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2019 Tax Filing Season (2018 Tax Year): Section 199A Deduction for Passthrough Business Income

The 2017 tax revision (P.L. 115-97) added, under Section 199A, a new deduction for passthrough business income. In design, the deduction is relatively simple: it is equal to as much as 20% of qualified business income in a tax year. Available evidence suggests that Congress created the deduction mainly to give noncorporate businesses a tax cut comparable to the reduction in the corporate income tax rate under P.L. 115-97 from a top rate of 35% to a single rate of 21%.

A passthrough business falls into one of three legal categories: a sole proprietorship, a subchapter S corporation, or a partnership (including a limited liability company [LLC] electing to be taxed as a partnership). In each case, the items of income, loss, gain, deduction, and credit for the business are passed through to the owners (whether distributed or not in the cases of S corporations and partnerships), and any profits are taxed at the owners' individual income tax rate. By contrast, the profits of a subchapter C corporation are taxed twice: once at the entity level, and a second time at the owners' level when the profits are distributed to them in the form of dividends and long-term capital gains. A sole proprietor reports her business profit or loss on Schedule C of Form 1040, while a partner and an S corporation shareholder report their share of their business's profit or loss on Schedule E.

Most U.S. businesses are organized as a passthrough business. According to the Internal Revenue Service, passthrough firms filed 95% of the 33.4 million business tax returns for the 2013 tax year; sole proprietors filed 72% of the returns, followed by S corporations (13%), partnerships (10%), and C corporations (5%).

Summary of Current Law

Section 199A allows individuals, estates, and trusts with passthrough business income to deduct up to 20% of their qualified business income (QBI) in determining their taxable income from 2018 to 2025. Owners of agricultural and horticultural cooperatives may also claim the deduction. The deduction does not affect a taxpayer's adjusted gross income (AGI), as it is claimed below the line. Nor can a taxpayer claim the deduction as an itemized deduction. Nonetheless, the Section 199A deduction may be claimed by taxpayers who take the standard deduction and those who itemize their deduction.

A taxpayer's QBI is defined as the net amount of items of qualified income, loss, gain, and deduction for each qualified domestic trade or business he or she actively or passively owns, in whole or in part. If a taxpayer owns more than one qualified business, then the QBI must be

determined separately for each of them; those amounts are combined to determine her or his total QBI in a tax year.

QBI does not include short-term and long-term capital gains, dividends, interest income and annuity unrelated to a qualified trade or business, certain income items described in Section 954, reasonable compensation paid to S corporation shareholders for services they performed for the business, and guaranteed payments to partners under Section 707(c) for services rendered to a partnership. Nor does it include income from the performance of services as an employee.

In general, the deduction for QBI in a tax year is equal to the sum of

- the smaller of (1) a taxpayer's "combined qualified income amount" for the year, or (2) an amount equal to 20% of taxable income computed without the Section 199A deduction, reduced by any net capital gain and qualified cooperative dividends, plus
- the smaller of (1) 20% of qualified cooperative dividends, or (2) taxable income, reduced by any net capital gain.

A taxpayer's "combined qualified income amount" is the sum of

- the deductible amounts of QBI from all qualified businesses she/he owns, and
- 20% of any qualified real estate investment trust (REIT) dividends and qualified income from publicly traded partnerships she/he receives.

The deductible amount from a qualified trade or business is generally the smaller of

- 20% of a taxpayer's QBI from all qualified trades or businesses, or
- a W-2 wages/qualified property limit, which is the larger of (1) 50% of a taxpayer's share of total W-2 wages attributable to each qualified business in a tax year, or (2) the sum of 25% of a taxpayer's share of W-2 wages plus 2.5% of her/his share of the unadjusted basis of all qualified property attributable to each business.

The deduction cannot exceed a taxpayer's taxable income from all sources in a tax year, reduced by any net capital gain. Use of the deduction hinges on four considerations: (1) the taxable income of a taxpayer with QBI, (2) the nature of the trade or business generating the QBI, (3) the taxpayer's share of W-2 wages for the QBI, and (4) the

taxpayer's share of the unadjusted basis of tangible, depreciable capital assets used to generate the QBI.

Taxable income denotes a passthrough business owner's AGI less all deductions, excluding the Section 199A deduction. All trades and businesses are eligible for the deduction, except for those deemed a "specified service trade or business (SSTB)," or those based on the performance of services as an employee. W-2 wages are the total wages attributable to a taxpayer's QBI during a tax year that are subject to withholding, elective deferrals, and deferred compensation. The unadjusted basis of tangible, depreciable assets refers to the acquisition cost of such property attributable to a taxpayer's QBI.

The definition of a SSTB merits close attention because it sets the boundaries between businesses that qualify for the deduction and those that do not for upper-income owners. Basically, an SSTB owned by such individuals does not qualify for the deduction. According to Section 199A, an SSTB is any trade or business involved in the performance of services in health, law, accounting, actuarial science, the performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, commodities, or partnership interests. Unlike Section 1202, which provides a capital gains tax exclusion for qualified small business stock and has a similar provision regarding eligible businesses, architecture and engineering do qualify for the deduction.

An SSTB also encompasses businesses whose principal asset is the reputation or skills of one or more of its employees or owners. For example, an independent contractor who has contracts with several unrelated companies and has minimal tangible and intangible property is considered an SSTB if the business's main asset is the reputation or skill set of the owner.

There are three basic outcomes for claiming the Section 199A deduction.

In the first outcome, taxpayers with QBI who have taxable incomes in 2018 up to threshold amounts of \$157,500 for single and head-of-household (HOH) filers, and \$315,000 for joint filers, should be able to take a Section 199A deduction equal to 20% of their QBI. This assumes that such an amount is less than 20% of any excess of the taxpayer's taxable income over the sum of any net capital gain and qualified cooperative dividends. Such an outcome is the least complicated of the three.

The second outcome is the most complicated of the three, as it includes a phase-in of the two limits. It applies to taxpayers with QBI and taxable incomes in 2018 between the threshold amounts of \$157,500 and \$207,500 for single and HOH filers, and between \$315,000 and \$415,000 for joint filers. For a taxpayer in this income range, the calculation of QBI takes into account the "applicable percentage" of all items of income, loss, gain, and deduction for the taxpayer, and of W-2 wages or W-2 wages plus qualified property allocable to the taxpayer's QBI. This percentage is 100% less the percentage that is the ratio of the excess of a taxpayer's taxable income above the

lower threshold amount to \$50,000 for single and HOH filers, and \$100,000 for joint filers.

The third outcome begins when the taxable income of taxpayers with QBI exceeds \$207,500 for single and HOH filers, and \$415,000 for joint filers. In this case, no deduction is available for income from SSTBs. In addition, the deduction is subject to the W-2 wages/qualified property limit. This means that the deduction for a qualified business is the smaller of 20% of a taxpayer's QBI for such a business, or the larger of (1) 50% of a taxpayer's share of W-2 wages for a qualified business or (2) 25% of those wages plus 2.5% of her/his share of the unadjusted basis of qualified property used in the business.

Comparison with Previous Law

Federal tax law immediately preceding P.L. 115-97 offered no deduction for passthrough business income. But passthrough businesses (and C corporations) engaged in qualified production activities (e.g., mining and manufacturing) were generally eligible for a deduction equal to 9% of their income from such activities. The deduction could not exceed a taxpayer's share of W-2 wages attributable to domestic production income.

Selected Filing Issues

According to one expert's estimate, over 90% of passthrough entities could qualify for a full or partial Section 199A deduction for the 2018 tax year.

But fewer firms may claim the deduction than are eligible for it. For many small passthrough business owners, two likely deterrents to benefiting from the deduction are the complexity of the provision and the recordkeeping required to claim it. Among the challenges for eligible taxpayers is determining whether a firm's business activities qualify for the deduction and to what extent. The final regulations (T.D. 9847) for Section 199A issued by the IRS in January 2019 provide some guidelines for identifying qualifying businesses, but eligibility ultimately hinges on the "facts and circumstances" for specific firms.

For example, consulting does not qualify for the deduction for upper-income taxpayers, whereas training does. So what would be the status of a firm's business income under the rules for the deduction if it were to provide training along with advice and counsel (which the IRS considers a form of consulting) related to the training?

Claiming the deduction for rental real estate businesses is also a challenge, since owners of such property must pass a three-part "safe harbor" test in order to qualify under IRS Notice 2019-7. The test requires a taxpayer to maintain separate books and records for each real estate business; demonstrate adequate recent active involvement in each business; and keep detailed records of the amount of time spent on this activity.

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