An Introduction to “Sec. 199A”
The Qualified Business Income Deduction

Deduction for Qualified Business Income (QBI)—Sec. 199A

- Sec. 199A qualified business income deduction (QBID) starts in 2018 and ends after 2025
- Deduction reduces income subject to federal income taxes but not self-employment income or AMT income

Qualified Business Income (QBI)

- Qualified Business Income (QBI) includes:
  - Income of a taxpayer, including a trust or estate, but not a C corporation, from a sole proprietorship, S corporation, and/or Partnership... “pass-through income,”
  - From the conduct of a qualified trade or business in the United States
  - Including rental income
  - Qualified Real Estate Investment Trust (REIT) Dividends, and
  - Qualified publicly traded partnership income
Qualified Trade or Business

- A qualified trade or business means any trade or business other than a “specified service trade or business” and other than the trade or business of being an employee
- We will address application of Sec. 199A to a “specified service trade or business” after we cover how the new rule applies to all other trades and businesses

Qualified Business Income Deduction (QBID)

- Sec. 199A deduction (QBID) is 20% of net overall qualified business income (QBI) (income less losses)
- QBID allowed to itemizers and non-itemizers
- QBID does not apply for purposes of 3.8% net investment tax under Sec.1411, but that should not be a problem since most investment income is excluded from QBI

Qualified Business Income Deduction (QBID)

- QBID is available to those taxpayers who itemize and those who take the standard deduction
- NOL does not include QBID
- QBID does not reduce SE tax
- QBID is the same for regular tax and for AMT
Effectively Connected

- For purposes of the QBID, items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States.

In The United States

- If an individual is a member of a partnership that at any time during the tax year is engaged in a trade or business in the United States, the individual is considered to be engaged in a trade or business in the United States.

- An individual is engaged in a U.S. trade or business if and when he or she performs personal services in the United States.

In The United States

- If an individual owns and operates a business in the United States selling services, products, or merchandise, he or she is, with certain exceptions, engaged in a trade or business in the United States.

- Profit from the sale in the United States of inventory property purchased either in the United States or in a foreign country is an effectively connected trade or business income.
Qualified Business Income Deduction (QBID)

For all qualified taxpayers whose taxable income does not exceed $315,000 for MFJ or $157,500 for all other taxpayers

In tax years beginning after 12/31/17 and before 1/1/26, an individual taxpayer may deduct 20% of qualified business income (QBI) from a partnership, S corporation, or sole proprietorship

EXAMPLE

A single taxpayer with $100,000 of QBI potentially gets a $20,000 deduction

Example 1

Sam owns and operates an S corporation which makes $300,000 before Sam’s salary

Sam receives $100,000 in wages

Sam’s QBID could be 20% of $200,000

Example 2

Samantha is a partner who receives a guaranteed payment from a partnership

Her share of partnership profits equals $200,000 and she received $100,000 as a guaranteed payment

Samantha’s QBID could be 20% of $200,000 or $40,000
Five Limitations

- So long as income is below the threshold amounts, the QBID calculation is fairly simple.
- For qualified taxpayers whose income exceeds $315,000 MFJ, or $157,500 for all others, five limitations may apply.

Limitation 1

- Ratio of income in excess of threshold amounts (general rule-part 1)
  - Applies to any trade or business, with a special rule for specified service trade or business that restricts other limitations.

Ratio of Income Limitation

- When taxable income exceeds the $157,500 and $315,000 threshold amounts, the otherwise available QBID is reduced by the ratio that excess amount bears to $100,000 in a joint return and $50,000 in all others.
Example 3

- Taxpayer, a single woman, has $150,000 of qualified business income from a sole proprietorship, selling T-shirts, and pays no W-2 wages.
- With income of $150,000 from that activity, and taxable income of $175,000, QBID must be reduced.
- ($175,000 - $157,500 = $17,500 / $50,000 = 35%); the percentage by which the otherwise available QBID must be reduced, in this case the allowable QBID is .65 x $30,000 or $19,500.

Limitation 2

- W-2 Wage limitation (general rule-part 2)
  - Applies to any trade or businesses EXCEPT a specified service trade or business.

W-2 Wage Limit

- At and below $157,500 and $315,000 taxable income amounts, the taxpayer does not need W-2 wages or depreciable property to take the Sec.199A deduction.
- The only limitation in this circumstance is the taxable income limitation -- which applies when taxable income is less than QBI.
Qualified Property

“Qualified property” is defined as the unadjusted basis, immediately after acquisition, of tangible, depreciable property held by, and available for use in, the qualified trade or business at the close of the tax year, used at any point during the tax year in the production of QBI, and the depreciable period for which has not ended before the close of the tax year.

Depreciable Period

“Depreciable period” means the later of a date that is 10 years after the property was placed in service, or the last full year in the property’s recovery period under IRC Sec. 168.

W-2 Wage Limit

QBI, when QBI is over the taxable income limit, is limited to the GREATER of either:
- 50% of taxpayer’s allocable share of W-2 wages paid by the business; or
- 25% of the taxpayer’s allocable share of W-2 wages paid by the business plus 2.5% of the taxpayer’s allocable share of the unadjusted basis immediately after acquisition of all qualified property.
Unadjusted Basis

- Depreciation deductions relative to the property are not taken into account with respect to the 2.5% limitation
- Taking bonus and Sec. 179 depreciation and will have no impact on this limitation

Included In W-2 Wages

- “Wages” includes taxable wages and deferred compensation, with an add-back for employees’ elective deferrals
- Allocable W-2 wages for a shareholder are, like all other items of an S corporation, allocated pro rata, on a per-share/per-day basis
- Wages paid to an employee include any elective deferrals into a Sec. 401(k)-type vehicle or other deferred compensation

Wages Allocated From Partnership

- Partner's allocable share of a partnership's W-2 wages is determined in the same manner as his or her share of the partnership's ordinary income
- A 20% partner may be specially allocated 80% of any depreciation and 30% of Schedule K-1, Line 1 ordinary income under the partnership agreement
- Because partner is allocated 30% of the partnership’s Line 1 income, partner is allocated only 30% of the partnership's W-2 wage expense for the purpose of QBID
Wages Allocated From S Corp

- S corporation shareholder’s share of wages paid by the corporation is the same percentage as the shareholder’s ownership of S corporation stock

Limitation 3

- Specified Service Trade or Business limitation
  - Applies ONLY to a trade or business identified in the statute as not qualifying for the general rule

Specified Service Trades and Businesses

- A specified service trade or business means 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, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.
  - Sec. 1202(e)(3)(A)
Specified Service Trades and Businesses

- Engineering and architecture, included in the Sec. 1202(e)(3)(A) list, were omitted in the final bill, so...
- Engineers and architects, and the businesses in which they engage are eligible for the regular QBID. That's not new!
- The purpose of Sec. 199A, like Sec. 199 before it, is to encourage economic activity... Production... In the U.S. Remember, engineering and architecture also qualified for the Sec. 199 deduction in effect through 2017

Disqualification for Specified Service Trade or Business

- Not every pass-through entity gets to use the full Sec.199A Qualified Business Income deduction
- "Specified service trades and businesses" are limited to a specific amount
- Includes most of the traditional white collar professions such as medicine, law, accounting, actuarial science, financial services and consulting, performing artists and athletics and any trade or business that relies on the "reputation or skill of one or more employees"

Disqualification for Specified Service Trade or Business

- If taxable income exceeds the $157,500/$315,000 taxable income threshold, the Sec. 199A deduction phases out as the taxpayer moves from $157,500 to $207,500 in taxable income if single (or from $315,000 to $415,000 if married filing jointly)
- A single taxpayer, with income of $150,000 from her accounting practice, and taxable income of $175,000, would reduce her QBID by ($175,000 - $157,500 = $17,500/$50,000 = 35%) by which the otherwise available QBID must be reduced, in this case the allowable QBID is .65 X $30,000 or $19,500
Disqualification for Specified Service Trade or Business

- Professional service firms with high-income owners, therefore, potentially do not get full benefit of the Sec. 199A deduction

Example 4

- Dave is unmarried and has a CPA practice where he earns $100,000 annually
- Assuming Dave’s taxable income is under $157,500, he is entitled to use the §199A deduction
- His §199A deduction would be 20% X $100,000 = $20,000

Example 5

- Doris is an MD with QBI of $500,000 from her medical practice
- She files an income tax return jointly with her spouse
- With his losses, their taxable income is only $310,000
- Even though Doris’ has QBI from a medical practice (a specified service trade or business), she is entitled to use the full Sec. 199A deduction because her joint return income is not greater than $315,000
- Doris’ Sec. 199A deduction is 20% X $310,000 = $62,000
Interplay of Phase-Out and Specified Service Trade or Business

- When income from a specified service trade or business exceeds the threshold amounts, and the phase-in ratio is zero, it is possible to qualify for a QBID, however...
- The calculation is more complex than a simple % of wages and property
- The ratio that would limit the QBID is applied to the potential wage and property amounts, to determine QBI to which the 20% allowable QBID can be applied

Limitation 4

- Capital Gain Limitation
  - Taxpayer cannot deduct more than 20% of his or her taxable income after subtracting net capital gains, but before deducting the Sec. 199A deduction

Example 6

- Assume taxpayer should receive a $40,000 Sec. 199A qualified business income deduction based on $200,000 of qualified business income from a pass-through entity
- If due to deductions, the taxpayer’s taxable income is only $160,000 and that amount includes $60,000 of net capital gains, the taxpayer’s QBID is limited to 20% of $100,000 ($160,000 - $60,000 = $100,000 X .20 = $20,000)
Limitation 5

- Investment Income Limitation
  - Qualified items do not include specified investment-related income, deductions, or loss

Investment Income

- Specifically, qualified items of income, gain, deduction and loss do not include:
  1. Any item taken into account in determining net LTCG or NLTCL,
  2. Dividends, income equivalent to a dividend, or payments in lieu of dividends,
  3. Interest income other than that which is properly allocable to a trade or business

QBI and Treatment of Investment Income

- The excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business,
- The excess of foreign currency gains over foreign currency losses from Sec. 988 transactions, other than transactions directly related to the business needs of the business activity,
QBI and Treatment of Investment Income

6. Net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (i.e., not treated as capital assets), and

7. Any amount received from an annuity that is not used in the trade or business of the business activity

Let's Revisit A Few Important Points

W-2 Wage Limitation

- Applies to a single individual with taxable income in excess of $157,500 or married taxpayers with taxable income in excess of $315,000, and an amount of QBI
- These taxpayers are subject to a reduction in their otherwise available QBI, limiting the deduction to a percentage of W-2 wages paid and/or a percentage of the cost of assets used in the trade or business producing the QBI
W-2 Wage Limitation

- For pass-through entities, other than sole proprietorships, the deduction cannot exceed the greater of:
  - 50% of the W-2 wages with respect to the qualified trade or business (“W-2 wage limit”), or
  - The sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all “qualified property”

Comment on W-2 Wage Limitation

- The wage-based limitation means that high income sole proprietors, partnerships, and real estate investors without W-2 employees will miss out on the deduction unless they form an S corporation, and pay themselves W-2 wages
- Count as wages only amounts reported timely to the Social Security Administration
- That reminds us to “do the math.” Is the QBID worth the “cost” of payroll taxes?

W-2 Wages

- For an S corporation shareholder, W-2 wages is an allocable share (the shareholder’s pro rata share) of wages paid, including reasonable compensation to shareholder/employees
- However, the W-2 wage limit begins phasing in, in the case of a taxpayer with taxable income exceeding $315,000 for married individuals filing jointly ($157,500 for other individuals), both indexed for inflation after 2018
W-2 Wages

- Application of the W-2 wage limit is phased in for individuals with taxable income exceeding these thresholds, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

Example 7

- Taxpayer has $150,000 of qualified business income from a sole proprietorship, selling i-phone parts and service after paying $100,000 in W-2 wages.
- With income of $150,000 from that activity, and taxable income of $175,000, without W-2 wages, QBID would be reduced by $(175,000 - $157,500 = $17,500/$50,000 = 35%) reducing the taxpayer's QBID to $.65 X $30,000 or $19,500.
- In this case, 50% of W-2 wages ($50,000) is more than $19,500 and the full QBID of $30,000 will be allowed.

Example 8

- Taxpayer has $2 million of QBI from a sole proprietorship, has no depreciable property, pays an assistant $100,000 and is potentially entitled to QBID of $400,000, reducing income tax by .37 X $400,000 = $148,000, however . . .
- The individual's taxable income far exceeds the $157,500 threshold, so the QBID is 50% of $100,000 . . . $50,000, potentially reducing the individual's federal income tax by .37 X $50,000 = $18,500.
Example 9

- Taxpayer, an S corporation shareholder, has $1 million of qualified business income and is potentially entitled to QBID of $200,000, but...
- Her allocated W-2 wages are $300,000 and the corporation has no depreciable property, she can only deduct $150,000 (50% X $300,000 = $150,000), potentially reducing income tax by (.37 X $150,000 = $55,500)

Example 10

- In the current tax year a qualified business has $100,000 of ordinary income from inventory sales, and makes an expenditure of $25,000 that is required to be capitalized and amortized over 5 years under applicable tax rules
- QB1 is $100,000 minus $5,000 (current-year ordinary amortization deduction), or $95,000
- QB1 is reduced only by the amount deductible in determining taxable income for the year

QBI Loss

- If net QBI from all qualified trades or businesses during the tax year is a loss, the loss is carried forward as a loss from a qualified trade or business in the next tax year
- Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced by 20% of any carryover qualified business loss
Example 11

- Taxpayer has QBI of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1
- Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2

Example 12

- In Year 2, Taxpayer has QBI of $20,000 from qualified business A and QBI of $50,000 from qualified business B
- To determine the deduction for Year 2, Taxpayer reduces the 20% deductible amount determined for the QBI of $70,000 from qualified businesses A and B by 20% of the $30,000 carryover qualified business loss

Thank You