

# AUGUST 2018 - TCJA SECTION 199A UPDATE

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## **Serving the People Behind the Numbers**

- ATS Advisors, A Certified Public Accounting Firm, Founder and President, 1997 to Present
- BA Accountancy, University of Notre Dame, 1995
- University of Michigan Primary Instructor–Tax Practitioners Institute, 2001 to Present
- US Army, 101<sup>st</sup> Airborne Division D Co. 3rd Bn. 187<sup>th</sup> AARCT Infantry, “Rakkasan” 1988-1991

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## OUR GROUND RULES:

- Common Courtesy
  - Please no Cell Phones – Set To Silent
  - We love Multi-tasking but only in silent mode, Tablet, laptops etc are welcome.
  - **Please no Sleeping in Class (excuse yourself and caffeinate)**
- Interaction is welcome and required
  - If you have a question please ask, especially if you disagree with something our instructors say.

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## ANTICIPATED TOPICS

### TAX CUT AND JOBS ACT

- Principles of §199A
- Making strategic decisions based on those changes

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## TAX CUT AND JOBS ACT

- December 20, 2017 Congress passed the long awaited plan to restructure the tax code, and the bill was signed into law on December 22. HR-1 “Tax Cut and Jobs Act”
- Corporate Highlights:
  - Federal Corporate Tax Rate = 21%
  - State and Local Tax Deduction NOT limited
  - Net Operating Loss (NOL)
    - NOL beginning 2018 is limited to 80% of taxable income, no carrybacks, and carryforward time frame is unlimited

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## TAX CUT AND JOBS ACT

- Capital Expenditures
  - Full expensing of qualified property defined in §168(k) (phasing out through 2028 )
  - Modifications to §179 expensing rules.
    - Increased to \$1 million with phase-out amount increased to \$2.5 million
    - Expands definition of qualifying property
    - Heating and cooling systems, Certain lodging expenditures, Improvements to property
  - \$25,000 expensing limit on certain heavy vehicles adjusted for inflation after 2018
  - An on an on and on and on

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26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

**IN GENERAL** In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of—  
the lesser of—

- (A) the combined qualified business income amount of the taxpayer, or
- (B) an amount equal to 20 percent of the excess (if any) of—
  - (i) the taxable income of the taxpayer for the taxable year, over
  - (ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

(2) the lesser of—

- (A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or
- (B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

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26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

# STEP ONE

“The journey of a thousand miles  
begins with a single step”

- Lao Tzu

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# DON'T PANIC!!



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- You've done this before!
  - These phase outs, limitations, special deductions, and other aspects of this legislation are an amalgamation of other previously limited use sections of the code.
  - Think about the wage limits under the DPAI deductions for §199.(which has been repealed)

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26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

DEFINING TERMS:

- **Taxpayer:** (26 USC § 199A(d)(1))
  - Notwithstanding section 7701(a)(14), the term “taxpayer” means any person subject to a tax under the applicable revenue law. (26 USC § 1313(b))
  - *OTHER THAN A CORPORATION!*

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26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

**What *other than a corporation* means:**

- **Pass through entities eligible for this deduction include the following:**
  - Any entity taxed as an S corporation.
  - Sole proprietorships (no entity, Schedule C).
  - Partnerships
  - Real estate investors (no entity, Schedule E).
  - Disregarded entities (single member LLCs).
  - Multi-member LLCs.
  - Trusts and estates, REITs and qualified cooperatives.

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26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

DEFINING TERMS:

- **Qualified Trade or Business** (26 USC § 199A(d)(1))
  - The term “*qualified trade or business*” means any trade or business other than—
    - a *specified service trade or business*, or
    - the trade or business of performing services as an *employee*

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26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

DEFINING TERMS:

- **Specified Trade or Business:** (26 USC § 199A(d)(2)) means any trade or business
  - (A) which is described in **section 1202(e)(3)(A)** (applied without regard to the words “engineering, architecture,”) or which would be so described if the term “employees or owners” were substituted for “employees” therein, or
  - (B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in), partnership interests, or commodities (as defined in section 475(e)(2)).

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DEFINING TERMS:

- **(section 1202(e)(3)(A))**
  - “any 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 trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.”

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**What *Specified Trade or Business* means:**

- **Pass through entities eligible for this deduction (within the thresholds) include the following:**
  - Traditional service professions such as doctors, attorneys, accountants, actuaries and consultants.
  - Anyone who works in the financial services or brokerage industry.
  - Performing artists. (actors, dancers etc.)
  - Paid athletes.
  - “Any trade or business where the principal asset is the reputation or skill” of the owner.

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### **Why were engineering and architecture removed from the list?**

- Please note we are unsure if the IRS will take the position that an architect or engineer operating a business based on his or her reputation or skill may be considered a “*specified service trade.*”

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

The catchall category, “any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees,”

This language comes from IRC Section 1202(e)(3), where these businesses are among those that do not qualify for the capital gain exclusion provided by that section.

In 2012, the Tax Court in *Owens v. Commissioner*.

The IRS argued that the principal asset of a successful insurance agency that had been sold was the skill of one of its owners. The court disagreed, finding that the principal reason for the success of the business was its training and organizational structure.

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

#### ▪ ***Combined Qualified Business Income Amount (QBI)***

(26 USC § 199A(b)(1))

- The term “*combined qualified business income amount*” means, with respect to any taxable year, an amount equal to— (A)the sum of the amounts determined under paragraph (2) for each *qualified trade or business* carried on by the *taxpayer*, plus
- 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

#### ***What isn't Qualified Business Income***

- short- and long-term capital gains.
- dividends, income equivalent to dividends and payments in lieu of dividends.
- interest income other than income generated as a part of the business.
- income from an annuity not related to the business.

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

#### *What isn't Qualified Business Income*

- gains from commodities transactions, including futures, forward and similar transactions except if used in connection with hedging by the business, or if selling commodities is the business of the taxpayer.
- foreign currency gains.
- net income from notional principal contracts.
- reasonable compensation paid to the taxpayer by a qualified business for services rendered with respect to the business, and any guaranteed payment or payment to a partner for services with respect to the trade or business.

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

- “*Threshold amount*”, paragraph (2) shall be applied without regard to subparagraph (B)
  - In the case of any taxpayer whose taxable income for the taxable year does not exceed:
    - \$157,500 (200 percent of such amount in the case of a joint return). (B) In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to— (i) such dollar amount, multiplied by (ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “calendar year 2017” for “calendar year 2016” in subparagraph (A)(ii) thereof. — {26 USC § 199A(e)(2)(A)}

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

*Determination of deductible amount for each trade or business:* the lesser of -

- 20% of the taxpayers QBI

the greater of

- 50% of the W2 wages or
- 25% of the W2 wages PLUS 2.5% of the *unadjusted basis* immediately after acquisition of all *qualified property*.

{WHAT!! so much for plain English}

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

*Qualified property*

- (A)The term “*qualified property*” means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under—
  - i. which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
  - ii. which is used at any point during the taxable year in the production of qualified business income, and
  - iii. the *depreciable period* for which has not ended before the close of the taxable year.

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

- ***Depreciable period*** {26 USC § 199A(b)(6)(B)}
  - The term “*depreciable period*” means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of—
    - i. the date that is 10 years after such date, or
    - ii. the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (without regard to subsection (g) thereof).

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

- ***Unadjusted Basis:*** {not defined in the code}
  - Unadjusted basis refers to the original cost to purchase an asset. This amount includes not only the initial price the purchaser paid to acquire the asset, but also includes other costs such as expenses and liabilities assumed to purchase it
  - Regulations will provide rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions

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## 26 U.S. CODE § 199A - QUALIFIED BUSINESS INCOME

### DEFINING TERMS:

*Qualified items of income, gain, deduction, and loss*

**(A) In general** - The term “qualified items of income, gain, deduction, and loss” means items of income, gain, deduction, and loss to the extent such items are

**(i)** effectively connected with the conduct of a trade or business **within the United States**

**(ii)** included or allowed in determining taxable income for the taxable year

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## 26 U.S. CODE § 199A – SPECIAL RULES

### Special Rules (Section f of 199A):

**(1) APPLICATION TO PARTNERSHIPS AND S CORPORATIONS**

**(A) In general** In the case of a partnership or S corporation—

- I. this section shall be applied at the partner or shareholder level,
- II. each partner or shareholder shall take into account such person’s allocable share of each qualified item of income, gain, deduction, and loss

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## 26 U.S. CODE § 199A - SPECIAL RULES

**(2) COORDINATION WITH MINIMUM TAX** - For purposes of determining alternative minimum taxable income under §55 QBI is determined without regard to AMT under §56-§59.

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## 26 U.S. CODE § 199A - SPECIAL RULES

- **ACQUISITIONS, DISPOSITIONS, AND SHORT TAXABLE YEARS**
  - The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.

{§199A(b)(5)}

*This means the rules have not been made up yet for the application of short years, dispositions, acquisitions etc.*

**THE IRS WILL MAKE THE RULES**

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26 U.S. CODE § 199A – SPECIAL RULES

Special Rules (Section f of 199A):

**(h) ANTI-ABUSE RULES** The Secretary shall—

- (1)** apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and
- (2)** prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

*THE IRS WILL MAKE THE RULES*

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26 U.S. CODE § 199A -

Special Rules (Section f of 199A):

**(i) TERMINATION** - This section shall not apply to taxable years beginning after December 31, 2025.

THE WHOLE THING EXPIRES!!

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## SECTION 199A - SOME PLAIN LANGUAGE

### What does it all mean to you?

- 20% deduction from taxable income of your qualified business income
- The deduction is limited by several factors including W2 wages and other items.
- Phase out begins at taxable income of \$157,500 single, \$315,000 joint and is fully phased out at \$207,500 single \$415,000 joint
- Deduction in computing **taxable income**, not AGI
- Available whether itemize or not

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## SECTION 199A – SOME EXAMPLES

### **Example 1:**

– A taxpayer, has:

- QBI = \$100,000
- LTCG, = \$100,000
- Deductions = (\$30,000)
- Taxable income of = \$170,000.

WHAT IS THE 199A Deduction?

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## SECTION 199A – SOME EXAMPLES

### **Example 1:**

Answer: \$14,000

WHY:

- The Sec. 199A deduction is limited to the lesser of:
  - \$20,000 (20% of \$100,000) or
  - \$14,000 (20% of \$70,000, the excess of taxable income of \$170,000 over net capital gain of \$100,000)

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## SECTION 199A – SOME EXAMPLES

### **Example 2:**

*Partner X* owns a 30% interest in WIDGET LLC,

Pursuant to the terms of the operating agreement:

- *X* is specially allocated 40% of all of the ordinary income or loss of the partnership and
- 70% of all depreciation expense.
- In 2018 WIDGET LLC pays \$100,000 of W-2 wages.

What is the Allocation of Wages for §199A to Partner *X*?

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## SECTION 199A – SOME EXAMPLES

### **Example 2:**

Answer: \$40,000

WHY:

- Because the partnership's deduction for W-2 wages is part of its ordinary income or loss X must be allocated 40% of the partnership's W-2 wages

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## SECTION 199A – UNADJUSTED BASIS

**We have defined *unadjusted basis immediately after acquisition and depreciable period previously*** (slides 25& 26)

- Things to remember -
  - Qualified property is tangible property subject to depreciation under Sec. 167
  - Only the unadjusted basis of qualified property is counted toward the limitation.
  - What about capitalized leasehold improvements?

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## SECTION 199A – UNADJUSTED BASIS

- capitalized leasehold improvements are generally treated as an adjustment to basis of the underlying building.

Are these considered qualified property?

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## SECTION 199A – UNADJUSTED BASIS

- What about a step up in basis in its underlying property pursuant to Sec. 754?
- Would this be qualified property
  - Maybe YES, because the for tax purposes the election is treated as a new asset.
    - If the step-up is allocated to depreciable assets, it would appear to create qualified property.
  - Since the congressional intent behind the "2.5% of unadjusted basis" limitation was to reward business owners who invest in tangible assets it may be unlikely that a Sec. 754 step-up, which reflects an increase in the underlying *value* of partnership property, NOT a new investment will be considered *qualified property*.

(we shall see)

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## SECTION 199A – UNADJUSTED BASIS

Remember the exact text of the legislation reads as follows:

- “*Qualified property* must have been used at any point during the tax year in the production of *qualified business income* and be held by, and available for use in, the qualified business at the close of the tax year”

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## SECTION 199A – DEPRECIABLE PERIOD

### ***Example 3:***

- On May 15, 2010, WIDGET LLC, placed in service a piece of equipment for \$60,000 that has a five-year (MACRS) life.
- How long will WIDGET LLC include this asset in the 2.5% threshold calculation?

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## SECTION 199A – DEPRECIABLE PERIOD

### **Example 3:**

Answer: 2019

WHY: Because the depreciable period runs for the **longer of:**

- 10 full years from May 15, 2010 (to May 15, 2020); or
- The last day of the last full year in the recovery period, which for a five-year MACRS asset placed in service during 2010 would have been 2014.

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## SECTION 199A – DEPRECIABLE PERIOD

### **Example 3:**

Plain language:

- Assets with lives **LONGER** than 10 years are included until their LAST full year of depreciation.
- Assets with lives **SHORTER** than 10 years are included until the last full year of depreciation whether the 9<sup>th</sup> or 10<sup>th</sup> year.

Remember *qualified property* - (iii) the depreciable period for which has not ended before the close of the taxable year

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## SECTION 199A – EXCEPTIONS TO W2 AND QP

***Remember for every rule there is an exception:***

The W-2 and qualified property-based limitations do not apply when the taxpayer claiming the deduction has taxable income for the year of less than \$315,000 (if married filing jointly; \$157,500 for all other taxpayers). §199A(b)(3)(A) and (e)(2)(A)

The exact text reads:

“Taxable income for these purposes is determined without regard to any §199A deduction”

Sec. 199A(e)(1).

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## SECTION 199A – W2 AND QP

***Example 4:***

- Eddie Entrepreneur for 2018, generated \$400,000 of QBI and pays \$120,000 of W-2 wages, and has \$100,000 of qualified property.
- Eddie files jointly with his spouse for 2018, and their combined taxable income for the year, including the QBI, is \$600,000.

What is their 199A Deduction?

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## SECTION 199A – W2 AND QP

### **Example 4:**

Answer: \$60,000

WHY:

- Because their taxable income for 2018 is greater than \$415,000, the W-2 limitations apply in full.

Therefore the deduction is limited to the greater of:

- 50% of W-2 wages = \$60,000; or
- 25% of W-2 wages (\$30,000) plus 2.5% of unadjusted basis of qualified property (\$2,500) = \$32,500.

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## SECTION 199A – QB LOSSES

- §199A requires that the deduction be determined separately for **each** qualified trade or business.
  - The statute does not specifically address how to compute the deduction for a taxpayer who operates multiple qualified trades or business, one which generates qualified business income, and one which generates a loss

THE NEW REGULATION WILL/DO.

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## SECTION 199A – QB LOSSES

- Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 23 percent of any carryover qualified business loss.
- There is NO CARRYBACK of section 199A deductions but losses must be carried forward

This is a **COMPLETELY** separate calculation from the standard NOL deduction!!

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## Section 199A

§ 199A – POTENTIAL STRATEGIES

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## § 199A – POTENTIAL STRATEGIES

- Income reduction:
  - try to lower taxable income by:
    - Reducing or deferring revenue
    - Increasing deductions
    - Spread out the income over multiple taxpayers

Stay below the income threshold where the wage & property thresholds kick in.

DOES THIS REMIND YOU OF ANYTHING?

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## § 199A – POTENTIAL STRATEGIES

- Income conversions:
  - Convert income derived from an otherwise non qualified business (accounting firm) to qualified income.
    - Oops my rent just went up?
  - Shift specified service business into income a company that is *not* a specified service business.

How do we think the IRS is going to feel about this?

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## § 199A – POTENTIAL STRATEGIES

### Contemplate Married Filing Separate (MFS)

- Because of the 200% threshold (single vs. MFJ) married couples filing separate returns find themselves in the unusual position of each actually getting the same benefit as single filers
  - This is not likely to be the case for most couples, due to the other impacts associated with filing separately, but it's an option that must be considered?

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## § 199A – POTENTIAL STRATEGIES

### Switch to an independent contractor model

- After you account for the higher compensation but the shift in employment taxes (i.e. FICA and FUTA) is roughly the same.
- IC could potentially receive a substantial QBI deduction.
  - As an added bonus items such as the cost of uniforms, equipment, mileage between work sites, etc., as business expenses...
    - This is especially appealing since such unreimbursed business expenses are no longer deductible under the new TCJA.

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## § 199A – POTENTIAL STRATEGIES

### Switch FROM an independent contractor model

- After you account for the higher compensation but the shift in employment taxes (i.e. FICA and FUTA) is roughly the same.
- Bringing on IC's as employees COULD give you a higher QBI deduction based on the 50% of W2 limits.

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## § 199A – POTENTIAL STRATEGIES

### One Example:

- The sole owner and employee of an S-corporation generates \$110,000 of gross income.
- pays a \$100,000 salary annually and takes \$10,000 of business profits.
  - deemed reasonable by the CPA 😊

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## § 199A – POTENTIAL STRATEGIES

- Previously structuring the business in this manner saved about \$1,500 in employment taxes annually (FICA taxes not paid on the last \$10,000).
- With the new QBI deduction, taxpayer will begin receiving an addition \$2,000 QBI deduction based on the \$10,000 of profits.

WHAT IS YOUR RECOMMENDATION?

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## § 199A – POTENTIAL STRATEGIES

- If we were to change structure of this entity such that it was taxed as a partnership/sole proprietor the entire \$120,000 of income would be eligible for the QBI deduction
- Thereby creating total QBI deduction of \$24,000, while the SE tax would only increase by ~\$1,500

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## § 199A – POTENTIAL STRATEGIES

### Shift Other Business-Owned Assets to Other Entities and Lease Them Back

- A medical practice also owns an medical equipment with an unadjusted basis of \$2,500,000
- This equipment could be spun off into yet another business, and the radiology practice could lease back the equipment.

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## § 199A – POTENTIAL STRATEGIES

### Shift Other Business-Owned Assets to Other Entities and Lease Them Back

- Suppose that MD employs this strategy and leases back the medical equipment at a rate of \$350,000 per year and that, after accounting for depreciation and other expenses, produces a profit of \$100,000
- This further decreases the profit of the medical practice (A SPECIFIED SERVICE BUSINESS) by another \$100,000 annually. The result is another \$20,000 (limited by 2.5% of the medical equipment) of QBI deduction for the MD saving almost \$7,500 in income taxes annually.

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## § 199A – REASONABLE COMPENSATION

- Reasonable Compensation was an area of concern for the IRS *before*,
  - Don't we think it will warrant a higher level of scrutiny by the IRS because the salary manipulation is both a FICA tax issue *and* a potential QBI deduction abuse.
  - Converting away from an S corporation to an LLC or partnership would take the FICA tax strategy off the table, for those already at or near the Social Security wage base,

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## § 199A – REASONABLE COMPENSATION

- Because the FICA cost is minimized once you are over the SS wage base
- A QBI deduction would no longer be an item of dispute (a red-flag for the IRS)
  - Since there is no such thing as business owner salary in a sole prop or LLC or partnership, and therefore nothing for the IRS to challenge

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§ 199A – QUESTIONS, COMMENTS  
AND DISCUSSIONS

THANK YOU FOR YOUR TIME &  
ATTENTION!

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