New Deduction for Pass-Through Entities IRC § 199A

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New Code § 199A

- Code § 199A generally allows a 20% deduction for "qualified business income" of pass-through entities.
  - S corporations
  - Partnerships
  - Sole proprietorships
- Qualified dividends from REITs and cooperatives and qualified income from publicly traded partnerships may also qualify for the 20% deduction.
- Assuming a 37% income tax bracket, a full § 199A deduction produces an effective 29.6% tax rate
- Available to individuals, estates, and trusts for taxable years beginning after 2017 and before 2026

New Code § 199A

- Applies at the individual level
  - At partner or shareholder level for partnerships and S corps
  - Deduction is on Form 1040
  - Deduction is *not* an above-the-line deduction
  - Deduction reduces taxable income
  - Deduction is available both to those who itemize and those who take the standard deduction
  - Same for AMT and regular tax
  - Does *not* reduce self-employment tax

New Code § 199A

- Qualified business income is produced by a "qualified trade or business"
- QTB is any trade or business *other than*:
  - Trade or business of performing services as an employee, or
  - A specified service trade or business
    - (Note: SSTB exclusion does *not* apply if taxable income is below specified thresholds - $315,000 for MFJ and $157,500 for all others)
- Specified service trade or business ("SSTB"):
  - "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"
  - Note architects and engineers are excluded

New Code § 199A

- Qualified business income:
  - Generally is net income from a qualified trade or business
  - If the net amount of QBI is less than zero, the loss will be carried to the next taxable year and included in the calculation of QBI for that year
  - QBI does *not* include:
    1. Income not effectively connected with the U.S. trade or business
    2. Specified investment-related items of income, gain, deduction, or loss, such as capital gains and loses, dividends, and non-business interest income
    3. Amounts paid to an S corporation shareholder that are reasonable compensation
    4. Guaranteed payments to a partner for services
    5. To the extent provided in regulations, payments to a partner for services rendered other than in the partner's capacity as a partner
    6. Qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income

New Code § 199A

- Determining the amount of the §199A deduction:
  - Sum of 3 buckets
  - Apply 2 limitations
- But if only QBI (no qualified REIT or cooperative dividends and no qualified income from a publicly traded partnership), only 1 bucket and 1 limitation

New Code § 199A

- Bucket 1: for each qualified trade or business, the **lesser** of:
    1. 20 percent of the qualified trade or business income, or
    2. The **greater** of:
        a. 50 percent of the W-2 wages, or

        b. The sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjudsted basis immediately after acquisition of all qualified property.

Note: W-2 wages/basis limitation in 2.a and b do *not* apply to taxpayers whose taxable income is below the $157,500/$315,000 thresholds.

Note: Calculate deduction separately for each QTB, and then combine the deduction from each QTB.

New Code § 199A

- **Qualified Property:** Acquisition cost (unadjusted basis) of depreciable tangible personal property and real property (excludes land)
  - held for use in the QTB at the close of the taxable year,
  - used at any point during the taxable year, and
  - depreciable period for which has not ended before close of the taxable year.
- **Depreciable Period:** Begins when first placed into service and ends on the **later** of (1) 10 years after such date or (2) the last day of the last full year in the applicable recovery period under § 168.

New Code § 199A

- Bucket 2: 20 percent of the sum of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.

- Bucket 3: lesser of
    1. 20 percent of qualified cooperative dividends, or
    2. Taxable income reduced by net capital gain.

New Code § 199A

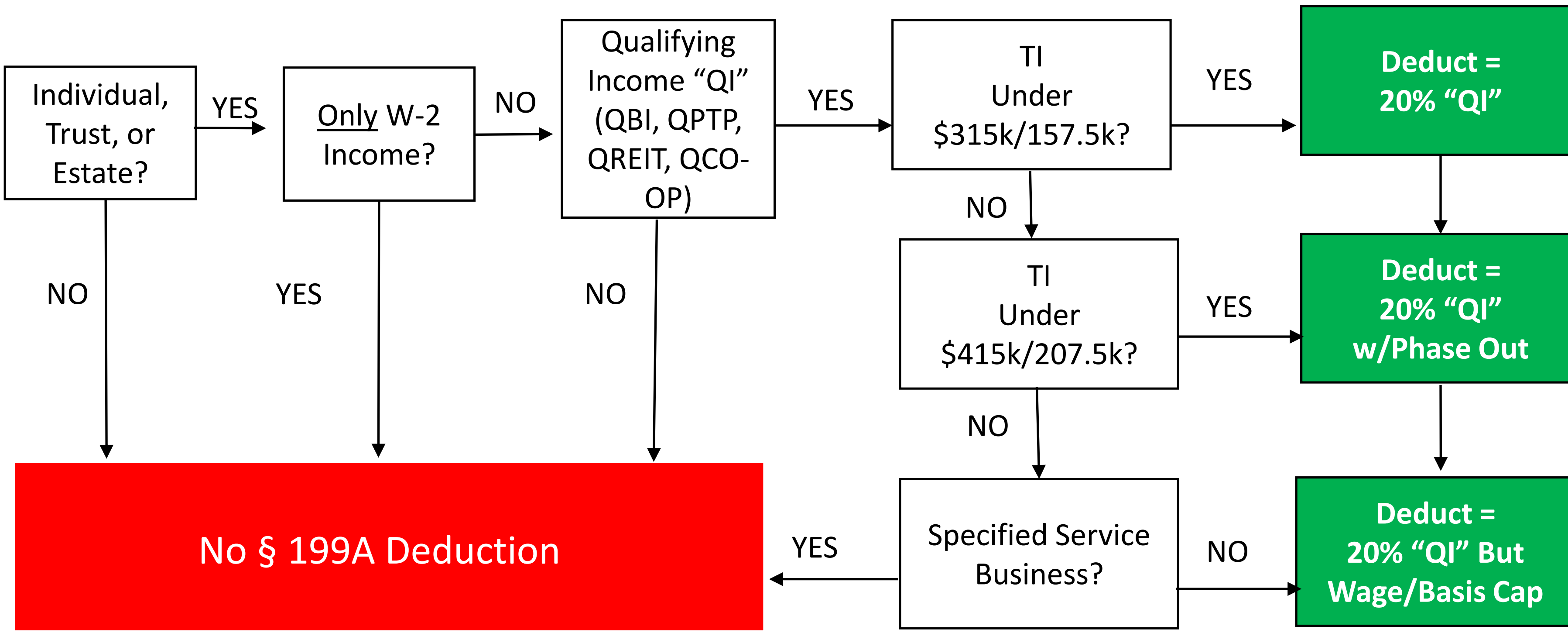
- Limitation 1:
  - Sum of Bucket 1 and Bucket 2 cannot exceed 20 percent of the amount by which the taxpayer's taxable income exceeds the sum of the taxpayer's net capital gain and qualified cooperative dividends.
- Limitation 2:
  - Sum of Buckets 1, 2 and 3 cannot exceed taxpayer's taxable income reduced by the taxpayer's net capital gain.
- If taxpayer only has QBI, then only Bucket 1 and Limitation 2 apply.

New Code § 199A

- Key consideration:
  - Is the taxpayer's taxable income (without the § 199A deduction) below or above the $157,500/$315,000 thresholds?
- If below:
  - Specified service businesses are still eligible for the deduction
  - Limitation of W-2 wages/basis does not apply
- If above:
  - Portion of income from specified service business eligible is phased out (and disappears at $207,500/$415,000)
  - W-2 wages/basis limitation phases in and fully applies at $207,500/$415,000.
- Observation: if the wages/basis limit does not apply, there's an incentive for S corporation shareholders to minimize salary

Flowchart

Limit 20% TI – NCG (but if QCO-OP income another limit applies)



New Code § 199A

- Other considerations:
  - What is a trade or business?
  - Activity level or entity level?
  - De minimis nonqualified income
  - QBI received by passive partner/shareholder
  - Grouping entities and W-2/property limit
  - Employee leasing and W-2 limit
  - Accuracy-related penalty
  - IRS guidance

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