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Section 199A: Qualified Business Income Deduction for Pass-through Businesses

Small business owners have a new tax deduction to lower their business's taxable income. As part of the Tax Cuts and Jobs Act (TCJA), Congress lowered the tax rates of all businesses, lowering the corporate tax rate to 21 percent and a 20 percent tax deduction for pass-through businesses. Unfortunately the pass-through deduction is temporary and will expire December 31, 2025. This brief will explain the new Qualified Business Income tax deduction and how it applies to pass-through businesses.

Section 199A

The Tax Cuts and Jobs Act (TCJA) included a new provision to lower taxes on pass-through businesses. The new deduction for qualified business income (QBI) reduces a business's taxable income by up to 20 percent if the trade or business meets certain requirements.

New Law: For taxable years 2018-2025 non-C corporate business owners (referred to as pass-through business owners) may receive a deduction up to 20 percent of the taxpayer's share of QBI depending on total income and type of business.

This provision was implemented to lower the effective tax rate of pass-through business income at a rate similar to the corporate tax rate.

Limitations on QBI Deduction: The final regulations released by the Department of Treasury help to clarify the implementation and guard rails contained in TCJA to prevent abuse of the deduction. There are two primary limitations that regulate the size of the deduction applied to the taxpayer's income:

Pass-through business owners with income below a safe-harbor threshold of \$315,000 (married filing jointly) or \$157,500 (other filing statuses) can utilize the full 20 percent deduction regardless of business type.

- The deduction for qualifying businesses over the threshold are limited to either:
 - 50 percent of W-2 wages paid to all common law employees (except owners), or
 - 25 percent of W-2 wages plus 2.5 percent of unadjusted basis immediately after acquisition (UBIA) of qualifying property.

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An additional test is applied based on the type of business if the taxpayer's income is above the safe-harbor threshold, to prevent abuse of the deduction. Certain service businesses such as health, accounting, financial services, or a "business where the principal asset is the reputation or skill of one or more of its employees" do not qualify for the deduction. Based on the final regulations, any wholesale-distributor will qualify for the full QBI deduction if they meet the W-2 or qualifying property limitation.

2018 tax filing: Normally the final rules would supersede the proposed rules, however because the timing of the final rule came just prior to tax season the IRS is allowing businesses to use the proposed rule or final rule when filing their 2018 taxes. This is an uncommon practice, but helpful for businesses already in the process of tax planning. If you have not already begun your tax filing, using the final rules is preferred.

Examples calculations of QBI deduction:

Example 1: QBI below safe-harbor threshold: Single owner S-corporation with \$1 million in gross income, \$100,000 in net income.

$$QBI = \$100,000$$

$$\text{If } QBI \leq \$315,000 \text{ (or } \$157,500 \text{ if not married filing jointly): } QBI \times 20\% \\ = \$100,000 \times 20\%$$

$$\text{Value of deduction} = \$20,000$$

Example 2: Full deduction: Single owner S-corporation with \$1 million in gross income, \$250,000 in W-2 wages (not including owner's compensation), \$500,000 in net income.

$$QBI = \$500,000$$

$$\text{If } QBI > \$315,000 \text{ (or } \$157,500 \text{ if not married filing jointly): } QBI \times 20\% = QBID \\ = \$500,000 \times 20\% = \$100,000$$

$$W-2 \text{ wages} \times 50\% = \$250,000 \times 50\% = \$125,000$$

$$\text{Wage limitation} \geq QBID: \$125,000 > \$100,000$$

$$\text{Value of deduction} = \$100,000$$

Example 3: Deduction reduced by wage limitation: Single owner S-corporation with \$1 million in gross income, \$150,000 in W-2 wages (not including owner's compensation), \$500,000 in net income.

$$QBI = \$500,000$$

$$\text{If } QBI > \$315,000 \text{ (or } \$157,500 \text{ if not married filing jointly): } QBI \times 20\% = QBID \\ = \$500,000 \times 20\% = \$100,000$$

$$W-2 \text{ wages} \times 50\% = \$150,000 \times 50\% = \$75,000$$

$$\text{Wage limitation} \geq QBID: \$75,000 < \$100,000$$

$$\text{Value of deduction} = \$75,000$$

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Example 4: Full deduction allowed via wage and property limitation: Single owner S-corporation with \$1 million in gross income, \$150,000 in W-2 wages (not including owner's compensation), \$2,500,000 in qualifying property, \$500,000 in net income.

$$QBI = \$500,000$$

$$\text{If } QBI > \$315,000 \text{ (or } \$157,500 \text{ if not married filing jointly): } QBI \times 20\% = QBID \\ = \$500,000 \times 20\% = \$100,000$$

$$\text{(W-2 wages } \times 25\%) + \text{(qualifying property } \times 2.5\%) \\ = (\$150,000 \times 25\%) + (\$2,500,000 \times 2.5\%) = \$100,000$$

$$\text{Wage and property limitation } \geq QBID: \$100,000 = \$100,000$$

$$\text{Value of deduction} = \$100,000$$

Additional notes to consider:

Tax experts and accountants are continuing to examine and evaluate the final Sec. 199A regulations. Below are some notes on how the final regulations will affect common practices in the wholesale-distribution industry.

Multiple businesses: Business owners with multiple businesses in a common field may aggregate the incomes from those businesses for purposes of claiming the 199A deduction. This allows businesses with multiple entities to do a single wage and qualifying property test to receive the deduction. In order for the multiple businesses to aggregate, each entity must meet four requirements: 1. Each aggregated trade or business must meet the requirements of Section 162 (be in business to make a profit, not as a hobby) 2. The same person or group of persons must own at least 50 percent of all of the businesses to be aggregated, 3. Each of the businesses must be owned for a majority of the year and include the last day of the year, 4. All business taxes must be reported in the same taxable year, 5. All businesses must qualify for the QBI deduction. This simplifies the deduction process and allows the business owners to receive the largest deduction possible. If any of the businesses have a loss for the year, that loss is offset by gains from the other aggregated businesses; a loss can only be carried forward to another taxable year if the loss is greater than the gain of all aggregated businesses. It is important to note that once a group of businesses aggregates it must continue to aggregate until there is a change in the facts and circumstances of the businesses.

Leasing real estate to the main business: Business owners that hold real estate in a separate business entity from their main wholesale business can aggregate the income from the lease with the wholesale business income as long as at least 50% of both the real estate and wholesale businesses share common owners and the lease is not a triple net lease where the tenant is responsible for all costs including repairs, property taxes, insurance, and maintenance.

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Trusts: Generally, any trust or trusts established for estate planning or liability reasons may qualify to receive the QBI deduction. However, any trust(s) established solely for the purpose of reducing income taxes by qualifying for the QBI deduction will be disallowed.

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