The New §199A Qualified Business Income Deduction: A Review and Update

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"The hardest thing in the world to understand is the income tax."

-Albert Einstein
A primary goal of tax reform in 2017 was to lower the Federal income tax rate for C corporations, improving the international competitiveness of U.S. corporations and attracting investment in the U.S. from non-U.S. multinational corporations.

With the reduction in the corporate income tax rate to 21% in 2018, Congress needed to provide a means of reducing the taxes on businesses that operate in different business forms (e.g., sole proprietors, partnerships, and S corporations).
Background

• There is more than one way to lower the tax rate on the business income non-corporate taxpayers earn from their businesses:
  – An alternative rate structure could be applied to business income (reasonable compensation approach).
  – Non-corporate taxpayers could be allowed a special deduction to reduce the income from their business activities, thereby lowering the tax base (and lowering the taxes due) (business deduction approach).
Background

• Leading up to the TCJA of 2017, the reasonable compensation approach was considered in the proposals of the Tax Reform Act of 2014 and the House Republican Tax Reform Blueprint released in June 2016.

• In the discussions in late 2017 that led to enactment of the TCJA of 2017, both the reasonable compensation approach (in the House bill) and the business deduction approach (in the Senate bill) were debated. Ultimately, the business deduction approach was selected.
• While the purpose of §199A is clear, its statutory construction and legislative text is anything but clear. The provision is rife with limitations, exceptions to limitations, phase-ins and phase-outs, and critical but poorly defined terms of art.

• As a result, §199A has created ample controversy since its enactment.
General Rule

• At its most basic level, §199A permits a taxpayer other than a C corporation a deduction equal to 20% of the taxpayer’s qualified business income earned in a qualified trade or business.
The deductible amount of qualified business income for each of the taxpayer’s qualified trades or businesses is determined separately and added together. The sum of these amounts is then subject to a second limitation.

– In all cases, the §199A deduction may not exceed 20% of the taxpayer’s modified taxable income (taxable income before the §199A deduction, reduced by any net capital gain).
Qualified Trade or Business

Section 199A defines qualified trade or business by exclusion; every trade or business is qualified, other than:

- The trade or business of performing services as an employee; and
- A specified service trade or business (SSTB)
Qualified Trade or Business

• A SSTB includes those trades or businesses involving:
  – The performance of services in certain fields, including health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services.
  – Services consisting of investing and investment management, trading or dealing in securities, partnership interests, or commodities.
  – Any trade or business where the business’s principal asset is the reputation of one or more of its employees or owners.

• Architects and engineers are specifically excluded.
Qualified Business Income

• Qualified business income (QBI) is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business that are effectively connected with the conduct of a trade or business within the U.S.
Qualified Business Income

• QBI does not include:
  – Certain investment-related income, including capital gains/losses and dividend income
  – Reasonable compensation paid to the taxpayer
  – Any guaranteed payments paid to a partner for services rendered
Limitations

• Once certain taxable income thresholds ($315,000 for married taxpayers filing jointly and $157,500 for all other taxpayers) are reached, two W-2 limitations apply.
  – These limitations are phased in over the next $100,000 of taxable income (if married filing jointly; $50,000 for all other taxpayers).
  – As a result, once taxable income reaches $415,000 for a married taxpayer filing jointly ($207,000 for all other taxpayers), these limitations apply in full.
Limitations

• The W-2 limitations state that the tentative deduction attributable to each separate qualified trade or business is limited to the greater of:
  – 50% of the W-2 wages with respect to the qualified trade or business, or
  – The sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.
Limitations

- Qualified property is defined as:
  1. Tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year,
  2. Which is used in the production of QBI, and
  3. For which the depreciable period has not ended before the close of the taxable year.

- The “depreciable period” means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under §168 (ignoring ADS).
The prohibition on claiming the §199A deduction based on income earned in a SSTB does not apply if the taxpayer has taxable income less than the previously-mentioned thresholds ($315,000 for married taxpayers filing jointly and $157,500 for all other taxpayers).

- This limitation is phased in over the same span of taxable income as the W-2-based limitations.
On August 8, 2018, the Treasury Department released proposed tax regulations related to the §199A deduction, providing guidance on a handful of topics.
Proposed Regulations

• Definition of a trade or business
  – The statute did not define “trade or business” for purpose of §199A.
  – The Proposed Regulations provide that “trade or business” means a trade or business within the meaning of §162 other than the trade or business of performing services as an employee.
Proposed Regulations

• Aggregation rules
  – The Proposed Regulations include a new set of rules under which multiple trades or businesses may (but are not required to be) aggregated at the owner level.
  – Aggregation is permitted if, among other requirements, the same person or group of persons directly or indirectly own a majority interest in each of the businesses to be aggregated for the majority of the taxable year.
Proposed Regulations

• Aggregation rules (continued)
  – Among other requirements, the trades or businesses must exhibit at least two of the following three factors:
    • The businesses provide products and services that are the same (e.g., restaurant and food truck) or customarily provided together (e.g., gas station and car wash).
    • The businesses share facilities or share significant centralized business elements (e.g., common accounting or purchasing).
    • The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (e.g., supply chain interdependencies).
Proposed Regulations

• Aggregation rules (continued)
  – Taxpayers must consistently report the aggregated trades or businesses in all subsequent tax years.
  – The Proposed Regulations provides rules for situations in which the aggregation rules are no longer satisfied as well as rules for when a newly created or acquired trade or business can be added into an existing aggregated group.
Proposed Regulations

• Specified service trades or businesses
  – The Proposed Regulations provide additional guidance on defining SSTBs; specific definitions are provided for the following fields: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, and dealing in securities, partnership interests, or commodities.

• These definitions are not applicable for purposes other than §199A.
Proposed Regulations

• Specified service trades or businesses (continued)
  – The Proposed Regulations also provide guidance on when a trade or business’s principal asset is the reputation or skill of one or more of its employees or owners for purposes of determining an SSTB. This includes:
    • A trade or business in which a person receives fees, compensation, or other income for endorsing products or services.
    • A trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual’s name, voice, or any other symbols associated with the individual’s identity.
    • Receiving fees, compensation, or other income for appearing at an event or on radio, television, or other media format.
Proposed Regulations

• Specified service trades or businesses (continued)
  – Anti-abuse rules
    • An SSTB includes any trade or business with 50% or more common ownership (directly or indirectly) that provides 80% of its property or services to an SSTB.
    • If a trade or business has 50% or more common ownership with an SSTB, but doesn’t meet the 80% assets or services threshold, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB).
Proposed Regulations

• Specified service trades or businesses (continued)
  – *De minimis* rule
    • An otherwise qualified trade or business will not be an SSTB if less than 5% of its gross receipts are from activities that would cause the business to be an SSTB, or less than 10% of its gross receipts if it has gross receipts of $25 million or less for the taxable year.
Proposed Regulations

• Specified service trades or businesses (continued)
  – Presumption for former employees
    • If an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee is presumed to still be in the trade or business of performing services as an employee notwithstanding the employer’s improper classification.
    • This presumption may be rebutted only upon a showing by the individual that, under the federal tax rules, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee.
Proposed Regulations

• Calculation of QBI
  – Effectively connected income
    • For purposes of §199A, if items are not attributable to a trade or business under §162, those items do not constitute QBI.
    • Similarly, the fact that a deduction is allowed for purposes of computing effectively connected taxable income does not necessarily mean that it is taken into account for purposes of §199A.
    • Section 199A only permits a deduction for income that is both attributable to a trade or business and that is also effectively connected income.
Proposed Regulations

• Calculation of QBI (continued)
  – Section 1231 gains or losses
    • The Proposed Regulations clarify that net §1231 losses will reduce QBI, but net §1231 gains generally must be excluded from QBI.
  – Items properly attributable to more than one trade or business
    • If a taxpayer directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the taxpayer must allocate those items among the several trades or businesses to which they are attributable using a reasonable method that is consistent with the purposes of §199A.
• Calculation of QBI (continued)
  – Deferred losses and deductions
    • Any previously disallowed losses or deductions [i.e., §465 (at risk), §469 (PAL), §704(d) (basis in partnership assets), and §1366(d) (basis in S corporation stock and debt)] are not taken into account in computing QBI when they are ultimately allowed.
      – However, such losses and deductions suspended after January 1, 2018 must be taken into account in the QBI computation for the tax year in which they are allowed.
    • The Proposed Regulations do not provide rules for tracing suspended losses to particular trades or businesses, or taxable years, when they become allowed in a subsequent year.
Proposed Regulations

• Calculation of QBI (continued)
  – Interaction with excess business loss and NOL rules
    • In general, NOLs are not considered trade or business income and thus would not be included in a QBI calculation.
    • However, to the extent an NOL is created under §461(l) (limitation on excess business losses of non-corporate taxpayers), the NOL must reduce QBI when allowed in a subsequent year.
    • This implies that excess business losses must be identified to a specific trade or business.
Proposed Regulations

• Calculation of QBI (continued)
  – Payments for services
    • A partnership’s deduction for guaranteed payments will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

• Operational rules
  – Negative QBI
    • If a taxpayer has negative total QBI, the negative total QBI amount is treated as negative QBI from a separate trade or business and carries forward to be taken into account in the next tax year.
Operational rules (continued)

- Pre-limitation netting
  - If a taxpayer has a QBI of less than zero from one trade or business, but has total QBI greater than zero when all of the taxpayer’s trades or businesses are taken together, the taxpayer must offset the net income in each trade or business that produced positive QBI with the net loss from each trade or business that produced negative QBI before the taxpayer applies the wage and basis limitation to the profitable business.
Proposed Regulations

• Operational rules (continued)
  – Pre-limitation netting
    • The taxpayer must apportion the net loss among the trades or businesses with positive QBI in proportion to the relative amounts of QBI in such trades or businesses.
    • The W-2 wages and UBIA from the trades or businesses which produced negative QBI are not taken into account and are not carried over into the subsequent year.
  – Effect on outside basis
    • The §199A deduction has no effect on the adjusted basis of a partner’s interest in a partnership or the adjusted basis of a shareholder’s stock in an S corporation.
Proposed Regulations

• Operational rules (continued)
  – SE tax, net investment income tax, and AMT
    • Both the SE tax and the net investment income tax are calculated as though there were no §199A deduction.
    • However, the §199A deduction is allowed for AMT computation.
Proposed Regulations

- **W-2 and basis limitation**
  - **UBIA**
    - The Proposed Regulations introduce a new term, “UBIA,” to refer to the unadjusted basis immediately after the acquisition of qualified property, and contain detailed rules for calculating UBIA.
      - For example, the taxpayer’s recovery period is not changed if a taxpayer claims additional first-year depreciation under §168(k) or §168(m).
      - UBIA is also determined without regard to any adjustments for any portion of the basis for which the taxpayer has elected to treat as an expense (e.g., under §179).
Proposed Regulations

• W-2 and basis limitation (continued)
  – Partnerships and S corporations
    • Partnership-level basis adjustments under §734(b) (resulting from distributions) or §743(b) (resulting from sales or exchanges of partnership interests and transfers of partnership interests upon death) are not treated as separate qualified property (i.e., they do not count as UBIA).
    • In the case of qualified property held by a partnership or an S corporation, each partner’s or shareholder’s share of the UBIA is an amount that bears the same proportion to the total UBIA as the partner’s or shareholder’s share of tax depreciation bears to the entity’s total tax depreciation attributable to the property for the year.
Tax Planning Issues

• Choice of business form
  – S corporation versus C corporation

• Married couples
  – For a married couple who does not reside in a community property state and has SSTB income above the thresholds that allow a QBI deduction, determine whether it might be better to file separate tax returns, potentially enabling the spouse with QBI to qualify for the QBI deduction.

• Employee versus independent contractor
  – Employees could consider becoming self-employed.