

New Code Section 199A

Pass-through Qualified Business Income Deduction

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The Tax Cuts and Jobs Act established new Code Section 199A, which provides for a deduction for Qualified Business Income (QBI). The deduction is generally 20% of QBI for pass-through entities. The deduction has multiple imitations and a myriad of rules. The new rules have significant impact on business owners of pass-throughs. The QBI deduction is applied on the taxpayer level, not on the entity level. It is a deduction to taxable income, not to AGI.

1. Definition of a pass-through. §199A(a) defines a pass-through entity as “all taxpayers other than a corporation”. This thereby includes:
 - a. Sole proprietorships
 - b. Partnerships
 - c. Subchapter-S corporations
 - d. LLCs (single or multi-member)
 - e. Trusts and estates (last-minute addition)
 - f. REITs
 - g. Qualified Cooperatives
 - h. Tiered pass-throughs (LLCs that own other LLCs)
2. Definition of QBI. QBI is the sum of:
 - a. The Lesser of:
 - i. ‘Combined qualified business income’ of the taxpayer. Or
 - ii. 20% of the excess taxable income over the sum of any net capital gain
 - b. Plus the lesser of:
 - i. 20% of qualified cooperative dividends, or
 - ii. Taxable income less net capital gain
3. Combined qualified business income is the sum of:
 - a. The lesser of:
 - i. 20% of the taxpayer’s qualified business income, or
 - ii. The greater of:
 1. 50% of W-2 wages with respect to the qualified trade or business, or
 2. 25% of W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property

PLUS

 - b. 20% of qualified REIT dividends
 - c. Qualified publicly traded partnership income
Note there is a MAJOR exception to a(ii) if taxable income is less than certain limits: poor CPA/Lawyer exception discussed below
4. QBI is “ordinary” income less deductions. Does not include wages. [*LL note: Thus if a business had two people, one an independent contractor and one a W-2 employee, the IC could use the QBI deduction.*] §199A(c). QBI does not include:
 - a. ST Capital gains or losses;
 - b. LT Capital Gains or losses;
 - c. Dividends; or

- d. Interest income
 - e. Wages
 - f. Guaranteed payments [*LL note: true or not?*]
5. QBI deduction does extend to real estate. §199A(c)(c) requires that the QBI can only be used by a "qualified trade or business". [*Is this the same as §162 definition of trade or business? Or will net investment income IRC 1411 rules be applied?*] Note – it was clearly intended to apply to commercial rental real estate based on the history of the legislation because it was only at the last minute that the W-2 limitation was modified.
 6. W-2 wages are the allocable W-2 wages paid by the entity
 - a. Wages defined as showing up on a payroll tax return.
 - b. Includes amount deferred in elective deferrals, like 401(k) §199A(b)(4)(c)
 - c. Partnership is same as partnership wage deduction §199A (f) (1). [*§704?*]
 7. Unadjusted basis in qualified property is tangible property used in business subject to depreciation. §199A (b)(6)(A). 2.5% is applied. Intended to allow QBI deduction for rental entities without W-2 wages.
 - a. Not reduced by depreciation §199A(b)(2)(B)(ii)
 - b. If asset is fully depreciated before 2018, it won't count toward the basis application
 8. Specified Service Trade or Business disqualification. §199A(d)(1) disqualifies anyone who is:
 - a. In the business of being an employee, or
 - b. Any specified service trade or business [§199A(d)(2)(A) referring §1202(e)(3)(A)]. Which includes
 - i. Service professions like doctors, attorneys, CPAs, actuaries, consultants, etc.
 - ii. Performing artists
 - iii. Professional athletes
 - iv. Financial services business [*Interestingly §1202(e)(2)(B) took fin services and §199A(d)(2)(B) adds it back in*]
 - v. Engineers and architects are excluded.
 9. Income threshold. If the taxpayer's taxable income is less than \$157,500 (\$315,000 for filing jointly), the W-2 limitations and the specified service business disqualification DO NOT apply. §199A(b)(3)(A). (A/K/A the "poor" CPA/Lawyer exception)
 - a. If taxable income under the threshold, no W-2 or service business limitations
 - b. If taxable income over the threshold, phases-in over \$50,000 (\$100,000 if filing jointly), making upper threshold \$207,500 (single) and \$415,000 (joint)
 10. QBI losses appear to carry-over. §199A(b)(6).
 11. QBI appear to tie to Alternative Minimum tax (AMT). §199A(f)(2).
 12. NOL does not include QBI. §172(d) amended.
 13. SE taxes appear to be calculated on full net business income before the QBI deduction.
 14. QBI calculation appears to be done on an entity-by-entity basis for the taxpayer. §199A(b)(1)(A).
 15. Questions:
 - a. What form of pass-through is ideal?
 - i. Sub-S, to save SE taxes and reduce UIIT? Could be ideal for certain business with substantial W-2 employees e.g. Contractors and manufacturers. Owner can take distributions (QBI) and use the 50% wage limitation to his advantage. Would have to take a salary (to satisfy

reasonable comp issue) and also take a substantial distribution eligible for QBI deduction and no SE tax! Risky option for Service SUB-S Corps because of R/C issues.

- ii. Partnership, since no reasonable comp issue? May be the only realistic option for service business. This form apparently (for now) avoids the reasonable comp issue that a Sub-S must grapple with under Sub-S rules. Partnerships do not have that same level of risk because partnerships cannot pay wages to partners, only guaranteed payments. There is no reasonable compensation standard for partnerships because partnership income is usually subject to self-employment tax (Mike Burke).
 - iii. How does reasonable comp interface into the calculus after guidance/regulations are issued
- b. Is it advantageous to try to reduce W-2 wages?
 - i. To owners
 - ii. To employee/ICs?
 - iii. Would PEO have an effect?
 - c. What about tiered pass-throughs? Is QBI computed on each?
 - d. How does this affect partners/members of CPA/LAW firms and other service business who are under the income thresholds? (the 'poor CPA'/poor Lawyer' exception?)
 - e. Note the 24% bracket ends at \$157,500 and \$315,000, then jumps to 32%.