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Decoding the Tax Cuts and Jobs Act – Part IV: The IRC § 199A Deduction for Qualified Business Income—the Devil Is in the Details and the Definitions!

By Larry Brant and Steven Nofziger on 1.29.18 | Posted in Legislation, Tax Laws, Tax Planning, Tax Procedure

BACKGROUND

The Tax Cuts and Jobs Act ("TCJA") adopted a new 20% deduction for non-corporate taxpayers. It only applies to "qualified business income." The deduction, sometimes called the "pass-through deduction," is found in IRC § 199A. There has been a significant amount of media coverage of this new deduction. Rather than repeat what you have undoubtedly already read or heard, we chose to focus this blog post on the not so obvious aspects of IRC § 199A—the numerous pitfalls and traps that exist for the unwary.

DEDUCTION FRAMEWORK

Overview; Purpose

IRC § 199A is effective for tax years after December 31, 2017. Unfortunately, unless lawmakers act, it sunsets (like many of the provisions in the TCJA) on December 31, 2025.

IRC § 199A potentially allows individuals, trusts and estates to deduct up to 20% of qualified business income ("QBI") received from a pass-through trade or business, such as an S corporation, partnership (including an LLC taxed as a partnership) or sole proprietorship. The notion behind the deduction is that it effectively reduces the new top 37% marginal income tax rate for business owners to approximately 29.6% (i.e., 80% of 37%), to put owners of pass-through entities on a more level playing field with owners of C corporations who now have the benefit of the greatly reduced 21% top marginal tax rate under the TCJA. The concept may sound simple, but the application is anything but simple. The new Code provision contains complex definitions, requires esoteric calculations, and is accompanied by many traps and pitfalls.

Deduction

IRC § 199A provides that a non-corporate taxpayer may, subject to certain adjustments and limitations, deduct 20% of the taxpayer's QBI with respect to each qualified trade or business, plus; 20% of the aggregate amount of qualified cooperative dividends, qualified real estate investment trust dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

The deductible amount of QBI from each qualified trade or business is subject to certain income limitations contained in IRC § 199A(b)(2). These limitations are discussed below.

The deduction is applied to the taxpayer's taxable income, not adjusted gross income, and it cannot exceed the amount of the taxpayer's taxable income for the tax year. In the case of partnerships and S corporations, the deduction applies at the partner or shareholder level, and each partner or shareholder takes into account his or her allocable share of items of income, deduction and loss from the partnership or S corporation.

Limitation; Income Thresholds and Phase-In

IRC § 199A(b)(2) applies a sliding-scale income limitation to determine the amount of QBI subject to the deduction. For taxpayers over the "threshold amount" (discussion below), this limitation is the greater of:

(1) 50% of the W-2 wages paid with respect to the qualified trade or business ("W-2 Wage Limit"), or

(2) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business, plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property" of the qualified trade or business (the "Wage and Capital Limit").

For these purposes, "qualified property" means tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of QBI, and the depreciable period for which has not ended before the close of the tax year. The "depreciable period" is the later of 10 years from the original placed-in-service date or the last day of the last full year of the applicable recovery period under IRC § 168.

The "threshold amount" is $315,000 for married individuals filing jointly and $157,500 for other individuals. Both amounts are subject to inflation adjustments in future years.

For married individuals filing jointly, these income limitations are phased in on a sliding scale over the next $100,000 of taxable income above the threshold amount. For other taxpayers, the phase in occurs over the next $50,000 above the threshold amount. Thus, the limits fully apply when taxable income is over $415,000 for married individuals filing jointly, and $207,500 for other individuals.

Qualified Trade or Business; Exclusion for Specified Service Businesses over Income Threshold

There are several key definitions within the IRC § 199A framework. The first is the definition of "qualified trade or business." IRC § 199A provides that a "qualified trade or business" means any trade or business other than a specified service business or the trade or business of performing services as an employee.

For these purposes, a "specified service business" means any trade or business in the fields of:

- Health;
- Law;
- Accounting;
- Actuarial Science;
- Consulting;
- Athletics;
- Financial Services;
- Brokerage Services;
- Businesses involving investing, investment management, trading or dealing in securities, partnership interests or commodities; and
- Businesses in which the principal asset of the business is the reputation or skill of one or more of its employees or owners.

Although the list of service businesses is broad, Congress specifically excluded architecture and engineering services from this list. Thus, engineering and architecture firms qualify for IRC § 199A purposes.

Importantly, the limitation for "specified service businesses" only applies to taxpayers with taxable income over same "threshold amount" described above, and it phases in using the same sliding scale as used for the phase in of the W-2 Wage Limit and Wage and Capital Limit.

Thus, a partner in a law firm who has less than $315,000 of taxable income (married filing jointly) is not affected by this exclusion, but his or her business partner with over $415,000 of taxable income is excluded entirely from using the deduction.

Qualified Business Income; Loss Carryover

A second key definition is QBI. QBI generally means the net amount of qualified items of income, gain, deduction and loss with respect to any U.S. trade or business that is a "qualified trade or business." It, however, expressly excludes:

- In the case of an S corporation, reasonable compensation of the taxpayer;
- In the case of a partnership, guaranteed payments for services and payments to a partner outside his or her capacity as a partner; and
- "Passive" investment income such as capital gains, interest, dividends and annuity income; however, it does not exclude rents.

If the taxpayer has a net loss when computing his or her QBI, the loss is carried forward and treated as a loss from a qualified trade or business in the following year.

KEY ASPECTS; TRAPS AND PITFALLS

Under this new framework, there are a number of key aspects to keep in mind.

1. Trade or Business. The deduction is only allowed with respect to qualifying income from an underlying trade or business. Much of the commentary published to date on IRC § 199A has focused on the limitations surrounding specified service businesses and the income thresholds. The requirement that only trade or business income qualifies for the deduction has not been the center of attention.

The term "trade or business" is not defined anywhere in IRC § 199A. While the term "trade or business" is used more than 150 times in the Code, it takes on multiple definitions, depending upon the provision in which it is used. Without a specific definition of "trade or business" in IRC § 199A, practitioners need to exercise caution. Keep in mind, even under general income tax principles, not all activities rise to the level of a "trade or business," regardless of whether the activities are conducted through an S corporation, LLC or other business entity.

Furthermore, even though the Wage and Capital Limit allows for a deduction of 2.5% of the depreciable property used in a particular activity, the underlying activity must be a trade or business. Merely owning and leasing real property, without more, does not typically constitute a trade or business. Landlords in particular should not forget this fundamental issue. While it

may be possible to group certain activities together for purposes of constituting a “trade or business,” there is no present guidance accepting this approach.

2. Reasonable Compensation. The exclusion of guaranteed payments (in the partnership context) and reasonable compensation (in an S corporation context) from the definition of QBI means that amounts paid as guaranteed payments to partners or LLC members or as reasonable compensation to S corporation shareholders must be subtracted from total income of the qualified trade or business before the deduction is applied. While this may not seem like a major concern, guaranteed payments and shareholder compensation can often be substantial.

Importantly, in the S corporation context, there is often a question as to how much compensation is “reasonable” in light of the actual services rendered by the shareholder. IRS audits of S corporations often focus on the issue of reasonable shareholder compensation, because the IRS views payment of unreasonably low compensation to shareholder employees as a means of improperly reducing Medicare taxes and/or Social Security taxes. When a shareholder’s income is over the Social Security wage base, the potential Medicare taxes at issue equate to 2.9% of the amount of the disputed compensation. For many taxpayers, the amount at issue is often not worth spending a lot of resources to contest. However, to the extent an S corporation shareholder takes an IRC § 199A deduction, the potential 20% deduction means much more tax liability will be at stake in these contests.

As discussed below, there is also a potential penalty kicker for mistakes. S corporation shareholders who claim an IRC § 199A deduction should be careful when setting shareholder compensation amounts and should review compensation periodically. We expect to see reasonable compensation audits of S corporations focused on this issue.

3. Deduction Nuances. Many of the calculations and the terms contained within the IRC § 199A deduction have detailed nuances. For example, in computing the amount of “W-2 Wages” for purposes of the W-2 Wage Limit and Wage and Capital Limit, taxpayers must take into account all compensation subject to wage withholding and include elective deferrals and deferred compensation payments with respect to employees of the trade or business. Similarly, for purposes of the Wage and Capital Limit, a taxpayer must calculate the amount of “qualified property.” Not all depreciable property counts. Records must be maintained and available to support these various calculations. Slip-ups will be easy to make, and taxpayer expectations for a substantial deduction based on broad generalizations may not be realized once actual calculations are made.

Moreover, there is no current guidance on how taxpayers should handle situations where there are multiple trades or businesses in the same entity or conducted by same taxpayer, only some of which may be qualified trades or businesses. Some type of allocation of wages, income,

expenses and “qualified property” almost certainly would need to be made across the various businesses, and taxpayers will need to support their allocation methodology. Hopefully, Treasury will address the many existing issues in regulations. Until then, taxpayers need to use caution.

4. Enhanced Penalty. Taxpayers should be aware that Congress included a penalty “kicker” in IRC § 199A—it lowered the threshold for when the 20% substantial understatement penalty kicks in. Under IRC § 6662(d), there is a “substantial understatement” of income tax if the amount of tax required to be shown on a taxpayer’s return is understated by the greater of 10% or $5,000. Congress must expect that taxpayers will attempt to take aggressive reporting positions relative to this new deduction, because IRC § 199A includes a provision specifically reducing the “substantial understatement” threshold to the greater of **5%** or $5,000 “in the case of any taxpayer who claims the deduction allowed under [IRC §] 199A.” Interestingly, the language of the statute does not state that the understatement must specifically relate to the IRC § 199A deduction for this lower threshold to apply. Rather, it applies if the taxpayer merely claims the IRC § 199A deduction, regardless of whether the understatement arose out of the IRC § 199A deduction or some other reporting error. As a result, taxpayers who claim the IRC § 199A deduction face a potential double-whammy. They are more likely to have a substantial understatement because the threshold is lower; and a greater portion of any understatement will be in excess of the 5% threshold, and therefore be subject to the additional 20% penalty. Be warned!

In sum, the new IRC § 199A deduction is a potential benefit to many taxpayers and small business owners. However, it has many potential pitfalls. Given the lack of present guidance in many areas, cautious planning is required!

Stay tuned! We will continue our reporting on the provisions of the TCJA.

Tags: Decoding the Tax Cuts and Jobs Act, deductions, Internal Revenue Code, Internal Revenue Service, IRC § 199A, IRS, limitations, pass-through entity, qualified business income, Reasonable Compensation, specified service businesses, Tax Cuts and Jobs Act, threshold amount