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Strafford
Requirements of Section 199A and Proposed Regulations, Defining “Qualified Business Income,” and Calculating the Deduction
Dina A. Wiesen, Deloitte Tax LLP
dwiesen@deloitte.com
October 11, 2018
Overview of Section 199A and the Proposed Regulations
Overview of Section 199A and the Proposed Regulations

Background

• Section 199A generally provides a deduction of up to 20 percent of qualified business income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, subject to certain significant limitations (the “section 199A deduction”). This provision applies to taxable years beginning after 2017 and before 2026.

• Section 199A was enacted on December 22, 2017 as part of the tax legislation (Pub. L. 115-97, commonly referred to as the “Tax Reconciliation Act”, or “TRA”), and later was amended by the Consolidated Appropriations Act, 2018 (“CAA”) (H.R. 1625) enacted on March 23, 2018.

• On August 8, 2018, the Treasury Department (“Treasury”) and the Internal Revenue Service (“IRS”) released proposed regulations under section 199A (the “proposed regulations”).
Overview of Section 199A and the Proposed Regulations
Section 199A Deduction

• Under section 199A, an individual, estate or trust taxpayer generally may deduct the sum of -
  − An amount for each trade or business, equal to the lesser of –
    ◦ 20 percent of the taxpayer’s QBI with respect to the trade or business, or
    ◦ The greater of the following limitations –
      − 50 percent of the W-2 wages with respect to the trade or business, or
      − the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the UBIA of qualified property.
    − 20 percent of aggregate qualified REIT dividends and qualified publicly traded partnership income.

• However, the section 199A deduction is limited to 20% of the amount by which taxable income exceeds net capital gain (the “overall limitation”)
Overview of Section 199A and the Proposed Regulations

Proposed Regulations Topics

The Proposed Regulations provide guidance on six major topics:

• Operational rules (Prop. Treas. Reg. § 1.199A-1)

• The wages and basis limitation (Prop. Treas. Reg. § 1.199A-2)

• Rules for calculating QBI, qualified REIT dividends and qualified PTP income (Prop. Treas. Reg. § 1.199A-3)

• Aggregation rules (Prop. Treas. Reg. § 1.199A-4)

• The definition of specified service trades or businesses (SSTBs) and the trade or business of performing services as an employee (Prop. Treas. Reg. § 1.199A-5)

• Rules for passthrough entities (Prop. Treas. Reg. § 1.199A-6)
Effective Dates of the Proposed Regulations

Overview of Section 199A and the Proposed Regulations

**In General:** The Proposed Regulations are effective for taxable years ending after the date on which the Proposed Regulations are finalized. However, taxpayers are permitted to rely on these Proposed Regulations in their entirety until that date.

**Exceptions:** The following anti-abuse rules provided by the Proposed Regulations are proposed to apply to taxable years ending after December 22, 2017 (the date on which section 199A was enacted) –

- Prop. Treas. Reg. § 1.199A-3(c)(2)(ii): REIT dividends not qualified if stock held fewer than 45 days.
- Prop. Treas. Reg. § 1.199A-5(c)(2): Business of providing services or property to an SSTB is an SSTB if commonly controlled.
- Prop. Treas. Reg. § 1.199A-5(c)(3): Business incidental to SSTB is treated as part of that SSTB if commonly controlled.
Overview of Section 199A and the Proposed Regulations

Key Terms and Definitions

• **Trade or business** for section 199A purposes means a section 162 trade or business other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business solely for section 199A purposes if the property is rented or licensed to a trade or business which is commonly controlled under the aggregation rule provided in Prop. Treas. Reg. § 1.199A-4. Prop. Treas. Reg. § 1.199A-1(b)(13)

• **Qualified trade or business (QTB)** is a trade or business other than an SSTB or the business of performing services as an employee. Section 199A(d).

• **Qualified business income (QBI)** means the net amount of *qualified items* of income, gain, deduction, and loss with respect to any QTB. QBI does not include any qualified REIT dividend or qualified PTP income. Section 199A(c) and Prop. Treas. Reg. § 1.199A-3(b).

  - Qualified items only include items that are (i) effectively connected with the conduct of a trade or business within the U.S. and (ii) included or allowed in determining taxable income. Qualified items do not include, for example, any capital gain or loss, dividend or income equivalent to a dividend, or investment interest income.
Overview of Section 199A and the Proposed Regulations
Key Terms and Definitions (Cont.)

• **Qualified REIT dividend** means any dividend received from a REIT during the taxable year which is not (i) a capital gain dividend, as defined in section 857(b)(3), or (ii) qualified dividend income, as defined in section 1(h)(11). See Prop. Treas. Reg. § 1.199A-3(c)(2).

• **Qualified publicly traded partnership (PTP) income** means the sum of -
  - the net amount of the taxpayer’s allocable share of each qualified item of income, gain, deduction, and loss from a PTP, plus
  - any gain or loss attributable to assets of the PTP giving rise to ordinary income under section 751(a) or (b). See Prop. Treas. Reg. § 1.199A-3(c)(3).

• **W-2 wages** means a trade or business’s W-2 wages properly allocated to QBI, as computed under Prop. Treas. Reg. § 1.199A-2(b).

• **Unadjusted basis immediately after the acquisition (UBIA) of qualified property** means the basis on the placed in service date of certain tangible property, as determined under section 1012 or other applicable sections of Chapter 1, subject to certain limitations and adjustments. See Prop. Treas. Reg. § 1.199A-2(c).
Overview of Section 199A and the Proposed Regulations
Key Terms and Definitions (Cont.)

• **Relevant passthrough entity (RPE)** means a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through qualified items relevant for a taxpayer’s section 199A deduction. Prop. Treas. Reg. § 1.199A-2(b)(9).

• **Individual** - For simplicity, the Proposed Regulations use the term individual when referring to an individual, trust, estate, or other person eligible to claim the section 199A deduction. Prop. Treas. Reg. § 1.199A-1(a)(2).

• **Threshold amount** means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). The threshold amount will be adjusted for inflation for taxable years starting from 2019. See Prop. Treas. Reg. § 1.199A-2(b)(11).

• **Phase-in range** means a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus $50,000 (or $100,000 in the case of a joint return). See Prop. Treas. Reg. § 1.199A-2(b)(3).
Determination of Qualified Business Income ("QBI")
Determination of QBI
Statutory Definition of QBI

- Under Section 199A(c)(1) and Prop. Treas. Reg. § 1.199A-3(b), **qualified business income (QBI)** means, for any taxable year, the net amount of **qualified items** of income, gain, deduction, and loss with respect to any trade or business.

- Section 199A(c)(1) also provides that QBI does not include any qualified REIT dividend or qualified PTP income.

- Section 199A(c)(3)(A) provides that qualified items only include –
  - Items that are effectively connected with the conduct of a trade or business within the U.S. (within the meaning of section 864(c), determined by substituting “qualified trade or business within the meaning of section 199A)” for “nonresident alien individual or a foreign corporation” or for “ a foreign corporation” each place it appears), and
  - Items that are included or allowed in determining taxable income for the taxable year.
Determination of QBI
Statutory Definition of QBI (Cont.)

• Section 199A(c)(3)(B) provides a list of specified items that do not constitute qualified items. These exceptions include (among other items) –
  – Capital gains and losses,  
  – Dividends and dividend equivalents, or  
  – Interest income not properly allocable to a trade or business.

• Section 199A(c)(4) provides that QBI shall not include the following –
  – Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,
  – Any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and
  – To the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.
Determination of QBI
Effectively Connected Income Requirement

• The preamble to the Proposed Regulations clarifies that not every item that is effectively connected with the conduct of a U.S. trade or business is necessarily included in determining QBI because to qualify as QBI the item also must be incurred “with respect to” a trade or business. Accordingly, for purposes of section 199A, if items are not attributable to a trade or business under section 162, those items do not constitute QBI.

  - For example, section 871(d) allows a nonresident alien individual to elect to treat income from U.S. real property that would not otherwise be treated as effectively connected with the conduct of a U.S. trade or business as effectively connected. This income does 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 section 199A.

  - For example, for purposes of computing effectively connected taxable income, section 873(b) allows certain deductions, including for casualty or theft losses of U.S. property and section 170 charitable contributions, to be taken into account regardless of whether they relate to effectively connected income from the conduct of a U.S. trade or business. However, for purposes of section 199A, these deductions are not taken into account.
Determination of QBI
Included or Allowed in Taxable Income Requirement

• Previously disallowed losses
  - Prop. Treas. Reg. § 1.199A-3(b)(1)(iv) provides that, to the extent that any previously disallowed losses or deductions (including under sections 465 (at risk), 469 (passive), 704(d) (basis in partnership interest), and 1366(d) (basis in S corporation stock)) are allowed in the taxable year, they are treated as items attributable to the trade or business.

  - However, losses or deductions that were disallowed, suspended, limited, or carried over for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing QBI in a later taxable year.

  - 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.
Determination of QBI
Included or Allowed in Taxable Income Requirement (Cont.)

• **Excess business loss and net operating loss (NOL) rules**

  - Prop. Treas. Reg. § 1.199A-3(b)(1)(v) provides that generally, a deduction under section 172 for a net operating loss is not considered attributable to a trade or business and therefore, is not taken into account in computing QBI.

  - However, to the extent the net operating loss is comprised of amounts attributable to a trade or business that were disallowed under section 461(l), the net operating loss is considered attributable to that trade or business, and will constitute QBI to the extent the requirements of section 199A, including Prop. Treas. Reg. § 1.199A-3, are satisfied.
Determination of QBI
Other Special Rules

**Section 751 gain or loss**
- The definition of qualified PTP income under section 199A(4)(B) specifically includes ordinary gains under section 751(a) on the sale of PTP interests.
- Prop. Treas. Reg. § 1.199A-3(b)(1)(i) clarifies that, if a partner recognizes ordinary income under section 751(a) or (b) (whether or not the relevant partnership is publicly traded), that income or loss is considered attributable to the businesses of the partnership, and is taken into account for purposes of computing QBI.

**Section 1231 gains and losses**
- Under section 199A, capital gains and losses are excluded from QBI. Prop. Treas. Reg.
- § 1.199A-3(b)(2)(ii)(A) clarifies that, to the extent section 1231 gains or losses are treated as capital gains or losses, such capital gains or losses are not included in QBI.
- This rule introduces additional complexity. Net section 1231 losses reduce QBI, but net section 1231 gains generally must be excluded from QBI.
Determination of QBI
Other Special Rules (Cont.)

- **Guaranteed payments under section 707(c)**
  - Section 199A(c)(4)(B) specifically excepted guaranteed payments for services from the definition of QBI; however, the statute does not address guaranteed payments for the use of capital (“GPUC(s)”) under section 707(c).
  - Prop. Treas. Reg. § 1.199A-3(b)(1)(ii) provides a partner that receives a GPUC cannot include the payment in QBI.
  - The preamble to the Proposed Regulations provides that neither guaranteed payments for services nor GPUCs are included in QBI, even if the partner is an RPE (i.e., an upper-tier partnership).
  - In contrast, a partnership’s deduction for a GPUC will be taken into account for purposes of computing QBI if the deduction is properly allocable to the trade or business and is otherwise deductible.
Determination of QBI
Other Special Rules (Cont.)

- **Section 707(a) payments for services**
  - Under section 707(a), a partner who engages in a transaction with a partnership other than in his or her capacity as a partner is treated as if he or she were not a member of the partnership with respect to that transaction.
  - Section 199A(c)(4)(C) provides that QBI does not include, to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.
  - Prop. Treas. Reg. § 1.199A-3(b)(2)(ii)(J) provides that any payment described in section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE.
  - However, the partnership’s deduction for section 707(a) payments for services will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.
Determination of QBI
Other Special Rules (Cont.)

• **Section 481 adjustments**

  − Prop. Treas. Reg. §1.199A-3(b)(1)(iii) provides that section 481 adjustments attributable to a trade or business, whether positive or negative, and arising in a taxable year ending after December 31, 2017, are treated as attributable to that trade or business. Accordingly, such section 481 adjustments will constitute QBI to the extent the other requirements of section 199A, including Prop. Treas. Reg. § 1.199A-3, are satisfied.

  − Section 481 adjustments arising in a taxable year ending before January 1, 2018, do not constitute QBI.
Determination of QBI
Allocation of Items Among Multiple Businesses

- Prop. Treas. Reg. § 1.199A-3(b)(5) provides that, if a taxpayer directly conducts multiple trades or businesses, and has items of QBI which 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**

based on all the facts and circumstances. For this purpose –

- The taxpayer may use a different reasonable method for different items of income, gain, deduction, and loss.

- The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business.

- The overall combination of methods must also be reasonable based on all facts and circumstances.

- The books and records maintained for a trade or business must be consistent with any allocations under this paragraph.

- These rules also apply with respect to RPEs that directly conduct more than one trade or business.
Examples – Calculating the Deduction
Examples – Taxpayer with Taxable Income Below the Applicable Threshold Amount

In each scenario below, A is an individual whose total taxable income for the 2018 taxable year (determined without regard to section 199A) is less than the threshold amount. Accordingly, neither the Specified Service Trade or Business Limitation nor the Wage and Basis Limitation applies.

**Example 1A (employee).** A earns $100,000 in wages as an employee of LLC. The definition of a qualified business does not include the business of performing services as an employee. Therefore, A’s wage income does not qualify for the 20 percent deduction.

**Example 1B (independent contractor).** A earns $100,000 of income from a U.S. trade or business by performing services for LLC as an independent contractor. This income qualifies for the 20 percent deduction.

**Example 1C (partner).** A is a partner in a limited liability company that is classified as a partnership for tax purposes. LLC earns income from a U.S. trade or business and allocates $100,000 of that income to A as a distributive share. A’s distributive share of $100,000 qualifies for the 20 percent deduction. If A receives the $100,000 as a guaranteed payment for services (and not as a distributive share of partnership income), the $100,000 payment would not qualify for the 20 percent deduction.
Examples – Employees Form Partnership

In each scenario below, B and C are individuals whose total taxable incomes for the 2018 taxable year (determined without regard to section 199A) are less than the threshold amount. Accordingly, neither the Specified Service Trade or Business Limitation nor the Wage and Basis Limitation applies.

Example 2A (employees). B and C each earn $100,000 in wages as employees of Corporation. The definition of a qualified business does not include the business of performing services as an employee. Therefore, B’s and C’s wage income does not qualify for the 20 percent deduction.

Example 2B (partners). B and C form a limited liability company that is classified as a partnership for tax purposes. LLC contracts with Corporation to provide the services that formerly were provided directly by B and C (i.e., as employees). LLC earns $200,000 of income from a U.S. trade or business and allocates that income equally between B and C. Each partner’s distributive share of income qualifies for the 20 percent deduction.
Examples – Taxpayer with Taxable Income Above the Applicable Threshold Amount

In each scenario below, D is an individual whose total taxable income for the 2018 taxable year (determined without regard to section 199A) is above the phase-in range. Accordingly, both the Specified Service Trade or Business Limitation and the Wage and Basis Limitation apply.

**Example 3A (employee).** D earns $1 million in wages as an employee of LLC. The definition of a qualified business does not include the business of performing services as an employee. Therefore, D’s wage income does not qualify for the 20 percent deduction.

**Example 3B (independent contractor).** D earns $1 million of income from a U.S. trade or business by performing services for LLC as an independent contractor. D’s trade or business has no W-2 wages. In 2018, D purchases qualified property with an unadjusted basis of $2 million.

If D’s sole proprietorship business is a specified service trade or business (e.g., a trade or business where the principal asset of the trade or business is the reputation or skill of D), the Specified Service Trade or Business Limitation would apply and D’s income earned as an independent contractor would not qualify for the 20 percent deduction.

If D’s trade or business is not a specified service trade or business, then D is entitled to claim a deduction of $50,000 (the greater of (i) 50 percent of the W-2 wages paid with respect to the qualified trade or business ($0), or (ii) the sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business ($0), and 2.5 percent of the UBIA of all qualified property (2.5% x $2 million or $50,000)).
Example – S Corporation with W-2 Wages

Example 4

E forms an S corporation to operate a U.S. trade or business. E owns all of the stock of the S corporation. E’s trade or business conducted through the S corporation is not a specified service trade or business. E’s total taxable income for the 2018 taxable year (determined without regard to section 199A) is above the phase-in range.

The S corporation earns $1 million of income (before paying any compensation to E) and pays reasonable compensation to E in the amount of $700,000. The S corporation has $700,000 of W-2 wages (paid entirely to E). The S corporation does not own or acquire any qualified property. E’s pro rata share of the S corporation’s qualified business income (after paying E’s compensation) is $300,000. Qualified business income does not include reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business. E’s pro rata share of the qualified business income of the S corporation ($300,000), however, qualifies for the 20 percent deduction, subject to the Wage and Basis Limitation.

E’s Wage and Basis Limitation is $350,000 (50 percent of $700,000). Because 20 percent of E’s share of qualified business income of the S Corporation ($60,000) is less than the amount of the Wage and Basis Limitation ($350,000), E’s deductible amount is $60,000. In contrast, if the S Corporation’s trade or business were a specified service trade or business, then none of E’s income from the S corporation would qualify as qualified business income.
Example – Partnership With No W-2 Wages or Qualified Property

Example 5

F and G form the FG partnership to conduct a U.S. trade or business that is not a specified service trade or business. Each of F’s and G’s total taxable income for the taxable year (determined without regard to section 199A) is above the phase-in range. The FG partnership has no employees and owns no qualified property.

The FG partnership earns $1.3 million of qualified business income and makes a guaranteed payment to F in the amount of $700,000 for services rendered by F. F’s allocable share of qualified business income from the FG partnership is $300,000. Qualified business income does not include any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business. Each of F’s and G’s allocable share of qualified business income from the FG partnership ($300,000), however, generally qualifies for the 20% deduction subject to the Wage and Basis Limitation.

The $700,000 guaranteed payment made to F does not qualify as W-2 wages. Because the FG partnership does not have any employees and does not own any qualified property, the Wage and Basis Limitation is $0. Therefore, F and G will not be entitled to any deduction with respect to their allocable shares of qualified business income from the FG partnership.
Example – Separate Trades or Businesses

Example 6

Two individuals, H and I, are equal partners in HI LLC. HI LLC has two distinct and separate U.S. trades or businesses that cannot be aggregated under Prop. Treas. § 1.199A-4: business one, which performs trucking services, and business two, which performs warehouse services. Each trade or business is a qualified trade or business that is not a specified service trade or business. Each of H’s and I’s total taxable income for the taxable year (determined without regard to section 199A) is above the phase-in range. Business one has qualified business income of $200,000 and W-2 wages of $160,000. Business two has qualified business income of $200,000 and W-2 wages of $0. Assume for simplicity that neither business one nor business two owns or acquires qualified property.

Business One
Each partner’s allocable share of qualified business income from business one is $100,000. Each partner’s share of W-2 wages is $80,000 and each partner’s Wage and Basis Limitation is $40,000. Because 20 percent of each partner’s allocable share of qualified business income ($20,000) is less than the amount of that partner’s Wage and Basis Limitation ($40,000), the Wage and Basis Limitation does not apply. Therefore, each partner’s deduction for business one is $20,000.

Business Two
Each partner’s allocable share of qualified business income from business two is $100,000. Each partner’s Wage and Basis Limitation from business two is $0. Because the amount of each partner’s Wage and Basis Limitation ($0) is less than 20 percent of each partner’s allocable share of qualified business income ($20,000), the Wage and Basis Limitation applies. Therefore, each partner’s deduction for business two is limited to $0.

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Example 7

Assume the same facts as Example 6, except that HI LLC’s trucking services and warehouse services are properly treated as a single trade or business for purposes of section 199A. If the services are treated as one trade or business, each partner’s allocable share of qualified business income would be $200,000 (50% of the total qualified business income of $400,000) and each partner’s Wage and Basis Limitation would be $40,000 (50% of the total W-2 wages of $80,000). Because 20 percent of each partner’s allocable share of qualified business income ($40,000) is equal to the amount of that partner’s Wage and Basis Limitation ($40,000), the Wage and Basis Limitation does not apply. Therefore, each partner’s deduction is $40,000 (rather than $20,000 as in the previous example).

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Limitations on certain types of businesses or services and phase-in of wages and capital limitations

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Specified Service Trade or Business – Section 199A(d)(2)

• “Specified Service Trade or Business” (“SSTB”) means:
  – Any trade or business which is described in IRC section 1202(e)(3)(A) EXCEPT FOR ENGINEERING AND ARCHITECTURE and substituting “employees or owners” for employees, i.e.:
    • 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, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners, and
    • Any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.
Thresholds: No Phase-out

• The thresholds are used to determine two separate limitations:
  1) the Specified Service Trades and Businesses limitation, and
  2) the Wages and Qualified Property limitation

• If you are completely below these amounts (and they are to be adjusted for inflation after 2018) then the Specified Service Trades and Businesses limitation and the Wages and Qualified Property limitations do not apply:
  - $157,500 for individuals
  - $315,000 for married joint filers
Specified Service Trade or Business Phase-out

• If you are over these amounts then there is no deduction:
  – Up to $207,000 for individuals
  – Up to $415,000 for married joint filers
Specified Service Trade and Business Phase-out

• Above the threshold amount, the deduction for income for any SSTB is phased out over the next $50,000 of income ($100,000 for married joint filers).

• Qualified business income of a SSTB is determined by taking into account only the “applicable percentage” of qualified income, gain, deduction, or loss, and of W-2 Wages.

• Applicable percentage = 100% - (Taxable Income - Threshold Amount)/$50,000 or $100,000 (for joint filers)
Examples

• Married taxpayer has taxable income of $300,000, all of which taxpayer earned as a law partner.
  – Below threshold of $315,000, and as such is deductible
• Married taxpayer has a taxable income of $420,000, all of which taxpayer earned as a law partner.
  – Above threshold, and therefore no deduction
• Married taxpayer has a taxable income of $350,000, all of which taxpayer earned as a law partner.
  – Deduction has partial phase-out: \((350,000 - 315,000)/100,000 = 35\%\).
  – As such, the taxpayer would lose 35% of taxpayer’s benefit. The “applicable percentage” would be 100%-35%=65%, which would then be multiplied against taxpayer’s allocable share of Qualified Business Income/W2 Wages/Basis of Assets. More about this in another example.
Wages and Qualified Property Limitation

• Deduction is limited to greater of:
  – 50% of W-2 Wages or
  – 25% of W-2 Wages and 2.5% of unadjusted basis immediately after acquisition of all qualified property

• Exception
  – Taxpayers with taxable income below the threshold amount are not subject to the limitation.
  – Above the threshold amount, the limitation is phased in over the next $50,000 of income ($100,000 for married joint filers).

• The taxpayer compares the amount that is 20% of a qualified trade or business income to the wage and capital limit amount. The excess is then multiplied by a percentage equal to ratio of the taxable income over the threshold amount to $50,000 (or $100,000).
Examples

• H and W have taxable income of $1,500,000 from their widget manufacturing business, which is an S corporation. They paid $450,000 of wages to employees.
  – Their deduction is $225,000 (the lesser of 20% of $1,500,000 or 50% of $450,000).

• Assume the facts above, but H and W also purchased widget-making machines with an unadjusted basis of $12,000,000 two years ago.
  – Their deduction is $300,000 (the lesser of 20% of $1,500,000 or (i) 25% of $450,000 and (ii) 2.5% of $12,000,000).

• Taxpayer has taxable income of $162,500 from his non-service business sole proprietorship and paid $50,000 of wages to employees.
  – His deduction is $31,750 (his tentative deduction of $32,500 reduced by $7,500 x 10%).
Examples

• Taxpayer has taxable income of $177,500 and $150,000 was earned from her dental practice, which is a disregarded entity. She paid $55,000 in wages to employees.
• The deduction is determined by calculating the applicable percentage of qualified items, which is equal to 100% reduced (not below zero) by the percentage equal to the amount of taxable income over the threshold amount over $50,000 (or $100,000 for joint filers).
  \[
  100\% - \frac{(177,500 - 157,500)}{50,000} = 60\%
  \]
• The applicable percentage of 60% is applied to determine qualified business income of $90,000 (60% x 150,000).
• The applicable percentage of 60% is applied to determine includible W-2 wages of $33,000 (60% x 55,000).
• Taxpayer’s tentative deduction is 16,500 (the lessor of 20% of $90,000 (18,000) or 50% of $33,000 (16,500). Final deduction of $17,400, which is calculated: $18,000 - 16,500 = 1,500 and then \( \frac{(177,500 - 157,500)}{50,000} = .4; 1,500 \times .4 = 600; 18,000 - 600 = $17,400 \) (this accounts for the phase in from 157,500 to 207,500).
Checklist

• If under $315,000 or $157,500, then no phase-outs or limitation to worry about
• If over $207,500 or $415,000 and is a specified service trade or business, then there is no deduction
• If between $157,500/$315,000 and $207,500/$415,000 then must calculate the phase-out percentage for specified service or trade or business and must calculate the phased-in wage or capital limit
• If over $207,500/$415,000 and not a specified service trade or business, then must calculate wage/capital limit
Issues from the Proposed Regulations

• A business will be considered an extension of a SSTB, and therefore a SSTB itself, if (1) at least 50% common ownership (with 207(D) attribution) AND 2) ancillary entity provides 80% or more of its property/services to SSTB with which it is commonly controlled.
• If less than 80% property/services provided, then only that portion is considered SSTB Income.
• Reasonable Compensation (Proposed Regulations state this concept regards S corporations paying owners a wage. Not expanded to K-1 or disregarded entities).
• Proposed regulations state that banking, real estate brokerage services and liability and casualty agencies are not SSTB.
• Investment banking, hedge fund management, lobbying, and veterinary medicine are SSTB.
• Reputation or skill category narrowly defined under proposed regulations, and generally applies to endorsements or fees from use of a person’s likeness or appearance fees.
Strafford Webinar: New Section 199A: Deductions, Limitations, Complexities, and Opportunities for Pass-Through Entities

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How to Claim the Deduction

• The 199A deduction is claimed by an individual taxpayer on certain income received from a partnership, S-corporation, or sole proprietorship for tax years after 2017

• Specific guidance is still needed on mechanics of claiming the deduction
  - Most taxpayers with a 199A deduction will claim it for the first time on their 2018 tax returns
  - IRS is anticipated to provide a new worksheet or form for calculating the deduction
  - This may take a form similar to Form 8903, Domestic Production Activities Deduction (which was repealed by the TCJA)
Important Tax Planning Considerations

- **Strategy: Reduce taxable income to increase deduction**
  - Increase retirement plan contributions
  - Fully-fund Health Savings Accounts
  - Capture all legitimate business expenses
  - Oil and Gas Investment?

- **Example: CPA George (married filing jointly) earns $450,000. He is not eligible for the deduction because he is in a specified service business.**
  - George has a SEP and an HSA. He funds the SEP with $55,000
  - He has family coverage, and therefore is able to fund his HSA with $6,900
  - He maintains a home office, and uses a vehicle for work, and has other business-related expenses, which together net annual business expenses of $10,000
  - Oil & Gas Investment $100,000:
    - Intangible drilling costs are 100% deductible in year incurred
    - Tangible drilling costs give rise to depreciation deductions
    - Depletion deduction
    - ~80% of investment is deductible in the year made
Important Tax Planning Considerations

- **Strategy: Convert from Employee to Independent Contractor**
  - Recall that no 199A deduction is available for income derived from the business of being an employee.
  
    - Can you convert to independent contractor status? Probably not. If an employee becomes an independent contractor while providing substantially the same services as when they were an employee, there is a presumption that the person is an employee for purposes of 199A. See Prop. Reg. 1.199A-5(d)(3).

  - Interesting to note that there is no presumption or prohibition on changing from independent contractor to W-2 employee...
Important Tax Planning Considerations

- **Strategy: Avoid Unused Deduction**
  
  - Increase wages to increase the deduction

- **Example: Architecture firm with two owners is organized as a partnership. It has Qualified Business Income of $800,000. Employee payroll is $200,000.**
  
  - $800,000 x 20% = $160,000 > $200,000 x 50% = $100,000
  
  - Deduction is limited to $100,000 because of W-2 wage limitation
  
  - Solution: Architecture firm makes S-election, shareholders pay themselves reasonable salaries of $75,000 each:
    
    - $650,000 x 20% = 130,000 < 350,000 x 50% = $175,000
    
    - Deduction is now $130,000 (now limited by QBI)
    
    - Added benefit: reduction of self-employment taxes
    
    - Note: S corp is subject to “reasonable compensation” analysis on shareholder salaries. What if reasonable compensation is $125,000 each? Deduction now only $110,000.

  - What if partners are below the income threshold of $157,500/$315,000? Reasonable compensation requirement not extended to partnerships, so partners could eliminate guaranteed payments to themselves.
Important Tax Planning Considerations

- **Strategy: Manage the QBI limitation by increasing business income**
  - Same Architecture firm after paying reasonable compensation of $75,000 to each partner
    - Total payroll is $350,000
    - QBI is $650,000
    - Because 20% of QBI (130,000) is smaller than 50% of wages (175,000), 199A deduction is limited by QBI
  - Strategy: Increase QBI. Architecture firm had been leasing equipment for $100,000 total each year. They decide to purchase leased equipment in Year 1. In year 2, QBI has increased by $100,000 to $750,000, thus allowing a 199A deduction of $150,000.
    - Purchase equipment that was previously leased
    - Purchase real estate in which business operates
    - Reduce leverage
Important Tax Planning Considerations

- **Strategy: Separate service business from non-service business**
  - Service business deduction ineligibility only applies to income earned from service business. If a taxpayer can separate out non-service business QBI, she may be able to take the deduction on that income.

- Pre proposed regulations “Crack and Pack” Example: Dermatologist earns more than $415,000 from her medical practice. She also has a retail component of that business where she sells skincare products and cosmetics.
  - Spin out retail business from medical practice
  - QBI from retail is $200,000, and it pays total wages of $100,000
    - $200,000 x 20% = $40,000 < $100,000 x 50% = $50,000
    - Dermatologist can take $40,000 199A deduction for her retail business

- See next slide for limitations on this strategy...
Important Tax Planning Considerations

• **Strategy: Separate service business from non-service business**
  - Service business deduction ineligibility only applies to income earned from service business. If a taxpayer can separate out non-service business QBI, she may be able to take the deduction on that income.

• **Limitations:**
  - An SSTB includes any business (i) with 50% or more common ownership, and (ii) provides 80% or more of its property or services to an SSTB (so a law firm will have difficulty spinning out a separate administrative services business...)
  - Common ownership is determined by applying attribution rules of Sec. 267(b) or 707(b), and includes attribution among trusts and their grantors and beneficiaries, and family attribution among siblings, spouses, ancestors, and descendants
  - For a business that meets the 50% test but not the 80% test, the portion of property or services provided to SSTB is treated as part of the SSTB.
  - If a business that would not otherwise be an SSTB, but (i) meets common ownership with the SSTB, (ii) shares expenses with the SSTB, and (iii) accounts for 5% or less of the gross receipts of the business and SSTB, the business will be treated as incidental to and part of the SSTB.

• Post-proposed regulations planning: avoid 50% common ownership
Important Tax Planning Considerations

- **Strategy:** Take advantage of aggregation for situations in which one business could benefit from the wages or property basis of the other.

  - Each entity is analyzed separately, so it can matter where expenses, wages, and qualified property are paid/held.
  
  - The proposed regulations created an easier way to do this by allowing a taxpayer to aggregate businesses meeting certain requirements. This will result in the combination of QBI, W-2 wages, and qualified property, which can be helpful in circumstances where one business has significant QBI, but not enough W-2 wages or qualified property, and a related business with excess W-2 wages or qualified property.

  - Aggregation is at the election of the taxpayer, and owners of a business do not need to make the same aggregation decision.

  - Businesses may be aggregated if

    - There is common ownership: the same person or persons, directly or indirectly, own 50% or more of each business being aggregated (ownership of spouse, children, grandchildren, and parents is attributed. No attribution from non-grantor trust to beneficiary)

    - Common ownership is consistent: the common ownership exists for a majority of the taxable year

    - All items attributable to each business are reported on returns having the same taxable year

    - None of the businesses is an SSTB, and:
Important Tax Planning Considerations

- **Business aggregation, continued**
  
  - Must meet factors described on previous slide, and meet at least two of the following factors:
    
    - The businesses provide products and services that are the same or are customarily offered together;
    
    - The businesses share facilities or significant centralized business elements (such as personnel, accounting, legal, manufacturing, purchasing, human resources, or IT resources; and
    
    - The businesses “are operated in coordination with, or reliance upon, one or more businesses in the aggregated group (such as supply chain relationships)

  - Election cannot generally be reversed, so care must be taken to make sure appropriate businesses are aggregated
Important Tax Planning Considerations

- Use succession planning to eliminate W2 and Qualified Property limitations:

  - Joyce gifts a 25% interest in business to two separate trusts settled for the benefit of each of her two children
  - Qualified business income = $600,000
  - Trust income = $600,000 x 25% / 2 = $75,000
  - Does each trust get a deduction of $15,000 ($75,000 x 20%)?
  - Probably not...Proposed Reg. 1.199A-6(d)(3)(v) states that a trust will not be respected if it is formed or funded with a significant purpose of receiving a deduction under 199A.
  - Proposed Reg. 1.643—1 addresses anti-abuse issues using multiple trusts but is not effective until it is final.

     - Two or more trusts will be aggregated and treated as a single trust if (i) they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (ii) a principal purpose for establishing the trusts is for the avoidance of federal income tax.

     - A principal purpose of tax avoidance is presumed if it results in a significant income tax benefit unless there is a significant non-tax benefit that could not have been achieved without the creation of the trusts
Important Tax Planning Considerations

Questions?