§199A – 20% Qualified Business Income Deduction for Pass-Through Income

The Tax Cuts and Jobs Act, signed into law on December 22, 2017, created §199A – Qualified Business Income (QBI). This code section allows taxpayers, other than corporations, to deduct a portion of QBI from their taxable income. The code section is long and arduous, with several areas of concern that could have the tax courts tied up for years. This article is intended to explain the new deduction, its limitations, and the areas of concern.

We would like to work with each of our clients so that the benefit of this new deduction can be optimized. We are offering our clients a full analysis of their pass-through income, billed at discounted hourly rates. Please reach out to our offices directly if you would like to have us analyze your pass-through income structure.

Why the 20% Deduction was Included in the Bill

The theory behind the deduction is that it will help keep the current tax advantages of pass-through entities in place. C-Corporations are hit with double taxation because the entity pays tax on its earnings first and then its shareholders pay tax on the payment of those earnings (dividends). The double taxation cannot be avoided by not paying dividends as doing so could trigger the Accumulated Earnings Tax (AET)[1].

For 2017, a C-Corporation will pay 35% tax on its earnings and its shareholders will pay another 23.8% tax on the disbursement of those earnings[2]. In 2018, the entity will pay tax at the reduced rate of 21%, but the shareholders will still pay 23.8% on those earnings. The cut drops the top corporate rate 14%, from 58.8% to 44.8%[3].

Meanwhile, income generated by pass-through entities are taxed at the shareholder, partner, or sole proprietor level. The top tax rate in 2017 is 39.6%, and is lowered to 37% in 2018, giving pass-through owners a 2.8% tax cut.

According to the Tax Foundation, as of 2010 there were:

1.7 million C-Corporations

7.4 million partnerships and S-Corporations

23 million sole proprietorships

The QBI deduction is meant to keep the parity between pass-through business owners and C-Corporations.

[1] Any C-Corporation that accumulates earnings in excess of what is deemed reasonable for the needs of the business is assumed to be accumulated solely for tax avoidance purposes under §533(a). The AET is actually a penalty, even though it has ‘tax’ in its name, and is 20% of the excess accumulated earnings. The penalty is only assessed during an IRS audit and the burden of proof lies solely on the C-Corporation.

[2] Qualified dividends are taxed at 20% and investment income (i.e. interest and dividends) is subject to an additional 3.8% under the Net Investment Income Tax rules of §1411.

[3] Top rates, excluding adjustments for the effective rate, are used for simplicity. The effective tax rates in 2017 and 2018, in practice, are likely lower.

What is the QBI Deduction?

The QBI deduction applies to income from pass-through sources. These sources include S-Corporations, Partnerships, and Sole Proprietorships. The allowed deduction is 20% of QBI, not to exceed 20% of the taxpayer's taxable income (less net capital gains for the year).

QBI is the income derived from a Qualified Trade or Business (QTB), excluding investment income. Specifically, QBI excludes:

1. Short Term Capital Gains and Losses;
2. Long Term Capital Gains and Losses; and
3. Any amount paid:
    a. By an S-Corporation treated as reasonable compensation[4];
    b. By a partnership to a partner as a guaranteed payment for services rendered; or
    c. By a partnership to a partner who is acting outside of the partner's capacity as a partner.

The exclusion of amounts paid to shareholders and partners does not exclude the deduction from the calculation of QBI. It prevents the shareholder or partner from adding these amounts back to their allocable share of QBI (which would increase the income base for the 20% deduction, but not the amount of taxable income).

The above deduction is allowed for taxpayers with taxable income less than $157,500 (single) or $315,000 (married filing joint). These are the 'threshold amounts' and are scheduled for inflation adjustments. Whether a taxpayer meets or exceeds the threshold amount is determined annually, meaning it is possible for a taxpayer to benefit from the QBI deduction one year, but not the next.

Qualified Trade or Business

§199A only states that a QTB is not a specified service trade or business (discussed in the next section) or the trade or business of performing services as an employee - it does not specifically identify the definition of a QTB. Over the years, the IRS has defined what constitutes a 'trade or business' differently, depending on the specific code section. No single definition has been acknowledged as the assumed meaning of 'trade or business' when no other definition is stated; however, the most frequently used definition the common law definition under §162[5]. Due to this ambiguity, it is likely that taxpayers and the IRS will disagree with what constitutes a QTB, meaning we could see a significant amount of litigation over this single definition.

Specified Service Trade or Business

In general, a specified service trade or business is not a QTB and would not qualify for the QBI deduction; however, the final bill allows these types of businesses to benefit from the full deduction so long as the taxpayer's taxable income does not exceed the threshold amount. The same phase-in limit, discussed in the next section, applies to these taxpayers as well. If the taxpayer's taxable income exceeds the phase-in limit threshold, the deduction is fully disallowed.

A specified service trade or business is any business meeting the definition of a qualified business under §1202(e)(3)(A), excluding engineering or architecture firms. Such a business is one that provides services in the fields of health, law, accounting, consulting, athletics, performing arts, financial services, brokerage services, or <u>any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners</u>, or involves the performance of services relating to investing, investment management, or dealing in securities, partnership interests (PTP), or commodities.

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[4] This includes amounts deemed to be reasonable compensation by the IRS. Note that there is not a similar rule governing partnerships; no amount will be deemed to be reasonable compensation for a partner in a partnership.

[5] A trade or business, for purposes of §162, is a for profit activity that is conducted with "continuity and regularity" (Com. V. Groetzinger, Robert, (1987). Again, this is not defined in the Code or Regulations, it is the most widely used definition applied by most courts.

Pass-through management companies, though not explicitly listed as a specified service trade or business, would appear to fall under the catchall business type where the principal asset of the business is the reputation or skill of one or more employees or owners. Traditional management companies generally hold no physical assets and exist only to accept management fees from related party entities in exchange for the owner and/or its employees providing management services.

Phase-in of Limit

If the taxpayer has taxable income in excess of the threshold amount but less than $207,500 (single) or $415,000 (married filing joint) (these are the phase-in threshold amounts) will qualify for a reduced QBI deduction. The reduction is based on the allocable percentage of income in excess of the threshold amount, applied against the 20% QBI deduction.

For example: a single taxpayer with taxable income of $200,000 would qualify for a reduced QBI deduction. The taxable income exceeds the threshold amount by $42,500, or 85% of the phase-in limit. The taxpayer would calculate the 20% QBI deduction, but 85% of the deduction would be disallowed. If the same single taxpayer would qualify for the full 20% QBI deduction based on the QBI Wage and Capital Limitations (discussed below), the larger of the two deductions would be allowed under §199A(b)(3)(B)(i)(II).

QBI Wage and Capital Limitations

Taxpayers who have taxable income in-excess of the phase-in threshold amount, may still qualify for the QBI deduction. The deduction is limited to the **greater** of:

1. The taxpayer's allocable share of 50% of W-2 wages paid by the QTB, or
2. The taxpayer's allocable share of 25% of W-2 wages paid by the QTB, plus 2.5% of the original cost of qualified property.

W-2 wages include the total amount of wages paid to employees plus the amount of elective deferrals, must be attributable to QBI, and must be included in a return timely filed with the Social Security Administration.

It would appear that in multi-entity businesses (such as automotive retail groups) where W-2 wages are paid out of one entity and shared between multiple entities, may be at a disadvantage. Based on the code, as written, it appears that if an entity does not report any W-2 wages on payroll tax returns under its EIN, it would have to use the Capital Limitation, which could result in a lesser deduction if it does not have a significant amount of physical assets on the books (discussed below). It is important to note that fees paid to a management company that provides the services of employees do not count as W-2 wages, even if those fees are directly used to pay the wages of the employees provided by the management company. This is our current interpretation of the new tax code and how we will apply the W-2 wage limitation; however, the final regulations may provide further guidance that allows for a broader interpretation.

The code, as written, does not explicitly exclude wages paid to owners; thus, it may be possible to benefit from an increased W-2 wage base for wages paid to owners. However, paying additional wages to owners in order to get a higher W-2 wage base could create a negative circular argument. First, the increased wage deduction on the pass-through entity would decrease the 20% QBI deduction (because QBI is reduced by the additional expense). Second, the owner's W-2 wages would increase with no expense offset (because the QBI deduction is reduced). Finally, the increased W-2 wages could push the owner into a higher tax bracket (because the QBI deduction is not included in the determination of tax brackets – discussed later). Furthermore, this could be a technical issue within the Code due to the swiftness of its passage, that will be clarified by future Regulations.

Qualified Property

Qualified property includes depreciable tangible (physical) property used in the QTB at the end of the taxable year **and** was used to produce income during that taxable year **and** the depreciation period for that asset has not expired. For purposes of this limitation, the depreciation period is the **later** of:

1. 10 years from the initial in-service date, or

2. The last day of the full year in the asset's normal depreciation period.

Assets with tax depreciation lives less than 10 years will fall under the first qualifier, while assets with longer tax depreciation lives, such as 39-year real estate, will fall under the second qualifier.

The QBI Wage and Capital Limitations, which give the potential for larger deductions, are not available for specified service trades or businesses (as discussed previously) where the taxpayer has income in excess of the phase-in threshold.

Real estate holding companies may be able to qualify as a QTB if the entity and benefit from the QBI Deduction if they hold a sufficient amount of capital. If the original cost of qualified property is at least 40 times more than the calculated QBI deduction, there will not be any limitation on the deduction. For instance, if the company holds a $1 million building that is still within the depreciation period, that entity could take up to a $25,000 deduction (2.5% of the original cost).

Additional Information

The 20% QBI deduction is a reduction to taxable income. It will not be included in the calculation of a taxpayer's adjusted gross income, which is used to determine the applicable marginal tax bracket of the taxpayer. It will likely be reported on page 2 of Form 1040, in a similar manner as the standard deduction. A taxpayer will not have to itemize in order to benefit from the deduction.

The QBI deduction is determined on a business by business basis and is the same for active and passive investors. Since there is no differential between active and passive participation in this code section, there is no discussion of how grouped activities would be treated. It is unlikely that the IRS will provide a re-grouping period similar to what was provided when the §1411 Net Investment Income Tax rules took effect.

Where pass-through entities incur a loss in the prior year(s), but have income in the current year, that loss must offset the current year income before the QBI deduction can be calculated. Furthermore, the QBI deduction cannot be used to increase the net operating loss of the taxpayer. It is unclear how disallowed business losses would impact this adjustment in future years. The first impacted tax year would be 2019; there should be additional guidance issued by that time.

Conclusion

§199A(f)(4) indicates that the IRS will be issuing Regulations for the purpose of properly calculating and taking this new deduction. Pieces of this new code section that we hope to see explained in future Regulations include:

1. What definition should be used to determine if a business is a QTB?
2. How does the catchall definition of specified service trade or business affect operational management companies and other non-corporate holding companies?
3. Are related party entities with shared expense structures limited to using the capital limitation if W-2 wages are paid out of one entity but allocated across multiple entities? Or can a reasonable allocation of wages be used?
4. Will Schedule K-1 be adjusted to provide the required information needed by the owner of the pass-through entity to calculate the wage base limitation (i.e. that owner's share of W-2 wages paid as well as the original cost of qualified property)?
5. How is the QBI loss carryforward affected by disallowed losses?

We encourage all our clients to contact our offices prior to making any drastic changes. We would like the opportunity to work through this deduction with each of our clients to determine how business operations can be restructured in a way that will maximize the benefits of this new deduction.

Contact a representative from our firm, Scott Lewis*, or* Jennifer Kobylarz *today to schedule a meeting to discuss the impact of the §199A Pass-Through Income deduction on your future tax bill.*