DEDUCTION FOR QUALIFIED BUSINESS INCOME OF PASS-THRU ENTITIES – IRC SECTION 199A

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PASS-THRU DEDUCTION – SEC 199A

- Section 199A provides that taxpayers may deduct a percentage of their income from a qualified trade or business
- This deduction can only apply to income from pass-through entities and sole proprietorships
- For taxpayers in the highest marginal tax rate (37% for tax years beginning after 2017), the effective marginal tax rate on pass through income *can potentially* be reduced to 29.6%

PASS-THRU DEDUCTION – SEC 199A

- There is no requirement that the income recipient be active in the business – active/passive qualifies
- Only business income effectively connected with a business conducted within the U.S. qualifies
- The 199A deduction does not reduce AGI but is a direct reduction to taxable income
- The Sec. 199A deduction sunsets for taxable years beginning after 12.31.2025

PASS THRU DEDUCTION – DISQUALIFIED TRADE OR BUSINESS

- What types of business income *do not qualify* for the Sec. 199A deduction? ** Generally, the following income types earned by a taxpayer from the performance of services (specified service business) will not qualify:
  - Health services
  - Accounting
  - Law
  - Financial / brokerage services / securities dealers
  - Investing / investment management
  - Actors / athletes

** See exception later

PASS-THROUGH DEDUCTION - DISQUALIFIED TRADE OF BUSINESS, *CON'T*

- Generally, any trade of business where the principal asset of the business is the reputation or skill of one or more of its employee owners

- Seems many owner operated business could meet this definition. However, the law is aimed at excluding professional services businesses

PASS-THROUGH DEDUCTION - QUALIFIED BUSINESS INCOME

- *Simply put, Qualified Business Income (QBI) includes income not disqualified in Sec. 199A*
- *Slide #6 shows categories of disqualified income (professional services income). However, more clarification is needed*
- *While income from professional services is excluded, engineering and architectural* services were

  <u>*specifically excluded*</u> from the definition of specified

  professional service business

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PASS-THRU DEDUCTION QUALIFIED BUSINESS INCOME

- A taxpayers share of the QBI amount is equal to the *<u>lesser of</u>* the following:

  - 20% of the QBI of the pass through entity, or the *<u>greater of</u>*;
  - 50% of the allocable domestic W-2 ** wages, or;
  - 25% of such allocable wages ** plus 2.5% of the unadjusted basis of all qualified property (tangible) on hand at year end excluding land used in the business ** <u>Wages reported on Form 941</u>!

- The above is calculated on a business-by-business basis
- Wages exclude shareholder wages and partner guaranteed payments
- QBI also <u>includes</u> REIT dividends, qualified cooperative/patronage dividends, and PTP income but <u>excludes</u>: capital gains/losses, other dividends, and interest

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PASS-THRU DEDUCTION – HOW IS THE DEDUCTION DETERMINED

- The deduction is equal to the *<u>lessor of</u>*:
  - The 'combined qualified business income' ('QBI") of the taxpayer, *<u>or</u>*;
  - 20% taxable income of the taxpayer less capital gains, <u>plus</u> the lesser of:
    - 20% of aggregate qualified cooperative dividends <u>or</u>;
    - taxable income reduced by net capital gains

PASS-THRU DEDUCTION – SERVICE BUSINESS EXCEPTION

- The W-2 and unadjusted asset base floor calculations are not required for taxpayers with taxable income below the following thresholds:

- Joint filers with taxable income below $315,000 with a phase out through $415,000**

- Single / (MFS) filers with taxable income below $157,500 with a phase out through $207,500**

- Limitations fully phased in at the $415,000 and $207,500 levels above

** Apply phase out calculation where taxable income between low/high thresholds

PASS-THRU DEDUCTION – LIMITATIONS

- Businesses that generate losses cannot generate a deduction
- For purposes of the 199A calculation, combined QBI losses carryover and treated as losses generated in the succeeding year. What does this mean?
- No guidance regarding suspended passive or at-risk losses
- Entities generating annual losses that are later sold at significant gain may be negatively impacted in the year of sale for purposes of Sec 199A
- Wage capitalization issues and timing of income recognition concerns

PASS-THRU DEDUCTION – PENALTY PROVISION

- Taxpayers are subject to a 20% accuracy-related penalty for an underpayment of tax attributable to negligence or a substantial understatement of income

- For purposes of this deduction, the accuracy penalty for substantial understatements of income tax applies if the amount of the understatement is 5% (instead of the usual 10%)

ISSUES TO BE CONDSIDERED NOW

- Are the owners taking excessive wages that could be detrimental to the Sec. 199A income deduction?
- Consider a reasonable compensation review – IRS can assert…
- Can a non-qualifying business be restructured to maximize benefits?
- Where multiple entities are present, consider potential benefits of reorganizing entities to eliminate lost benefits
- Consider taking 2017 income estimates adjusted for discreet items to project the impact of 199A and other provisions for 2018
- Meet with your tax advisors sooner that later!!!

PASS-THRU DEDUCTION – WHAT'S NEXT

- The law as currently written is open to interpretation in places leaving both practitioners and taxpayers unsure how to apply and plan for this provision

- The Treasury Department and the IRS are very much aware there's an immediate need for clarity on the 199A Pass-Thru Deduction as well as many other TCJA provisions recently written into law

- We should expect significant Technical Corrections and clarifications over the coming year

QUESTIONS?

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