The Qualified Business Income Deduction

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The Tax Cuts and Jobs Act passed by Congress in 2017 included a reduction in the corporate tax rate. In recognition of the fact that most businesses in the U.S. are not incorporated, but rather are sole proprietorships or passthrough entities, the Act also included Section 199A that applies to businesses operated as sole proprietorships, partnerships, limited liability companies treated as partnerships for tax purposes, or S corporations. The maximum potential deduction, which is available for individuals, trusts or estates, is 20 percent of qualified business income (QBI). Unlike many tax items, this is a deduction against taxable income, not adjusted gross income (AGI).

The 199A deduction is available beginning with 2018 returns, but will, unless Congress extends it, terminate Jan. 1, 2026.

Just in time for tax filing season – and despite the government shutdown – on Jan. 18, the IRS released regulations for Section 199A. The final regulations are 274 pages long and further guidance is expected. The IRS also released corrected draft final regulations Feb. 1, 2019. Therefore, this will necessarily be an abbreviated summary of the portions of the regulations that we believe will be of most common interest. The full text of the regulations is available at https://www.irs.gov/pub/irs-drop/td-reg-107892-18.pdf and it is important that details in the regulations be reviewed when advising clients. For taxable years ending in 2018, taxpayers can rely on either the proposed regulations (not discussed in this document) or the final regulations in their entirety.

The regulations provide specific rules for agricultural and horticultural cooperatives to qualify for the deduction. We have not included the details of the rules for those businesses in this discussion.

General Rule

Generally, if income is derived from a business as described in Section 162 that has QBI, then subject to the limitations described below, the taxpayer can deduct 20 percent of the QBI from taxable income (not deductible from AGI) of his/her share of the income from the business plus, if applicable, 20 percent of income received from real estate investment trusts (REITs) and publicly traded partnerships (PTPs). The QBI deduction cannot exceed 20 percent of the taxpayer's taxable income after subtracting his/her net capital gains and unrecaptured Section 1250 gain.

The definition of what constitutes a trade or business is mostly derived from case law, but the IRS has issued Notice 2019-7 providing guidance on the circumstances where rental activity will qualify as a business for purposes of 199A. Additionally, the regulations provide guidance for self-rental arrangements and, generally, triple-net leases do not qualify.

Once the hurdle is cleared that the entity qualifies as a "business," the next step is to identify the portion of its income that constitutes QBI. Consider the following:

- Generally, passive income, such as dividends, interest, capital gains and losses, and Section 1231 gains do not qualify.
    - Section 1231 recapture does qualify as QBI.
- Additionally, the regulations provide that QBI is net of "reasonable" compensation paid to an S corporation shareholder and guaranteed payments for services to a partner.
- Specific limitations, discussed below, apply to higher income individuals.
- Suspended losses from Dec. 31, 2017 and earlier, when allowed against taxable income after that date, do not reduce QBI. Suspended losses originating after Dec. 31, 2017 will reduce QBI.

Limitations for High Income Individuals

If the taxpayer's taxable income exceeds $157,500 single or $315,000 married filing joint (adjusted in future years by the cost of living adjustment pursuant to IRC 1(f)(3)), the amount of the deduction is limited to the greater of:

- 50 percent of the taxpayer's share of W-2 wages paid by the business, or
- 25 percent of eligible wages plus 2.5 percent of the taxpayer's share of the unadjusted basis (immediately after acquisition) of the business property (UBIA).
    - The unadjusted basis is not based on book or tax depreciation. Rather, it assumes a minimum 10-year life.
    - UBIA is not reduced by depreciation expense; rather, the cost of assets with lives under 10 years are included in the calculation for 10 years; the cost of assets with lives over 10 years are included in the UBIA calculation for their useful life.
- The regulations and Rev. Proc. 2019-11 provide a detailed discussion of what qualifies as W-2 wages and "qualified property" for this purpose.
- The W-2 wages and qualified property data must be allocated in proportion to the owner's allocable share of the related expenses. (Depreciation expense is considered the related expense for UBIA allocation purposes.)
- Regulation Section 1.199A-6 requires S corporations, partnerships, and trusts and estates to attach a statement describing the QBI, W-2 wages and UBIA of qualified property for each separate trade or business to the Schedule K-1 issued to each shareholder, partner or beneficiary.
- Details in Regulation Section 1.199A-4 permit a taxpayer owning more than one business to make an irrevocable election to "aggregate" the businesses in determining the wage and asset limitations.
    - It is not applicable to a specified service trade or business (SSTB) described below.
    - A majority of each of the businesses must be owned by the same person or group of persons.
    - The businesses must have some features in common, such as same year end, similar products, shared facilities, etc.

- Aggregation is beneficial, for instance, if one business has QBI without salaries and another business has several salaried employees.

Specified Service Trade or Business Limitations

The ability to claim the 20 percent deduction for QBI from an SSTB is phased out for taxpayers with taxable incomes between $315,000 and $415,000 married filing joint and $157,500 and $207,000 filing single. Be aware that:

- SSTBs include health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services or businesses for which the principal asset of the business is the reputation or skill of its owner or employees. The regulations cited above provide specific definitions for each of these categories.
- Engineering and architectural services are specifically excluded from the definition of SSTBs.
- Regulation Section 1.99A-5(c)(1) provides a *de minimis* rule that the SSTB categorization will not apply if the business has gross receipts of less than $25 million and less than 10 percent of the gross receipts are derived from SSTB-type activity or if gross receipts exceed $25 million and the SSTB-type activity is less than 5 percent of those receipts. Where a business falls outside the *de minimis* rule, examples in the regulations imply the business can still qualify for the 199A deduction if it keeps separable books and records for each distinct business activity.

Employees Becoming Independent Contractors

Employees, other than owner-employees, do not qualify for the 199A deduction. But what is to prevent an employee from "resigning" and becoming an independent contractor? The regulations deal with this possibility by providing that an employee who becomes an independent contractor is not permitted the 199A deduction for three years if the services they provide are substantially the same as what they provided as an employee.

Effective Date

For "relevant passthrough entities" (RPEs) that are on a fiscal year, the regulations are effective for the first taxable year that begins before Jan. 1, 2018 and ends after Dec. 31, 2017.

Reporting Requirements

An RPE is required to report on Schedule K-1, any QBI, W-2 wages, UBIA of qualified property or SSTB determinations. The RPE must also report each owner's allocated share of any qualified REIT dividends received by the RPE (including through another RPE), as well as any qualified PTP income or loss received by the RPE for each PTP in which the RPE holds an interest (including through another RPE).

Going Forward

Section 199A is extraordinarily complex and will continue to evolve for years. Tax professionals should work through their clients' circumstances to determine if and how they may qualify for the deduction. Tax professionals should also advise their clients as early as possible that a more detailed and time-consuming analysis may be required to prepare their tax returns, which may necessitate an extension request if not all the information is timely provided.