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20% Deduction For Qualified Business Income - Section 199A

On December 22, 2017 President Trump signed into law The Tax Cuts and Jobs Act that created a significant new tax deduction taking effect in 2018. It should provide a substantial tax benefit to individuals with "**qualified business income**" from a partnership, S corporation, LLC, or sole proprietorship. This income is sometimes referred to as "pass-through" income.

The pass-through deduction was designed to reduce the tax burden on individuals, estates and trusts and mitigate the rate advantage enjoyed by corporations. The deduction is 20% of your qualified business income ("QBI") from a partnership, S corporation, or sole proprietorship, added to 20% of the combined amount of qualified REIT dividends and qualified publicly traded partnership ("PTP") income. The business must be conducted within the U.S. to qualify, and specified investment-related items are not included, e.g., capital gains or losses, dividends, and interest income (unless the interest is properly allocable to the business). The trade or business of being an employee does not qualify. Also, QBI does not include reasonable compensation received from an S corporation, or a guaranteed payment received from a partnership for services provided to a partnership's business.

The deduction is taken "below the line," i.e., it reduces your taxable income but not your adjusted gross income. But it is available regardless of whether you itemize deductions or take the standard deduction. In general, the deduction cannot exceed 20% of the excess of your taxable income over net capital gain. If QBI is less than zero it is treated as a loss from a qualified business in the following year.

Rules are in place (discussed below) to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the deduction.

For taxpayers with taxable income above $157,500 ($315,000 for joint filers), an exclusion from QBI of income from "specified service" trades or businesses ("SSTB") is phased in. These are trades or businesses involving the performance of services in the fields of health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners. Here's how the phase-in works: If your taxable income is at least $50,000 above the threshold, i.e., $207,500 ($157,500 + $50,000), all the net income from the specified service trade or business is excluded from QBI. (Joint filers would use an amount $100,000 above the $315,000 threshold, viz., $415,000.) If your taxable income is between $157,500 and $207,500, you would exclude only that percentage of income derived from a fraction the numerator of which is the excess of taxable income over $157,500 and the denominator of which is $50,000. So, e.g., if taxable income is $167,500 ($10,000 above $157,500), only 20% of the specified service income would be excluded from QBI ($10,000/$50,000). (For joint filers, the same operation would apply using the $315,000 threshold, and a $100,000 phase-out range.)

Additionally, for taxpayers with taxable income more than the above thresholds, a limitation on the amount of the deduction is phased in based either on wages paid or wages paid plus a capital element.

Here's how it works: If your taxable income is at least $50,000 above the threshold, i.e., $207,500 ($157,500 + $50,000), your deduction for QBI cannot exceed the greater of (1) 50% of taxpayer's allocable share of the W-2 wages paid with respect to the qualified trade or business, or (2) the sum of 25% of such wages plus 2.5% of the unadjusted basis immediately after acquisition ("UBIA") of tangible depreciable property used in the business (including real estate). So, if your QBI were $100,000, leading to a deduction of $20,000 (20% of $100,000), but the greater of (1) or (2) above were only $16,000, your deduction would be limited to $16,000, i.e., it would be reduced by $4,000. And if your taxable income were between $157,500 and $207,500, you would only incur a percentage of the $4,000 reduction, with the percentage worked out via the fraction discussed in the preceding paragraph. (For joint filers, the same operations would apply using the $315,000 threshold, and a $100,000 phase-out range.)

Qualified Business Income

The term qualified business income means, for any tax year, the net amount of qualified items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year. Expenses for all wages paid or incurred, in the case of an accrual method taxpayer, must be taken into account in computing QBI. If an individual or relevant pass-through entity ("RPE") directly conducts multiple trades or business and has items of QBI allocable to more than one trade or business, the individual or RPE must allocate items among the several trades or businesses to which they are attributable using a reasonable method based on all the fact and circumstances. The chosen method must be consistently applied from one tax year to another and must clearly reflect the income and expenses of each trade or business. In addition:

1. With respect to a partnership, if section 751(a) or (b) applies (income and loss from unrealized receivables and inventory items) giving rise to ordinary income that is attributable to a trade or business, it is taken into account for purposes of computing QBI.

2. Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI; however, the partnership's deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

3. Section 481 adjustments arising after December 31, 2017 are taken into account for purposes of computing QBI to the extent that the requirements of section 199A are satisfied.

4. Generally, previously disallowed losses or deductions arising after December 31, 2017 from at risk limitations, passive activity loss limitations, partnership and S corporation basis limitations allowed in the taxable year are taken into account for purposes of computing QBI.

5. Generally, a deduction for a net operating loss is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, to the extent that the net operating loss is disallowed under section 461(l), the net operating loss is taken into account for purposes of computing QBI.

The following items are not taken into account in determining qualified income, gain, deduction or loss:

1. Any items of capital gain or loss including gains and losses under section 1231 treated as capital

gains and losses.

2. Any dividend income or income equivalent to a dividend.
3. Any interest other than interest which is properly allocable to a trade or business.
4. Any item of gain or loss from transactions in commodities or excess foreign currency gains.
5. Any income from notational principal contracts.
6. Any amounts received from an annuity contract which is not received in connection with the trade or business.
7. Any qualified REIT dividend or any qualified PTP income.
8. Reasonable compensation received by a shareholder from an S corporation. However, the S corporation's deduction of such compensation will reduce QBI if such deduction is allocable to the trade or business and is otherwise deductible for Federal income tax purposes.
9. Any guaranteed payments received by a partner. However, the partnership's deduction of such payments will reduce QBI if such deduction is allocable to the trade or business and is otherwise deductible for Federal income tax purposes.
10. Any payment received by a partner for services rendered with respect to the trade or business and is otherwise deductible for Federal income tax purposes.

Qualified Publicly Traded Partnership Income

The rules applicable to the determination of QBI described above also apply to the determination of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP. An individual's allocable share of income from a PTP is qualified PTP income only to the extent the items meet the qualifications of section 199A and this section including the requirement that the item is included or allowed in determining taxable income for the taxable year. For example, if an individual owns an interest in a PTP, and for the taxable year is allocated a distributive share of net loss which is disallowed under the passive activity rules, such loss is not taken into account for purposes of section 199A. Furthermore, each PTP is required to determine its qualified PTP income for each trade or business and report that information to its owners.

Carryover Rules

If the total QBI amount is less than zero, the portion of the individual's section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Negative combined qualified REIT dividends/qualified PTP income. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Wages

On August 8, 2018 Proposed regulations were issued setting forth definitional and computational rules and principles under Section 199A. Simultaneously with the issuance of the proposed regulations, the Service issued a proposed revenue procedure, **notice 2018-64**, which prescribes three methods for calculating W-2 wages. Under the **unmodified box method**, W-2 wages are calculated by taking the lesser of the total Form W-2 box 1 (wages, tips and other compensation) or box 5 (Medicare wages and tips). Under the **modified box 1 method** W-2 wages are calculated by taking the total of box 1 and subtracting amounts that are not treated as wages for purposes of income tax withholding and adding the amounts reported in box 12 coded D, E, F, G & S. Under the **tracking wages method,** the total wages subject to Federal income tax withholding reported on form W-2 are added to the amounts reported in box 12 coded D, E, F, G & S.

The proposed regulations set forth a three-step process for determining W-2 wages paid for a QBI. First, each individual or RPE determines its total W-2 wages paid for the tax year as determined above. Second, each individual or RPE that conducts more than one trade or business must allocate its W-2 wages between or among those trades or businesses. The third step requires each individual or RPE to determine the amount of such wages that are allocable to the QBI of each trade or business.

Unadjusted Basis Immediately after Acquisition ("UBIA")

The term qualified property means, with respect to any trade or business of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation:

1. Which is held by, and available for use in, the trade or business at the close of the taxable year.
2. Which is used at any point during the taxable year in the trade or business's production of QBI, and
3. The depreciable period for which has not ended before the close of the individual's or RPE's taxable year.

Under the proposed regulations, a determination of the UBIA of qualified property is required to be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules. Each partner's or shareholder's share of UBIA of qualified property held by an RPE is determined in the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. For property that has been fully depreciated for tax purposes, each partner's share of the UBIA is based on how the gain from the sale of such asset would be allocated. The addition or improvement of qualified property is treated as separate qualified property first placed in service on the date the addition or improvement is placed in service. Basis adjustments under **Sections 734(b)** and **743(b)** are not treated as qualified property. Property is not qualified property if acquired within 60 days of the end of the tax year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the **Section 199A** deduction.

The term depreciable period means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of 1) the date that is 10 years after date the property was first placed in service by the individual or RPE or, 2) the last day of the last full year in the applicable recovery period that would apply to the property under section 168(c).

Aggregation rules

For taxpayers with taxable income in excess of the thresholds, a limitation on the amount of the deduction is phased in based either on wages paid or wages paid plus a capital element. An individual or RPE may be engaged in more than one trade or business. Except as provided, each trade or business must be considered separately for purposes of applying these limitations. The taxpayer may elect to aggregate certain trade or businesses, but aggregation is not required. Trades or businesses may be aggregated only if:

1. The same person or group of persons own 50% or more, directly or indirectly, of each trade or business to be aggregated.
2. The common ownership existed for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income.
3. All items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into accounts short taxable years.
4. None of the trades or businesses to be aggregated is a specified service trade or business.
5. The trades or businesses to be aggregated satisfy at least two of the following factors based on all the facts and circumstances:

    a. The trades or businesses provide products and services that are the same or customarily offered together.
    b. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
    c. The trades or businesses are operated in coordination with, or reliance on, one or more businesses in the aggregated group (for example supply chain interdependencies).

An individual may aggregate trades or businesses operated directly and the individual's share of QBI, W-2 wages and UBIA of qualified property from trades or businesses operated through RPEs. If an individual elects to aggregate multiple trade or businesses the individual must combine the QBI, W-2 wages and UBIA of qualified property for all aggregated trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations.

The individual must consistently report the aggregated trades or businesses in all subsequent tax years. Newly created or newly acquired trades or businesses may be added to an existing group if the requirements above are satisfied. If the facts and circumstances change such that the individual's prior aggregation no longer qualifies for aggregation under the above rules, the trades or businesses will no longer be aggregated, and the individual must reapply the rules above to determine a new permissible aggregation (if any).

For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated. The statement must contain –

1. A description of each trade or business;
2. The name and EIN of each entity in which a trade or business is operated;
3. Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year; and
4. Such other information as the Commissioner may require in forms, instructions, or other published guidance.

If an individual fails to attach the statement required, the Commissioner may disaggregate the individual's trades or businesses.

If an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The adjusted QBI is then used for purposes of applying the W-2 wage and UBIA of qualified property limitations. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not taken into account for purposes of the limitation and are not carried over to the subsequent year.

If an individual's QBI from all trades or businesses combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not taken into account for purposes of this paragraph and are not carried over to the subsequent year.

Computational and Reporting Rules For RPEs

An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for its owners to determine their section 199A deduction.

Using the following four rules, an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their section 199A deduction.

1. The RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB.
2. The RPE must determine the QBI for each trade or business engaged in directly.
3. The RPE must determine the W-2 wages and UBIA of qualified property for each trade or business engaged in directly.
4. The RPE must determine whether it has any qualified REIT dividends earned directly or through another RPE. The RPE must also determine the net amount of qualified PTP income earned directly or indirectly through investments in PTPs.

   An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE, each owner's allocable share of QBI, W-2 wages, and

UBIA of qualified property attributable to each such trade or business, and whether any of the trades or businesses is an SSTB. An RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT dividends or qualified PTP income or loss received by the RPE (including through another RPE). If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner any items required, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

Other Provisions

In the case of a partnership or S corporation, section 199A is applied at the partner or shareholder level. The section 199A deduction has no effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

The deduction under section 199A does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411.

If all of an individual's QBI from sources within the Commonwealth of Puerto Rico is taxable under section 1 of the Code for a taxable year, then for purposes of determining the QBI of such individual for such taxable year, the term "United States" includes the Commonwealth of Puerto Rico.

For purposes of determining alternative minimum taxable income, the deduction allowed under section 199A(a) for a taxable year is equal in amount to the deduction allowed under section 199A(a) in determining regular taxable income for that taxable year.

For rules related to the imposition of the accuracy-related penalty on underpayments for taxpayers who claim the deduction allowed under section 199A, the accuracy penalty for substantial understatements of income tax applies if the amount of the understatement for any tax year exceeds the greater of 5% of the tax required to be shown on the return for the taxable year, or $5,000.

In the case of any trade or business of a patron of a specified agricultural or horticultural cooperative, the amount of section 199A deduction with respect to such trade or business must be reduced by the lesser of 1) Nine percent of the QBI with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or 2) 50 percent of the W-2 wages with respect to such trade or business as are so allocable.

Obviously, the complexities surrounding this substantial new deduction can be formidable, especially if your taxable income exceeds the threshold discussed above. If you wish to work through the mechanics of the deduction with us, with particular attention to the impact it can have on your specific situation, please give Griffing & Company, P.C. a call.