

SECTION 199A THE PASS-THROUGH DEDUCTION

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The recent reconciliation act known as the Tax Cuts and Jobs Act (TCJA) significantly reduces the federal income tax rate of regular C corporations from a top rate of 35% to a flat 21%.¹ That reduced tax rate does not apply to businesses organized as partnerships, most limited liability companies (LLCs), S corporations, and sole proprietorships. To attempt to achieve some parity in tax treatment, TCJA provides for up to a 20% deduction against taxable income of the owners from these businesses that are not C corporations that are engaged in qualified trades or businesses.² The deduction is sometimes called the Section 199A deduction or the pass-through deduction, and can result in a greater than 7% reduction in the effective federal tax rate to the applicable taxpayer. However, there are many exceptions and limitations, as well as specific methods of determining the amount of the deduction.

Certain businesses, referred to as “specified service trades or businesses” are excepted from being “qualified trades or businesses” and the Section 199A deduction is denied to their owners. Specified service trades or businesses include the fields of law, accounting, health (e.g., physicians practices), and other fields.

¹ TCJA, Section 13001, amending Internal Revenue Code (“Code”) Section 11(b).

² New Code Section 199A is effective for taxable years beginning after 12/31/2017 and has many more provisions than are mentioned in this article. For example, and not by way of limitation, not discussed are foreign source income, tax penalties, the effect of ownership of REITs, cooperatives and publicly traded partnerships, alternative minimum tax, partial year ownership, the myriad of issues regarding trusts, tax partnerships and S corporations. Sec.199A was enacted pursuant to section 11011 of the act reconciling varying House and Senate bills to enact the TCJA, P.L. 115-97. References to sections are to the sections of the Internal Revenue Code as amended by TCJA unless otherwise stated.

Nonetheless, there is an exception to this exception, which applies to varying degrees to most of the owners of these specified service businesses. This law is complicated. Unlike the C corporation rate cut, but like such much of the individual tax changes in the act, Sec. 199A shall not apply to taxable years beginning after December 31, 2025.³

1. Mechanics of the Sec. 199A deduction. The pass-through deduction is stated as being a 20% deduction against business income of an individual. For many it will work out to be almost that easy. However, if taxable income of a taxpayer is above the Threshold Amount (taxable income above \$315,000 for married couples filing a joint return, and \$157,500 for all others),⁴ then it is not that simple, and the rules are amazingly detailed. The rules described below lay out the statutory roadmap:

Statutory roadmap. Section 199A permits a deduction of the “combined qualified business income amount” (Combined QBI Amount), but not greater than 20% of the taxable income of the taxpayer (excluding the Sec. 199A deduction, net capital gains and qualified cooperative dividends).⁵ The Combined QBI Amount is the sum of the Sec. 199A(b)(2) “deductible amount” of each qualified trade or business (QTorB), plus 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.⁶

A QTorB is “a trade or business other than a specified service trade or business (“SSTorB”) or the trade or business of being an employee.”⁷

The Section 199A(b)(2) deductible amount for each QTorB is 20% of qualified business income (“QBI”) of the QTorB. However, if the taxable income of the taxpayer is above the Threshold Amount plus the applicable Phase-in Range (described below), then, if lesser, the greater of:

- (i) the W-2 Wages Test (the deductible amount cannot exceed 50% of W-2 Wages, described below) or
- (ii) the W-2 Wages and Capital Test (the deductible amount cannot exceed 25% of W-2 Wages plus 2.5% of the unadjusted basis of qualified property, described below).⁸

Over the Phase-in Range, the deductible amount is in between 20% of QBI and the wage and capital tests.

³ Sec. 199A(i).

⁴ The Threshold Amounts are adjusted annually for inflation. The amounts stated in this article are for taxable years beginning in 2018.

⁵ Sec. 199A(a)(1) and (e)(1).

⁶ Sec. 199A(b)(1).

⁷ Sec. 199A(d)(1).

⁸ Sec. 199A(b)(2) and (3).

QBI of a QTorB is generally the net taxable income from the QTorB, but excludes, among other things:

- Capital gains and losses.
- Foreign source income.
- Interest income not properly allocable to a trade or business.
- Annuity income.
- Guaranteed payments and reasonable compensation for services.⁹

If taxable income of the taxpayer (excluding only the Sec. 199A deduction) exceeds the applicable Threshold Amount, then (i) Sec. 199A(d)(2) reduces or eliminates QBI of certain business that are “specified service trades or businesses” and, (ii) Section 199A(b)(3)(B), as mentioned above, can further reduce the amount of the deduction depending on the payroll and cost of depreciable property of the business.

2. Only trades or businesses qualify. Net income from activities other than “trades or businesses” will not qualify for the deduction. For example, if a taxpayer leases property to one tenant under a long term triple net lease, then perhaps the activity is not a trade or business. The more activity and landowner duties the better when a Sec. 199A deduction is material.

3. Applies to individuals, trust and estates. The deduction is available to a taxpayer, other than a corporation.¹⁰ Those taxpayers include individuals, estates and trusts.¹¹ Literally a taxpayer could be a partnership or LLC (that is taxed as a partnership). There can be tiers of trusts, estates, tax partnerships, and S corporations.¹²

4. Multi-step tests. A partner of partnership, member of an LLC, shareholder of an S corporation, and a sole proprietor must pass through the “Gauntlet,” discussed below, to have the advantage of the Sec. 199A deduction, which could be as high as the 20% of the sum of the qualified business income from qualified trade or business of the taxpayer. However, this amount is subject to phase-out rules above the Threshold Amount and overall taxable income limitation, which could reduce or eliminate the deduction. The benefit of the deduction is reduced proportionately as taxable income of the taxpayer is increased through the Phase-in Range¹³ above the Threshold Amount. Depending on the business, there may be two such phase outs applied to the same taxpayer, compounding denial of the tax benefit. In each case the Threshold Amount and Phase-in Range is the same, but the specifics of the phase out computations are different.

⁹ Sec. 199A(c).

¹⁰ Sec. 199A(a).

¹¹ Sec. 199A(a).

¹² Tiering rules are mentioned in Sec. 199A(f)(4)(B).

¹³ The phrase “phase-in” is used in the Sec. 199A(b) phase out provision, but not in the Sec. 199A(d) phase out provision. “Phase-in Range” is used in this discussion to apply to both phase outs.

The Threshold Amount for a taxable year beginning in 2018 is \$157,500 of taxable income without regard to the Sec. 199A deduction (“TI”), a Phase-in Range of \$50,000, with complete phase-out at \$207,500, except for couples filing married joint returns, when the Threshold Amount is \$315,000, a Phase-in Range of \$100,000, with complete phase-out at \$415,000. The applicable Threshold Amount (but not the \$50,000 or \$100,000 Phase-in Range) is adjusted annually for inflation.¹⁴ Each business is tested separately. **A brief overview of the tests through which a trade or business owner must pass is as follows:**

Test #1: To minimize or avoid distributions by a tax partnership from being a guaranteed payments, defined in Sec. 707(c).¹⁵ This test only applies to owners of partnerships and LLCs taxed as partnerships. Similarly, a taxpayer would desire to minimize or avoid payments from the trade or business being considered compensation as an employee.

Test #2: To avoid in whole or in part Specified Service Trade or Business (“SSTorB”) status so to be a Qualified Trade or Business (“QTorB”), even if in the fields of law, accounting, health, etc., by being under the Threshold Amount plus the Phase-in Range of \$50,000 or \$100,000 as applicable.¹⁶ This test only applies to owners of SSTorBs.

Test #3: Then, after application of (1) above to an SSTorB, to avoid in whole or in part the W-2 Wages Test or the W-2 Wages and Capital Test¹⁷ (discussed below) by being under the Threshold Amount plus the Phase-in Range of \$50,000 or \$100,000 as applicable.¹⁸ This test applies to owners of all trades or businesses.

Test #4: The deduction is limited to 20% of taxable income (excluding the Sec. 199A deduction, net capital gains, and qualified cooperative dividends [not discussed in this article]).

A more detailed explanation of these tests is discussed below.

5. Sec. 199A is only an income tax deduction. The Sec. 199A deduction will not reduce “self-employment tax” or “net investment income tax.”¹⁹

6. Sec. 199A deduction is after AGI, but not an itemized deduction. The Sec. 199A deduction is “below the line” (i.e., not used to determine adjusted gross income – AGI), but is not an itemized deduction.²⁰ So a taxpayer is entitled to both a

¹⁴ Sec. 199A(e)(2).

¹⁵ Sec. 199A(c)(4).

¹⁶ Sec. 199A(d)(3).

¹⁷ Sec. 199A(b)(2)(B)(i) and (ii).

¹⁸ Sec. 199A(b)(3).

¹⁹ Sec. 199A(f)(3).

²⁰ Sec. 62(a); Sec. 63(b) and (d).

Sec. 199A deduction and the standard deduction.²¹ Many states' income taxes for individuals are determined from federal AGI, so there may be no deduction on state returns derived from the Sec. 199A deduction.²²

7. No NOL carryforward of Sec. 199A deduction. The Sec. 199A deduction cannot be taken as part of an NOL to be carried forward.²³

8. Net Sec. 199A loss specially carried forward. If the net annual amount of QBI of all qualified trades or businesses of a taxpayer is a loss, this "carryover qualified business loss" is treated as a loss from a QTorB in the succeeding year's application of Sec. 199A.²⁴ This has the effect of reducing the Sec. 199A deduction for the subsequent year.

9. Application of QTorB losses. If a QTorB generates a "qualified business loss" in a year when other QTorBs have QBI, then there is a "reduction to the deduction" by 20%²⁵ of the qualified business loss against the Sec 199A deductible amount derived from the positive QTorBs' QBI.²⁶ Additionally, if there is a Section 199A(c)(2) "carryover qualified business loss" from a prior year, then there is also a reduction to the deduction by 20% of the carryover qualified business loss.²⁷ There is no example or guidance at the time of writing of this article when TI is above the Threshold Amount, or the effect of differing Threshold Amounts between years as to the computations when TI is in or above the Phase-in Range, when there are qualified business losses.²⁸

Example when under the Threshold Amount: If taxpayer has a QTorB with QBI in year 2 of \$100,000, another QTorB with QBI that is a loss of \$30,000 in year 2, and also has a carryover qualified business loss from year 1 of \$10,000, then the Section 199A(b)(1) combined qualified business amount is \$12,000 $[(\$100,000 \times 20\%) - (\$30,000 \times 20\%) - (\$10,000 \times 20\%) = \$20,000 - \$6,000 - \$2,000 = \$12,000]$.

Example when over the Threshold Amount plus Phase-in Range: If taxpayer has a QTorB with QBI that is a loss of \$100,000 in year 1. In year 2 the QTorB has QBI of \$200,000, W-2 Wages of \$40,000 and Unadjusted Basis is \$0. In year 2 taxpayer's TI and modified TI is \$500,000. The deductible amount of the QTorB in year 2 is \$20,000. [The lesser of 20% x \$200K or 50% x \$40K W-2 Wages.] The reduction of

²¹ Joint Explanatory Statement of the Committee of Conference to H.R. 1, the Tax Cuts and Jobs Act, p.39.

²² For example, Arizona Form 140 for 2017, line 12; see 2017 Arizona Form 140 Resident Personal Income Tax Booklet, page 8.

²³ Sec. 172(d)(8).

²⁴ Sec. 199A(c)(2); Joint Explanatory Statement of the Committee of Conference, Example 2 on p.37.

²⁵ At least in a year when taxable income is below the Threshold Amount,

²⁶ Joint Explanatory Statement of the Committee of Conference, Example 2 on p.37.

²⁷ Id.

²⁸ Presumably, an SSTorB loss in a fully phased out year is not carried forward to a year when the business would be a QTorB.

deduction due to the carryover qualified business loss from year 1 is \$20,000. The combined qualified business income amount (Combined QBI Amount) and Section 199A deduction in year 2 is \$0.

If the taxpayer recognized no QBI loss from the QTorB in year 1 and \$100,000 in year 2 (instead of a loss of \$100K in year 1 and \$200K in year 2), then taxpayer will have a Combined QBI Amount and Section 199A deduction in year 2 of \$20,000 from the QTorB, [The lesser of 20% of QBI of \$100K or 50% x \$40K W-2 Wages.]

Assuming a 35% marginal income tax rate, the difference in the Section 199A deduction is \$20,000 and income tax due to timing of recognition of income is \$7,000 [35% x \$20K]. This detrimental result can occur whenever the deductible amount in the subsequent year is limited by the W-2 and Capital test.

NOTE: Avoid QTorB losses when subsequent year's TI may be in the Phase-in Range.

10. Apply at the pass-through owner level. Sec. 199A(f)(1) clarifies that the Section 199A “applies at the partner or shareholder level.” Therefore specific application of Sec 199A is not made by a tax partnership or S corporation, but instead by the highest tier owners that are individuals, trusts or estates, with their respective Threshold Amounts and phase out rules.²⁹ Each of the co-owners of the business has their own full Threshold Amount, but are allocated only his or her or its share of taxable items of the business for purposes of applying the rules of Sec. 199A.

11. Trust and estate rules. It is not clear how Sec. 199A is applied to a trust or estate and its beneficiaries when distributions are made from it. At the time this outline was written, there was no guidance as to how to so apply the Section. The author’s view is that the rules of Section 199 (repealed by the TCJA, although referenced elsewhere for a different purpose in Section 199A) will generally apply. If the trust is a grantor trust for federal income tax purposes, then the grantor would report the tax items on her return.³⁰ Otherwise, following the application of Section 199 regarding trust or estate taxation to Section 199A, the applicable business income would be allocated between each of the trust or estate and its beneficiaries to each based on proportion of distributable net income each is allocated, with income allocated to corpus being, likely, that of the trust or estate.³¹

12. Planning just now starting. Much will be written about planning under Section 199A after the first wave of just explaining it. Here are examples of planning:

²⁹ Sec. 199A(e)(2).

³⁰ See Reg. Sec. 1.199-5(c).

³¹ See Reg. Sec. 1.199-5(d).

(i) Moving assets or payroll, into a business, on its face, offers the prospect of increasing the W-2 Wages or depreciable property to increase the W-2 Wages Test or the W-2 Wages and Capital Test result, increasing the deduction for that business.

(ii) Transferring some operations out of an SSTorB to another hopefully profitable non-SSTorB entity to then furnish services, facilities, or other items or products to the SSTorB may be eyed. The net income from that provider business would be intended to be outside the SSTorB limitation, while the SSTorB income may be reduced.

(iii) Transferring tax partnership interests or S corporation stock to multiple nongrantor trusts for different family members could permit additional separate Threshold Amounts, and at the same time lower the TI of the transferor.³²

(iv) Adjusting the compensation of an S corporation owner may save taxes. There is a special limitation on higher income owners tied to payroll and asset costs (the wages and capital test, described above and below).

(v) Converting a sole proprietorship, partnership or LLC into an S corporation to effect the savings described in example (iv) immediately above. This may also permit mitigation of the self-employment tax, if applicable.³³

(vi) Identifying trades or businesses.

However, the government may limit the most abusive of these techniques through the issuance of regulations or compliance enforcement.

13. Regulations and technical corrections coming. There is no question that both regulations and significant technical corrections are needed to corral the many possible interpretations of Section 199A, and to change unambiguous provisions as well. The Treasury Department is granted broad power to promulgate regulations.³⁴ Stay tuned.

THE GAUNTLET: QUALIFICATION FOR AND DETERMINATION OF THE SECTION 199A DEDUCTION

³² If the trust owns a share of a personal use residence, it will separately have a \$10,000 property tax itemized deduction potential it could obtain by paying it with the LLC interest or S corporation stock cash flow. See 164(b)(6)(B).

³³ This technique might be detrimental in the case of a rental real estate trade or business, since its income is generally not subject to self-employment tax. Sec. 1402(a)(1).

³⁴ Sec. 199A(f)(4).

(The method of computations necessary to determine the Sec 199A deduction when applying these Steps is shown in two separate Computation Sheets accompanying this discussion. One is for an SSTorB (a law practice) and the other a QTorB of rental real estate. The Computation Sheets have summaries of the rules to be applied, and example facts applying the rules. So they may be useful to copy and make notation, with the actual or guesstimated numbers near the example numbers, to obtain a result.)

Step 1 (Guaranteed Payment – skip this Step if the business is not in a partnership or LLC):

The distribution to a partner of a partnership (including a member of an LLC or PLLC taxed as a partnership) must not be a guaranteed payment, or the taxable income attributable thereto will not be subject to the Sec. 199A deduction. Qualified business income does not include, among other things, reasonable compensation and “guaranteed payments described in section 707(c) paid to a partner for services...”, and, to the extent provided in prospective regulations, any payment described in Sec. 707(a) to a partner for services.³⁵

The interest earned on capital by members or partners of pass-through trades or businesses are guaranteed payments for capital, but are they guaranteed payments paid “for *services rendered* with respect to the trade or business” and therefore no Sec. 199A deduction is available against that income? Such payment, however, may be treated as interest to deny a Section 199A deduction.

This guaranteed payment rule applies regardless of the type of trade or business or the taxable income of the owners.

Step 2 (SSTorB (e.g., law, accounting, health, etc.) Test – skip this Step if the business is not an SSTorB):

The business activity for which the Sec. 199A deduction applies must be a Qualified Trade or Business (“QTorB”).³⁶ A “Specified Service Trade or Business” (“SSTorB”) or employee status is not a QTorB.³⁷ (But see EXCEPTION below.)

An SSTorB is “a trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other 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].”³⁸ However, Sec. 199A(d)(2)(A) specifically

³⁵ Sec. 199A(c)(4).

³⁶ Sec. 199A(d).

³⁷ Sec. 199A(d)(1) and (2).

³⁸ Sec. 199A(d)(2)(A) referencing Sec. 1202(e)(3)(A). Apparently there is no authoritative guidance as to the meaning of “or any other trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.”

excepts the engineering and architecture fields from denial of the Sec. 199A deduction, and adds “or owners” to the description of the business. An SSTorB is also any trade or business “which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).”³⁹

EXCEPTION: An owner of an SSTorB (whether a sole proprietor, S corporation shareholder, or a tax partner of a tax partnership (member of an LLC and partner of a partnership)) can still have his SSTorB be treated as a QTorB if his taxable income determined without regard to the Sec. 199A deduction (“TI”)⁴⁰ is no more than the Threshold Amount plus the applicable Phase-In Range (\$50,000, except it is \$100,000 in the case of a married joint return).⁴¹ The 2018 Threshold Amount is \$157,500 for trusts, estates, single individuals, and those filing married separate returns, and the QBI of the SSTorB is proportionately reduced in the \$50,000 Phase-In Range to the extent TI is greater, being zero when TI is equal or greater than \$207,500. The 2018 Threshold Amount is \$315,000 for those filing married joint returns, and the QBI is proportionately reduced in the \$100,000 Phase-In Range to the extent TI is greater, being zero when TI is equal or greater than \$415,000.

If the TI of the owner of an SSTorB is in the Phase-in Range then the QBI, the W-2 Wages and unadjusted basis of qualified property (described below) of the SSTorB are each multiplied by the excess of 1 minus a fraction, the numerator of which is the extent to which TI exceeds the applicable Threshold Amount, and the denominator of which is the applicable Phase-in Range. The resulting QBI, W-2 Wages and unadjusted basis of qualified property, as reduced, are then tested under Step 2 below as a QTorB.

Example 1: Unmarried CPA in accounting business (an SSTorB) has QBI of \$200,000, TI and modified TI of \$170,000, W-2 Wages of \$50,000 and unadjusted basis of \$60,000. The “applicable percentage” is 75% (1 minus 25% ($(\$170,000 - \$157,500) / \$50,000 = 25\%$)). The taxpayer will take into account for Step 3 QBI of \$150,000, W-2 Wages of \$37,500, and unadjusted basis of \$45,000.

Step 3 (Qualified Trade or Business W-2 Wages Test and W-2 Wages and Capital Test):

If the TI of an owner of a QTorB is no more than the Threshold Amount, then the W-2 Wages Test⁴² and the W-2 Wages and Capital Test⁴³ are not applicable, and the full 20% deduction of Sec. 199A applies to the QBI of the QTorB and is the “deductible amount.”⁴⁴ The deduction is subject to phase out when TI is above the Threshold

³⁹ Sec. 199A(d)(2)(B).

⁴⁰ Sec. 199A(e)(1).

⁴¹ Sec. 199A(d)(3) and (e)(2).

⁴² Sec. 199A(b)(2)(B)(i).

⁴³ Sec. 199A(b)(2)(B)(ii).

⁴⁴ Sec. 199A(b)(3)(A).

Amount, but in a different manner as described in Step 2,⁴⁵ However, for SSTorB owners, this phase out is with respect to the business's QBI, W-2 Wages and unadjusted basis of qualified property remaining after application of Step 2.

If the owner's TI is no less than the Threshold Amount plus the Phase-in Range, the otherwise 20% deduction is further limited under this Step 3 to the greater of:

- (i) the W-2 Wages Test or
- (ii) the W-2 Wages and Capital Test.

If the TI of the owner is in the Phase-in Range then the Sec. 199A deduction for the QTorB (the deductible amount) is the excess of:

- (i) 20% of the QBI, over and reduced by
- (ii) the product of:
 - (a) a fraction, the numerator of which is the extent to which TI exceeds the applicable Threshold Amount, and the denominator of which is the applicable Phase-in Range, multiplied by
 - (b) the excess of: (I) 20% of the QBI, over and reduced by (II) the greater of: (A) the W-2 Wages Test or (B) the W-2 Wages and Capital Test.

W-2 Wages Test. This test in Sec. 199A(b)(2)(B)(i) limits the 199A deduction to 50% of the W-2 Wages of the QTorB (which, if the QTorB is an S corporation, could include employee compensation of the shareholder). W-2 Wages are those defined in Sec 6051(a)(3) and (8), which are **wages** defined in Sec. 3401(a) plus **deferred wages** (primarily deferrals under Sec. 401(k) and Sec. 457, but excluding profit sharing contributions) **of employees** of the QTorB.⁴⁶ If the wages are not reported on a return required to be filed with the Social Security Administration within 60 days of the due date of the return then they are not counted.⁴⁷

The partners and S corporation shareholders share these numbers with their fellow co-owners. Each shall be treated as having W-2 Wages "determined in the same manner as the partner's or shareholder's allocable share of wage expenses. In the case of an S corporation, an allocable share shall be the shareholder's pro rata share of an item."⁴⁸

The W-2 Wages and Capital Test. This test in Sec. 199A(b)(2)(B)(ii) limits the Sec. 199A deduction to the sum of (i) 25% of W-2 Wages, plus (ii) 2.5% of the "unadjusted basis immediately after acquisition of all qualified property" of the QTorB. The Treasury is to provide regulations for application of Sec. 199A to acquisition and

⁴⁵ Sec. 199A(b)(3)(B).

⁴⁶ Sec. 199A(b)(4).

⁴⁷ Sec. 199A(b)(4)(C).

⁴⁸ Sec. 199A(f)(1)(A)(iii) and flush language of Sec. 199A(f)(1)(A).

disposition of “the major portion of a trade or business” or a separate unit thereof.⁴⁹ Qualified property is tangible property subject to Sec. 167 depreciation “which is used at any point in the taxable year in the production of qualified business income,” and placed in service any time within the earlier of: (a) 10 years before the end of the taxable year, or (b) the beginning of the recovery period of the property under Sec. 168 without application of Sec. 168(g).⁵⁰ Is otherwise depreciable property not qualified property if immediately expensed pursuant to Sec. 179?

Each partner and S corporation shareholder shall be treated as having the unadjusted basis of the qualified property “determined in the same manner as the partner’s or shareholder’s allocable share of depreciation. In the case of an S corporation, an allocable share shall be the shareholder’s pro rata share of an item.”⁵¹

Application of rules of Section 199(d)(1)(B)(i) apply to estates and trusts for apportionment of W-2 Wages and qualifying property.⁵²

The Sec. 199A deduction remaining for each QTorB is referred to as the Sec. 199A(b)(2) deductible amount of the QTorB.

Inherited business interests. If the business interest is acquired as a result of death of the prior owner, is the “unadjusted basis” the transferee’s stepped up basis resulting from inclusion in the decedent’s gross estate under Section 1014? Is the “acquisition” the date of death? The Joint Explanatory Statement of the Committee of Conference does not address this issue. Logically, the answer to both of these questions is “yes” if the interest is a sole proprietorship. If an interest is of a tax partnership or S corporation stock, Sec. 199A(f)(1)(A) should cause the result for sole proprietorships to apply to the same extent. In the case of an S corporation, perhaps the time of “acquisition” is date of death, but “unadjusted basis” would not change. In the case of a partnership, the acquisition should be date of death, but unadjusted basis of qualified property should be the stepped up basis permitted with a Sec. 754 election.

A new date of acquisition can extend the time the property remains qualifying property. Sec. 199A(f)(1)(A)(iii) and (f)(4) grant redundant powers to the government to promulgate regulations. However, Sec. 199A(h)(2) authorizes the Treasury to “prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.” Perhaps this is indicative of Congress’s intent that regulations to require original acquisition dates and unadjusted basis of property of a business to carryover to successors only to the extent basis is carried over.

⁴⁹ Sec. 199A(b)(5). Will this mean that the purchase of less than a major portion of an LLC interest, even with a Sec. 754 election to adjust its interest in depreciable assets, will not permit the use of a higher basis for qualifying property within the LLC if the regulations provide otherwise?

⁵⁰ Sec. 199A(b)(6).

⁵¹ Sec. 199A(f)(1)(A)(iii) and flush language of Sec. 199A(f)(1)(A).

⁵² Sec. 199A(f)(1)(B).

NOTE: For the W-2 Wages and Capital Test to apply instead of the W-2 Wages Test, the cost of depreciable property must be at least ten times the W-2 Wages.

For S corporations, the characterization of income as a shareholder distribution or as employee compensation can cause significant difference in taxation.

Example 2: Assume an S corporation with one owner-shareholder has taxable income (*before the deduction for the owner's compensation*) of \$900,000. If the owner takes \$125,000 as employee compensation, the \$775,000 balance of income is treated as a taxable distribution to the owner from the company. Under the rules of Sec. 199A, let's assume the owner may be entitled to the Sec. 199A deduction of \$62,500. However, if the owner's salary is raised \$125,000 to \$250,000 (thereby lowering the shareholder's S corporation taxable distribution to \$650,000), then the Sec. 199A deduction would be \$125,000 due to the higher payroll expense. That change alone could reduce the owner's income tax by over \$20,000.

NOTE: The phase out of the 20% Sec. 199A deduction under Step 3 is different than under Step 2 for an SSTorB. Under Step 2 the 20% deduction could reduce to 0% at the top end of the Phase-in Range. In Step 3, the reduction cannot cause the Sec. 199A deduction to be less than the greater of (i) 50% of W-2 Wages or (ii) the sum of 25% of W-2 Wages plus 2.5% of (generally the cost of the depreciable assets of the business). Hence the Step 3 percentage rate of reduction of the Sec. 199A deduction over the Phase-in Range will always be less than the Step 2 percentage rate of reduction, except when there is no payroll and no depreciable property in the business.

Example 3: (Continuing with the unmarried CPA in Example 1 in Step 2 above.) The CPA's TI and modified TI is \$170,000 and adjusted QBI is \$150,000, W-2 Wages is \$37,500, and unadjusted basis is \$45,000. The tentative Sec. 199A deduction (the Combined QBI Amount before the final taxable income limitation) is **\$27,188** [$20\% \times \$150,000 - 25\% \times (20\% \times 150,000 - 50\% \times \$37,500) = \$30,000 - 25\% \times (\$30,000 - \$18,750) = \$30,000 - 25\% \times \$11,250 = \$30,000 - \$2,812 = \$27,188$].

NOTE: If the payroll and/or the original cost of depreciable property in the business is very high relative to income, then this Step 3 should not limit the Sec. 199A deduction. In other words, the Threshold Amount and the Phase-in Range may have no effect on the Sec. 199A deduction. This "no effect result" occurs if the W-2 Wages Test or W-2 Wage and Capital Test yields a value greater than 20% of QBI. (But don't forget that if the business is an SSTorB it is still subject to Step 2 above.)

Example 4: Assume QBI of a QTorB is \$200,000 and W-2 Wages are \$90,000. 20% of QBI equals \$40,000. 50% of W-2 Wages equals \$45,000. The QTorB "deductible amount" is \$40,000, regardless of TI of the taxpayer.

NOTE: If the business is an SSTorB and has little or no payroll or moderate or no depreciable property, when taxable income of the taxpayer is in the Phase-in Range, the fraction of the deduction available is roughly the mathematical square of the fraction available under each test. Assume, in the following examples, an unmarried lawyer with law practice net income of \$200,000 having no payroll or depreciable property, taxable income in the \$157K to 207K range, and a marginal federal income rate of 32%:

Example 5: Deirdre is a unmarried lawyer. Her taxable income is \$162,500 (\$5,000 over the \$157,500 Threshold Amount, and 10% into the \$50,000 Phase-in Range), then the law practice is characterized as a QTorB and 90% of the law practice income remains QBI after the SSTorB Step 2, and then roughly 81% (90% x 90%) would be QBI subject to the 20% deduction under Sec. 199A after this Step 3. The Sec. 199A deduction amount is 20% x 81% x \$200,000 = \$32,400.

Example 6: If Deirdre's taxable income is \$197,500 (\$40,000 over the \$157,500 Threshold Amount, and 80% into the \$50,000 Phase-in Range), then 20% of the law practice income remains QBI after the SSTorB Step 2, and then roughly 4% (20% x 20%) would be QBI subject to the 20% deduction under Sec. 199A after this Step 3. The Sec. 199A deduction amount is 20% x 4% x \$200,000 = \$1,600.

NOTE: The effective federal marginal income tax rate for a single person in the Phase-in Range under the examples above (without consideration of other phase outs, self-employment tax, and state income tax⁵³) is over 60%.⁵⁴

Step 4 (determining the Section 199A deduction):

The total of the Section 199A(b)(2) deductible amounts of all QTorBs (plus 20% of qualified REIT dividends and qualified publically traded partnership income) is the Combined QBI Amount. The lesser of (i) the Combined QBI Amount or (ii) 20% of the taxable income of the taxpayer (excluding the Sec. 199A deduction, net capital gains and qualified cooperative dividends) is the Section 199A deduction.⁵⁵ This long trail brings us back to the beginning of the statutory roadmap in Paragraph 1 of this article.

Example 7: (Continuing with the unmarried CPA in Example 1 in Step 2 and Example 3 in Step 3 above.) The CPA's TI and modified TI is \$170,000 and his Combined QBI Amount before this final taxable income limitation test is

⁵³ Net investment income tax and alternative minimum tax might apply in certain circumstances.

⁵⁴ $(\$32,400 - \$1,600) / (\$197,500 - \$162,500) = 88\%$. $(88\% + 100\%) \times 32\%$ (single return marginal tax rate in most of the phase-in range) = 60.16%. This is an extreme result because there is no dampening of the Step 2 phase out arising from payroll or depreciable property, and taxable income is less than SSTorB net income – in this case \$37,500 less. One can posit facts (unrealistic as they may be) that would make the effective marginal rate on small changes in taxable income many magnitudes higher than 100%.

⁵⁵ Sec. 199A(a)(1) and (e)(1).

\$27,188. His modified taxable income limitation is \$34,000 (20% x \$170,000). Therefore his Sec. 199A deduction is \$27,188 (the lesser of the two amounts).

CONCLUSION.

With its wide application and the significant tax deduction involved, Section 199A needs to be understood by practitioners. This overview of the Code Section, along with the computation sheets for calculating the dollar amount of the deduction, can be a starting point for gaining a working knowledge of Section 199A. Yet, many aspects of the provision's application are subject to speculation so that guidance from the Treasury and the IRS is necessary.

Planning should not wait.

**SECTION 199A QUALIFIED TRADE OR BUSINESS – STEP 3 COMPUTATION SHEET
(skip STEP 2 because not a Specified Service Trade or Business)
(W-2 WAGES AND CAPITAL TEST RULES) (Rental Real Estate Example)**

Les Raatz

Facts: Rental Real Estate taxable income of \$100K. Qualifying property unadjusted basis is \$400K. Zero payroll (No W-2 Wages). Married joint taxable income (excluding Sec. 199A deduction) is \$355K (40% through “Phase-in Range” (Sec. 199A(b)(3)(B))). \$30K of net capital gain. Sole owner.

ASSUMPTIONS: Only one trade or business. No capital gain or loss, dividends, or interest income in law trade or business. No qualified REIT dividends. No qualified cooperative dividends. No qualified publicly traded partnership income. No ownership of specified agricultural or horticultural cooperatives (Sec. 199A(g)). No guaranteed payments. All US source income. No Sec. 199A carryover qualified business loss (Sec. 199A(c)(2)).

Sec. 199A deduction allowed for a qualified trade or business (“QTorB”) (excludes employee compensation and a specified service trade or business). “QBI” means net amount of QTorB items of income, gains, deductions and loss with respect to any qualified trade or business (limited to US source).

W-2 & CAPITAL TEST is the greater of (i) 50% of W-2 Wages **0** OR (ii) the sum of (I) 25% of W-2 Wages + (II) 2.5% of unadjusted basis of qualified property (depreciable tangible property) still being used. **0 + 400K x 2.5% = 10K. Greater is 10K.**

For single individuals, individuals who are married but filing separate returns, and trusts and estates the Threshold Amount is \$157,500 of taxable income, excluding Sec. 199A deduction (“TI”), with complete phase out at \$207,500 of TI. For married filing joint return the Threshold Amount is \$315K of TI, with complete phase out at \$415K of TI. For single individuals, individuals who are married but filing separate returns, and trusts and estates the Phase-in Range is next \$50,000 above Threshold Amount, except the Phase-in Range is \$100,000 for married couples filing joint return.

RULES (but subject only to TI LIMITATION RULE):

IN ALL CASES: If W-2 WAGES & CAPITAL TEST is equal or greater than 20% of QBI, then 20% of QBI = Sec. 199A deduction **N/A**

IN ALL CASES: If TI does not exceed the Threshold Amount, then 20% of QBI = Sec. 199A deduction **N/A**

PHASE-IN IF NEITHER RULE APPLIES:

APPLY PHASE-IN IF TI IS ABOVE THRESHOLD AMOUNT AND NEITHER RULE ABOVE APPLIES:

If in Threshold Phase-in Range (for married joint, TI of 315K to 415K), and 20% of QBI exceeds W-2 & CAPITAL TEST **YES** then:

Sec. 199A deduction is excess of (i) 20% of QBI **20K**, over and reduced by (ii) product of: (excess of 20% of QBI **20K**, over and reduced by the W-2 & CAPITAL TEST **10K**) multiplied by a fraction, the numerator of which is the excess of TI **355K**, over and reduced by the Threshold Amount **married joint 315K** (not to exceed 100K[50K if not married joint]), and the denominator of which is 100K[50K if not married joint]. **20K - ((20K-10K) x ((355-315)/100K)) = 20K-4K = 16K.**

COMBINE ALL OF THE ABOVE DETERMINED FOR EACH QTorB, then added together (Combined Qualified Business Income Amount (CQBI) (Sec. 199A(b)). (If all QBIs together generate a loss, it is carried forward

as a loss from a QToB for the succeeding year for purposes of Sec. 199A. Sec. 199A(c)(2.) Test CQBI under **TI LIMITATION RULE**:

TI LIMITATION RULE: deduction cannot exceed 20% of the excess of TI less net capital gains. **N/A, 16K**
DOES NOT EXCEED 20% x (355K-30K) = 65K. ANSWER= \$16,000.

SECTION 199A SPECIFIED SERVICE TRADE OR BUSINESS – STEP 2 COMPUTATION SHEET

(Law Trade or Business Example)

Les Raatz

Facts: Lawyer firm taxable income of \$400K. Qualifying property unadjusted basis is \$100K. Payroll (W-2 Wages) of \$100K. Married joint taxable income (excluding the Sec. 199A deduction) is \$365K (halfway through “Phase-in Range” (Sec. 199A(b)(3)(B))). \$30K of net capital gain. Sole owner.

ASSUMPTIONS: Only one trade or business. No capital gain or loss, dividends, or interest income in law trade or business. No qualified REIT dividends. No qualified cooperative dividends. No qualified publicly traded partnership income. No ownership of specified agricultural or horticultural cooperatives (Sec. 199A(g)). No guaranteed payments. All US source income. No Sec. 199A carryover qualified business loss (Sec. 199A(c)(2)).

Sec. 199A deduction for a Specified Service Trade or Business (“SSTorB”) is not available, unless the taxpayer’s taxable income, excluding the Sec. 199A deduction (“TI”), is no more than the Threshold Amount plus the Phase-in Range (described below). SSTorB includes the field of law.

For single individuals, individuals who are married but filing separate returns, and trusts and estates the Threshold Amount is \$157,500 of TI, with complete phase out at \$207,500 of TI, and Phase-in Range is the next \$50,000 above Threshold Amount. For married filing joint return the Threshold Amount is \$315K of TI, with complete phase out at \$415K of TI, and Phase-in Range is the next \$100,000 above Threshold Amount.

QBI means net amount of qualified business items of income, gains, deductions and loss with respect to any qualified trade or business (limited to US source and excludes capital gains and losses).

RULES:

1. IN ALL CASES: if TI does not exceed the Threshold Amount, then (i) the SSTorB is a qualified trade or business (“QTorB”), (ii) its income items are QBI, (iii) other Computation Sheets are skipped, and (iv) the Sec. 199A deduction = 20% of QBI, but the deduction cannot exceed 20% of the excess of TI less net capital gains. Sec. 199A(a)(1)(B). **N/A**
2. IN ALL CASES: if TI exceeds the Threshold Amount plus the Phase-in Range, then Sec 199A does not apply to any SSTorBs (other Computation Sheets are skipped). **N/A**

PHASE-IN IF NEITHER RULE APPLIES:

APPLY PHASE-IN IF TAXPAYER TAXABLE INCOME, EXCLUDING 199A DEDUCTION (“TI”), IS ABOVE THRESHOLD AMOUNT AND RULE DOES NOT APPLY:

If in Threshold Phase-in Range (for married joint, TI of 315K to 415K, otherwise \$157,500 to \$207,500) **YES**, then the SSTorB is QTorB, but only as to a fraction of each item of income, gain, deduction or loss, W-2 Wages, and qualifying property, of the SSTorB, which will available to determine the Sec 199A deduction under the SECTION 199A QUALIFIED TRADE OR BUSINESS – COMPUTATION SHEET (W-2 WAGES AND CAPITAL TEST RULES).

The fraction of the SSTorB income and its items is determined as follows:

1 minus a fraction, the numerator of which is the excess of TI **365K** over Threshold Amount **married joint 315K** (not to exceed 100K[50k if not married joint]) **50K**, and the denominator of which is 100K[50K if not married joint]. $1 - \frac{1}{2} = 50\%$. **100K . QBI = 400K x 50% = 200K. QTorB W-2 Wages = 100K x 50% = 50K. QTorB qualifying property = 100K x 50% = 50K. CARRY THESE TO QUALIFIED TRADE OR BUSINESS COMP SHEET AS A QUALIFIED TRADE OR BUSINESS (NEXT PAGE).**

SECTION 199A QUALIFIED TRADE OR BUSINESS – STEP 3 COMPUTATION SHEET (W-2 WAGES AND CAPITAL TEST RULES) (Law Trade or Business Example)

Facts: Lawyer firm taxable income of \$400K. Qualifying property unadjusted basis is \$100K. Payroll (W-2 Wages) of \$100K. Married joint taxable income (excluding Sec. 199A deduction) is \$365K (halfway through “Phase-in Range”). \$30K of net capital gain. Sole owner.

CARRY OVER FROM SECTION 119A SPECIFIED SERVICE TRADE OR BUSINESS STEP 2 COMPUTATION SHEET (Law Practice): QBI = 200K. QTorB W-2 Wages = 50K. QTorB qualifying property = 50K.

Sec. 199A deduction allowed for a qualified trade or business (“QTorB”)(excludes employee compensation and a specified service trade or business). “QBI” means net amount of QTorB qualified items of income, gains, deductions and loss with respect to any qualified trade or business (limited to US source and excludes capital gains and losses).

W-2 & CAPITAL TEST is the greater of (i) 50% of W-2 Wages **50K x 50% = 25K** OR (ii) the sum of (I) 25% of W-2 Wages **50K x 25% = 12,500** + (II) 2.5% of unadjusted basis of qualified property (depreciable tangible property) still being used. **50K x 2.5% = 1,250. Greater is 25K.**

For single individuals, individuals who are married but filing separate returns, and trusts and estates the Threshold Amount is \$157,500 of TI, with complete phase out at \$207,500 of TI, and Phase-in Range is the next \$50,000 above Threshold Amount. For married filing joint return the Threshold Amount is \$315K of TI, with complete phase out at \$415K of TI, and Phase-in Range is the next \$100,000 above Threshold Amount.

RULES (but subject only to the TI LIMITATION RULE):

IN ALL CASES: If W-2 & CAPITAL TEST is equal or greater than 20% of QBI, then 20% of QBI = Sec. 199A deduction **N/A**

IN ALL CASES: if TI does not exceed the Threshold Amount, then 20% of QBI = Sec. 199A deduction **N/A**

PHASE-IN IF NEITHER RULE APPLIES:

APPLY PHASE-IN IF TI IS ABOVE THRESHOLD AMOUNT AND NEITHER RULE ABOVE APPLIES:

If TI is in Threshold Phase-in Range (for married joint, TI of 315K to 415K), and 20% of QBI exceeds W-2 & CAPITAL TEST **YES** then:

Sec. 199A deduction is excess of (i) 20% of QBI **40K**, over and reduced by (ii) product of: (excess of 20% of QBI **40K** over W-2 & CAPITAL TEST **25K**) multiplied by a fraction, the numerator of which is the excess of TI **365K** over Threshold Amount **married joint 315K** (not to exceed 100K[50K if not married joint]), and the denominator of which is 100K[50K if not married joint]. **40K - ((40K-25K) x ((365K-315K)/100K)) = 40K-7,500 = 32,500.**

COMBINE ALL OF THE ABOVE DETERMINED FOR EACH QTorB, then added together (Combined Qualified Business Income Amount (CQBI) (Sec. 199A(b)). (If all QBIs together generate a loss, then no Sec. 199A deduction and loss is carried forward as a loss from a QTorB for the succeeding year for purposes of Sec 199A. Sec. 199A(c)(2).) Test CQBI under **TI LIMITATION RULE:**

TI LIMITATION RULE: deduction cannot exceed 20% of the excess of TI less net capital gains. **N/A, 32,500 DOES NOT EXCEED 20% x (365K-30K) = 67K. ANSWER= \$32,500.**