBI of $1,000,000; W-2 wages of $500,000*
- *Y- QBI of $1,000,000; no W-2 wages*
- *Z-QBI of ($600,000) W-2 wages of $500,000.*

- F has taxable income in excess of the threshold and does <u>not</u> elect to aggregate all three businesses.
- F must first allocate the loss from Z to X and Y based on respective QBI. The wages are not allocated.
- Thus, X's QBI becomes $700,000. Deduction is $140,000 limited to $250,000, or $140,000.
- Y's QBI is also reduced to $700,000. Deduction is $140,000 limited to $0.
- Thus, total deduction is $140,000.

When Taxable Income Exceeds the Threshold

Netting of losses, net loss.

Ex. F, a single taxpayer, owns 100% of X, Y, and Z. None have UBIA, but each have QBI and wages as follows:

- *X – QBI of $1,000,000; W-2 wages of $500,000*
- *Y- QBI of $1,000,000; no W-2 wages*
- *Z-QBI of ($2,150,000) W-2 wages of $500,000.*

- F has taxable income in excess of the threshold.
- F does not elect to aggregate all three businesses.
- Total QBI is ($150,000). No 199A deduction. The $150,000 loss carries over, but the W-2 wages do not.
- In the next year, the $150,000 of loss is allocated among any business with positive QBI. There is no rule that says the loss must first be allocated against income from Z.

SSTB: Income in Excess of the Threshold

- A and B are married.
- Taxable income is $375,000.
- A is a 50% owner of an S corporation
  - A's share of S corporation income: $300,000
  - A's share of S corporation W-2 wages: $40,000
  - A's share of the unadjusted basis of assets used in S corporation's business: $10,000
- The S corporation IS an SSTB; A is a lawyer.

SSTB: Income in Excess of the Threshold

- **Step 1:** We start by determining what A's deduction would have been if his taxable income had been less than $315,000. This is determined by taking the LESSER OF:
  - 20% of QBI of $300,000, or $60,000, or
- The GREATER OF:
  - 50% of W-2 wages of $40,000, or $20,000, or
  - 25% of $W-2 wages of $40,000 + 2.5% of basis of property of $0, or $10,000.
- Because taxable income is less than $315,000, not only does A get to take the deduction despite being a lawyer, in addition, the W-2 limits don't apply at that level of income. Thus, while A would generally be entitled to a deduction of only $20,000 in this case, had taxable income been $315,000 or less, he would have gotten the full $60,000.
- Because taxable income is greater than $315,000, however, we must now determine how much of that $60,000 deduction A has to give up.

SSTB: Income in Excess of the Threshold

Step 2: We begin by figuring out, once again, how much of his $100,000 "phase-in" threshold A has exceeded, although now it's probably more accurately described as a "phase-out" threshold. The math looks the same as before:

Taxable income:	$375,000
Less: threshold:	($315,000)
Excess taxable income:	**$60,000**

A has gone $60,000 of the way through a $100,000 phase-in range. Putting this into percentage terms, here is how much of the benefit A should lose:

Excess taxable income:	$60,000
Divided by: Total phase-in range	$100,000
Percentage:	**60%**

SSTB: Income in Excess of the Threshold

Step 3: Thus, A should lose 60% of his benefit. Section 199A(d)(3)(B) accomplishes this by requiring A to compute his "applicable percentage," which is simply 100% - the percentage from Step 2:

Starting Percentage	100%
Less: percentage from Step 2:	(60%)
Applicable percentage	**40%**

A is only entitled to take into consideration, in computing his deduction, the applicable percentage of his allocable share of QBI, W-2 wages, and basis of assets. Like so:

	Allocable Share	Applicable % (40%)
QBI	$300,000	$120,000
W-2 Wages	$40,000	$16,000
Basis of Assets	$0	$0

SSTB: Income in Excess of the Threshold

- Next, we determine A's deduction under the general rules using these new numbers. If we needed to net, it is these numbers that would be used.
- **Step 4**: A's deduction is equal to the LESSER OF:
  - 20% of QBI of $120,000, or $24,000,
  - or the GREATER OF:
    - 50% of W-2 wages of $16,000, or $8,000, or
    - 25% of W-2 wages of $16,000 , or $4,000, plus 2.5% of basis, or $0, for a total of $4,000.
- Thus, A's tentative deduction is $8,000.
- However, the W-2 limit doesn't apply if taxable income is less than $315,000, and is phased in as income goes from $315,000 to $415,000.
- We now have to jump through those hoops as well. On to Step 5, which starts by figuring out the excess amount the new law would have given A if the W-2 limit didn't apply at all:

SSTB: Income in Excess of the Threshold

- **Step 5:** The excess amount is the excess of the deduction allowed to A in the absence of a W-2 limit over what the deduction would be if the limit applied in full force. Thus, it is $16,000 ($24,000-$8,000).
- Next, we have to reduce that excess benefit based on how much A's taxable income exceeds $315,000.

- **Step 6:** A gets a TOTAL RANGE of $100,000 of taxable income -- from $315,000 to $415,000 -- before his $16,000 "get out of jail free" card is totally eliminated. So it makes sense that the $16,000 benefit should be reduced based on *how far A is into that $100,000 range.*

Taxable income:	$375,000
Less: threshold:	($315,000)
Excess taxable income:	**$60,000**

SSTB: Income in Excess of the Threshold

- A has gone $60,000 of the way through a $100,000 phase-in range. Putting this into percentage terms, here is how much of his excess amount of $16,000 A should no longer be entitled to:

Excess taxable income:	$60,000
Divided by: Total phase-in range	$100,000
Percentage of benefit A should lose:	**60%**

- **Step 7:** A started with a benefit of $16,000: a $24,000 deduction when a $8,000 W-2 limit would have otherwise applied. Now that A has burned through 60% of that phase-in range, he should lose 60% of that $16,000 benefit, or $9,600.

20% of QBI deduction:	$24,000
Reduction in $24,000 benefit because income is over $315,000:	($9,600)
Final deduction	**$14,400**

PASS-THROUGH DEDUCTION UNDER §199A

- Assume an S Corp. has the following for 2018:
  - Qualified business income $1,000,000
  - Wages paid to employees $600,000
  - Unadjusted basis in qualified property $0
- Assume a 25% shareholder in such S Corp. has taxable income (ignoring the §199A deduction) of $370,000 (filing status MFJ)
- What is the taxpayer's IRC §199A deduction?

PASS-THROUGH DEDUCTION UNDER §199A

- Allocable share of QBI = $250,000
  - 25% of $1 million
- Allocable share of wages = $150,000
  - 25% of $600,000
- 20% of QBI = $50,000
- 50% of W2 = $75,000
- Here the deduction is $50,000 as wage limit greater
  - So taxable income really not relevant in this case

PASS-THROUGH DEDUCTION UNDER §199A

- Assume same facts except employee wages total only $320K (instead of $600K)
- What is the taxpayer's §199A deduction?
  - Allocable share of QBI = $250,000
  - Allocable share of wages = $80,000
  - 20% of QBI = $50,000
  - 50% of W2 = $40,000
  - The $10,000 difference is referred to as the "excess amount" and it is this amount that is phased out

PASS-THROUGH DEDUCTION UNDER §199A

- Taxable income is $370K, i.e., $55K over threshold
  - $55,000 / $100,000 = 55%
- So the taxpayer loses 55% of the excess amount and their §199A deduction is $44,500 as follows:
  - $50,000 – (.55 * 10,000) = $44,500

Pass-through Deduction Under §199A

- What if all facts were the same except the taxpayer's taxable income was under the $315,000 threshold?
  - The deduction would be $50,000 as the wage-based limit would not apply
  - i.e., no phaseout if not over threshold
- What if all facts were the same except taxable income was $415,000 (or more)?
  - Amount over threshold would be $100K and taxpayer would lose 100% of their excess amount, limiting the deduction to $40,000 (50% of their allocable share of wages paid by the business)
  - Excess amount is fully phased out

Pass-through Deduction Under §199A

- An additional limitation is provided in the case of a "specified service trade or business" (SSTB) as defined by new IRC §199A(d)(2)
- SSTBs begin to lose §199A deduction altogether at phase- in amounts, and totally lose at $100K (MFJ, $50K others) above such amounts, so …
  - If taxable income under threshold, limits N/A
    - i.e. deduction = 20% of QBI
  - If $100K+ ($50K+) over threshold deduction zero
    - i.e. deduction fully phased out

Pass-through Deduction Under §199A

- So let's assume our taxpayer from before was a shareholder in an accounting firm. Recall these facts:
  - Allocable share of QBI = $250,000
  - Allocable share of wages = $80,000
  - 20% of QBI = $50,000
  - 50% of W2 = $40,000
  - Taxable income is $370K ($55K over threshold)
  - $55,000 / $100,000 = 55%
  - In the case of a SSTB we subject both QBI and W2 wages to the threshold reduction
    - Prop Regs §§ 1.199A-1(d)(2)(i); 1.199A-1(d)(4) Ex. 6

Pass-through Deduction Under §199A

- Reduced allocable share of QBI = $112,500
  - $250,000 * (1 - .55) = $112,500
- Reduced allocable share of wages = $36,000
  - $80,000 * (1 - .55) = $36,000
- 20% of QBI = $22,500
- 50% of wages = $18,000
- Excess amount = $4,500
- Reduction in excess amount = 55% * $4,500 = $2,475
- §199A deduction = $20,025
  - $22,500 - $2,475 = $20,025 (= 45% * $44,500)

Pass-through Deduction Under §199A

- What if taxable income is $415K or more?
  - Taxable income is $100K over threshold
  - $100,000/$100,000 = 100%
  - I.e., phase-out complete
- Reduced allocable share of QBI = $0
  - $250,000 * 0% = $0
- Reduced allocable share of wages = $0
  - $80,000 * 0% = $0
- 20% of QBI = $0
- 50% of wages = $0
- So no deduction – fully phased out

Pass-through Deduction Under §199A

- What if taxable income is $315K or less?
  - Deduction = 20% of QBI = $50,000
- No phase out if at or under threshold
  - Even for SSTBs
- Again this is true for all taxpayers
  - i.e., if pre 199A taxable income under threshold deduction = 20% of QBI

Pass-through Deduction Under §199A

- Assume a CPA owns 100% of an S Corporation with income of $300K prior to the payment of any compensation
  - CPA takes W2 compensation of $175K (assume reasonable)
  - QBI therefore $125K
- Assume taxable income under the threshold such that no limits apply (filing status MFJ)
  - §199A deduction = 20% * $125K = $25K
- What if CPA operates instead as sole proprietor?

PASS-THROUGH DEDUCTION UNDER §199A

- What if CPA operates instead as sole proprietor?
- It appears the deduction would now be $60K!
  - Why?
  - Because sole proprietors don't take compensation!
  - (Chance likely a bit less as deduction for ½ SE tax likely reduces QBI)
- Would of course need to weigh additional SE tax where taxed as sole proprietor
  - I.e., SE tax would be levied on full $300K whereas payroll taxes only on $175K of wages
    - Though 2.9% of $125K pretty inconsequential compared to additional $35K deduction!

PASS-THROUGH DEDUCTION UNDER §199A

- Consider a non-SSTB sole proprietor with no employees, little in the way of qualified property, and very significant income
- E.g. a manufacturer's rep with QBI and taxable income of $1 million, no employees, and no qualified property
- Recall that at $100K (MFJ, $50K others) over the threshold the §199A deduction is <u>lesser</u> of (A) or (B)
  - (A) 20% of QBI ($200,000 here) or
  - (B) Greater of (i) 50% of wages paid ($0 here) or (ii) 25% of wages paid plus 2.5% of qualified property basis ($0)

PASS-THROUGH DEDUCTION UNDER §199A

- There is no deduction as the phase-out is complete and no wages/qualified property
- I.e., recalling the computations from above, the "excess amount" is the difference between (A) \$200,000 and (B) \$0, or \$200,000
- The phase-out percent is 100% of excess amount (as taxable income more than \$100K over threshold), so deduction is \$200,000 - \$200,000 = \$0

PASS-THROUGH DEDUCTION UNDER §199A

- What if she incorporates?
  - Or as SMLLC elects to be taxed as S Corporation?
  - She can then pay wages
  - Deduction now lesser 50% * W2, or 20% * QBI
  - "Sweet spot" is compensation of 2/7 of pre-W2 income
    - I.e., W2 = $1 million * 2/7 = $285,714
      - 50% = $142,857
    - QBI now $1 million - $285,714 = $714,286
      - 20% = $142,857
      - Taxed on $1 million - $142,857 = $857,143
      - -- Save $53K in tax
    - BUT compensation must be reasonable

S Corporations – Reasonable Compensation

- Consider:
- Sole proprietor with compensation of $100K per year for last three years – so average compensation = 100K
- Assume that at current age could adopt DB plan and get a $100K deduction
  - As sole prop pension would actually be limited to ~$93K (earned income = Net SE – deduction for ½ SE tax)
- Since pension is not deductible in determining SE tax, there would be a sizeable SE tax (~$14K)

S CORPORATIONS – REASONABLE COMPENSATION

- Incorporate – and have (S) corp adopt plan
- Average compensation still $100K (as controlled group)
- $100K pension leaves no taxable income
- Reasonable compensation OK
- *All current tax eliminated – CPA and client happy!*

S Corporations – Reasonable Compensation

- How would this work with §199A?
- Ignoring pension and incorporation – and assuming taxable income below thresholds – there would be a §199A deduction of $20,000 (20% of $100,000)
  - Possibly a bit less as SE tax likely will reduce QBI
- So net taxable income would be $80K
- But SE tax still ~14K
  - SE tax on full $100K – §199A deduction allowable only for income-tax purposes [IRC §199A(f)(3)]

S Corporations – Reasonable Compensation

- If $100K pension contribution made, then QBI zero – no §199A deduction
  - So $100K of pension reduces taxable income by $80K!
- But again, there is $14K of SE tax
- What if we incorporate?

S Corporations – Reasonable Compensation

- If we just took the $100K as pass-through (no wages paid to shareholder) there would be no payroll taxes and §199A deduction = $20K
  - Net taxable income would be $80K
  - <u>But we have reasonable compensation rules!</u>
  - If we took the $100K as wages we accomplish nothing by incorporating as payroll taxes ~ SE tax
    - And there'd be <u>no</u> §199A deduction (QBI = zero)

S Corporations – Reasonable Compensation

- But if we incorporate and put $100K in pension – as discussed above – we do away with the SE taxes
  - Yes we only reduce taxable income by ~$80K due to loss of §199A deduction – and $100K will later be taxed when it comes out of plan – but this is certainly more than mitigated by SE tax savings

S Corporations, §199A, and Pension Deduction

- Consider:
  - S Corporation owned 100% by one person (no other employees)
  - Taxable income (pre §199A deduction) = $300,000 (MFJ so under threshold so phase-outs NA)
  - Pass through (QBI) = $100,000
  - Wages = $200,000 (assume = reasonable compensation)
  - §199A deduction = $20,000
  - Net taxable income = $280,000

S Corporations, §199A, and Pension Deduction

- Consider pension contribution of $40,000
- Taxable income (pre §199A deduction) now $260,000 ($300,000 - $40,000)
- QBI now $60,000 ($100,000 - $40,000)
- §199A deduction now $12,000
- Net taxable income now $248,000

S Corporations, §199A, and Pension Deduction

- Compare to $280,000 without pension
- $40,000 of pension – ALL OF WHICH WILL BE TAXED WHEN DISTRIBUTED – effectively resulted in deduction of $32,000
- Will likelihood of lower tax rates upon distribution result in this still making sense?
- BUT WAIT!!

S Corporations, §199A, and Pension Deduction

- Note that the shareholder could have taken less current compensation
- That is, as discussed, reasonable compensation must be taken, and it was determined that $200K was reasonable
- But instead of $200K in current compensation the shareholder could take $160K – as the $40K of pension is considered compensation for this purpose (recalling Treas. Reg. §1.404(a)-1(b))

S Corporations, §199A, and Pension Deduction

- QBI now $100k again and we're back where we started with respect to the §199A deduction
- Taxable income (pre §199A deduction) would be $260K (as $40K less in wages were taken) and the §199A deduction is again $20K
- Net taxable income = $260K - $20K = $240K
- Effectively the pension is again deductible dollar-for-dollar

S Corporations, §199A, and Pension Deduction

- Recall that for a “specified service trade or business” (SSTB) where taxable income more than $100K ($50K) over the threshold the §199A deduction is moot
- <u>Such a case will result in full benefit of pension deduction as there is no §199A deduction with or without pension</u>
- What about an owner in a specified service business right at or slightly over threshold plus $100K (or $50K)?
- Here things get VERY interesting

S Corporations, §199A, and Pension Deduction

- Again consider a CPA S Corporation shareholder
- Compensation = $250K
- QBI = $200K
- Taxable income (pre §199A deduction) = $415K
- So phase-out complete and no §199A deduction
- Net taxable income = $415,000
- What if $100K contributed to pension?

S CORPORATIONS, §199A, AND PENSION DEDUCTION

- First we'll assume current comp. stays same
- Taxable income (pre §199A deduction) = $315K
- QBI now $100K ($200K less $100K pension)
- As we're no longer over the threshold our §199A deduction is 20% of $100K or $20K
- So net taxable income now $295K
- So $100K pension deduction results in $120K reduction in taxable income!!
  - And $20K is permanent (pension taxed eventually)

S CORPORATIONS, §199A, AND PENSION DEDUCTION

- And what if because of $100K in pension current compensation is reduced by same amount?
- QBI <u>pre</u>-pension now $300K, and <u>post</u>-pension $200K – where we started
- Taxable income $315K (pre §199A) post pension
- Not over the threshold so §199A deduction is 20% of $200K or $40K
- Net taxable income now $275K
- So $100K pension deduction combined with $100K reduction in W2 comp results in $140K reduction in taxable income!
  $40K permanent!

Thank You