DEC 26, 2017 @ 08:48 AM 177,496 EDITOR'S PICK

# Tax Geek Tuesday: Making Sense Of The New '20% Qualified Business Income Deduction'

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*I focus on tax policy, court decisions and planning opportunities.* FULL BIO

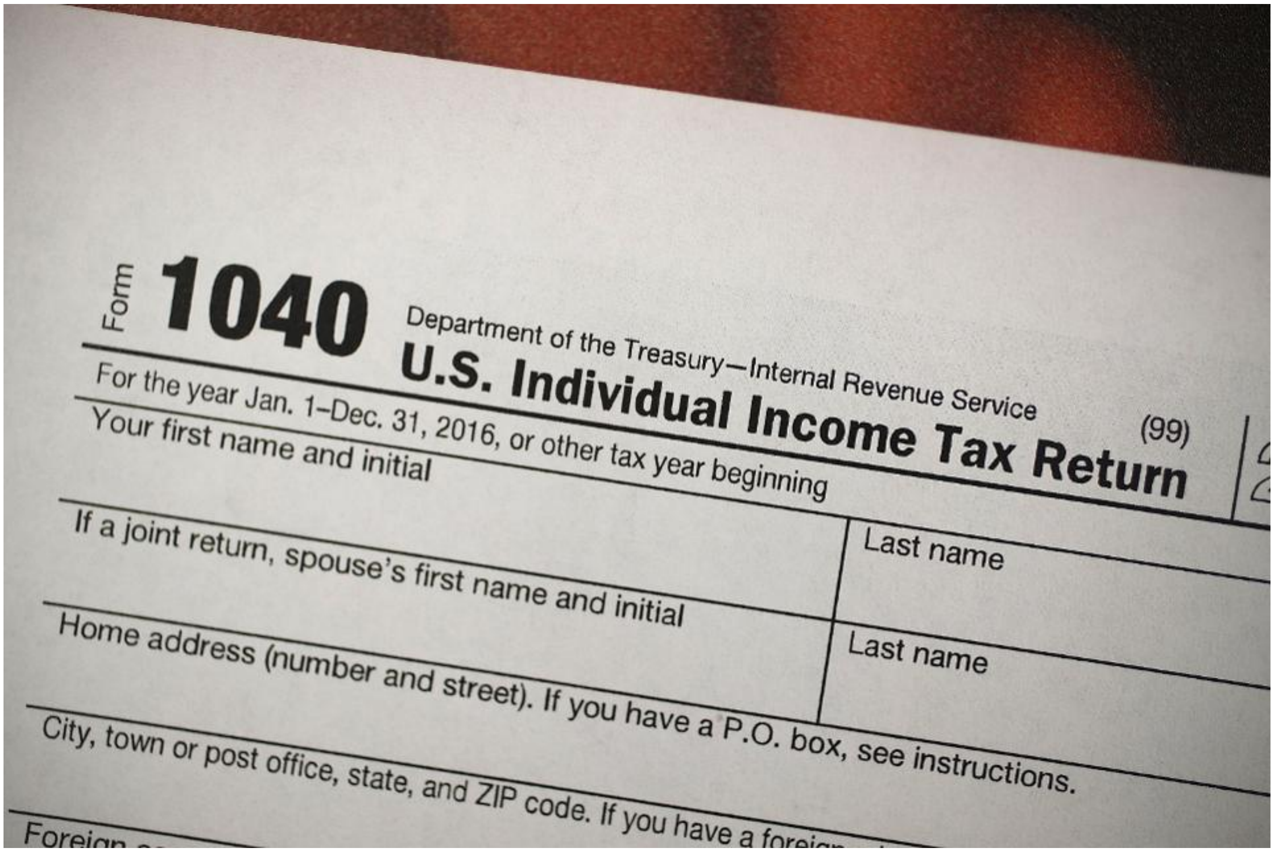


On December 22nd, President Trump signed into law the Tax Cuts and Jobs Act, finalizing a once-in-a-generation overhaul of the existing Code and leaving the once-burdensome tax law so simple, we'll all be preparing our returns on postcards come the spring of 2019.

HAHAHAHAHAHA

/wipes tear from cheek

Simple. That's rich. I'll make a deal with you: how about we spend some time diving into *just one* aspect of the bill -- the new deduction bestowed upon owners of sole proprietorships, S corporations, and partnerships -- and then you decide for yourself just how *simple* this all will be?



*MIAMI, FL - DECEMBER 22: A copy of a IRS 1040 tax form is seen at an H&R Block office on the day President Donald*[+]

For those of you who are familiar with the format of a "Tax Geek Tuesday," you know what to expect. For those of you who are new to this space, what we do here is beat the heck out of a narrow area of the tax law. In great, painstaking, long-form level of detail. The hope, of course, is that we can accomplish what Congress can't: making the law more manageable for those who need to apply it. Let's get to it.

**Entity Choice Under Current Law**

If you want to operate a business, there are four main choices for doing so:

1. C corporation
2. Sole proprietorship
3. S corporation
4. Partnership

Owners of a "C corporation" are subject to double taxation. When income is earned by the corporation, it is first taxed at the business level, at a top tax rate of 35% under current law. Then, when the corporation distributes the income to the shareholder, the shareholder pays tax on the dividend, at a top rate of 23.8%. Thus, from a federal tax perspective, owners of a C corporation pay a combined total rate on the income earned by the business of 50.47% (35% + (65% * 23.8%)).

Of course, you don't *have* to operate as a C corporation. Instead, you can operate a business as a sole proprietorship. Or as an S corporation. Or as a partnership. And what do these three business types have in common? They all offer a *single level of taxation*: when income is earned at the business level, it is generally not taxed at that level; rather, the income of the business is ultimately taxed only once, at the individual level.

A sole proprietor simply reports his or her income directly on Schedule C. In the case of an S corporation or a partnership (the so-called "flow-through entities), the income of the business is allocated among the owners and then included on their individual returns. In either scenario, the business owner pays tax on their share of the income at ordinary rates, which rise to as high as 40.8% under current law (39.6% top rate plus a 1.2% phase out of itemized deductions for high earners).

So to summarize, under current law, the top effective tax rates paid by C corporations versus other business types are:

- C corporations: 50.47%
- Sole proprietors/shareholders in an S corporation/partners in a partnership: 40.8%

**Entity Choice Under the New Law**

Regardless of how the plan may have been sold to the public, the foundation of the recently-enacted Tax Cuts and Jobs Act was the reduction in the C corporation tax rate from 35% to 21%. But Congress couldn't do this in isolation, because such a a one-sided dramatic decrease would cause the business playing field to tilt, with sole proprietors and owners of flow-through entities losing much of their advantage over their corporate competitors. To wit, the effective combined rate on corporate owners would become 39.8% (21% + (79%*23.8%), while the top rate on ordinary individual income -- the rate applied to the income of sole proprietors and owners of flow-through entities, whether distributed or not -- would become 37%. Thus, the advantage of a single level of taxation would shrink from 10% to just 2.8%.

While many politicians tend to treat S corporations and partnerships as replacement terms for "small business," the reality is quite the opposite -- many of the largest businesses in America are operated as flow-through entities. As a result, there was tremendous pressure on the tax reform process to provide a break to owners of flow-through businesses so they weren't left out in the cold with the corporate tax cuts.

After the House and Senate initially approached the non-corporate tax break from very different angles, the final law found some common ground, resulting in the creation of Section 199A, a new provision of the Code. On its surface, Section 199A will allow owners of sole proprietorships, S corporations and partnerships -- and yes, even stand-alone rental properties reported on Schedule E -- to take a deduction of 20% against their income from the business. The result of such a provision is to reduce the effective top rate on these types of business income from 40.8% under current law to 29.6% under the new law (a new 37% top rate * a 20% deduction= 29.6%).

Courtesy of this new deduction, sole proprietors and owners of flow-through businesses retain their competitive rate advantage over C corporations: it is 10% under current law, and will be 10% under the new law (39.8% versus 29.6%).

New Section 199A, however, is anything but simple, and the 20% deduction is far from guaranteed to business owners. Claiming the new deduction requires navigating a tangle of limitations, terms of art, thresholds, and phase-ins and phase-outs, with one critical definition thrown in the mix that could potentially jeopardize the whole damn thing.

It's not every day that we get handed a brand spankin' new section of the Code to wrap our arms around. But over the coming months, tax advisors and business owners will be tasked with doing just that. To speed up that process, I figured we should tackle new Section 199A in a Tax Geek Tuesday, and approach this uncharted territory in the best way we know how in this space: with a little bit of Q&A.

But I'm warning you: this is going to get *looong*. So for ease of future reference , I will break the Q&A into sections so that you can key in on those areas of need. Let's jump in.

### Overview of the QBI Deduction

**Q:** A 20% deduction. How hard can this be? First things first: Who gets to take it? Is it available to all taxpayers? Like, corporations, individuals, partnerships, etc...?

**A:** That's actually FOUR questions, which tells me that you really don't understand how a Q&A works. But I get the gist of what you're asking. Section 199A(a) makes clear that the deduction is available to all taxpayers <u>other than a corporation.</u> This would certainly seem to indicate that if an S corporation or partnership has an interest in a lower-tier flow-through entity, the upper-tier S corporation or partnership will have to determine its deduction first, before determining the amount of its income to pass through to its ultimate shareholders or partners. In fact, Section 199A(f)(4)(B) provides that regulations are coming to tell us how to determine the deduction in the case of tiered entities, so yes, it appears that this is in fact the case.

It's also worth nothing that at the last minute, Congress decided to allow the 20% deduction to trusts and estates that own an interest in a flow-through business. Rules under (now-repealed) Section 199 will be provided to determine how a trust or estate determines it's share of the "W-2 wages" and "adjusted basis" limitations we're going to discuss in detail below.

**Q:** Got it. Sounds like trusts, estates, individuals, and even S corporations and partnerships are eligible for the 20% deduction. So now can you just tell me how the 20% deduction works?

**A:** Sure, I'll do just that....over the next 9,000 words. We've got a number of terms to define, thresholds to establish, and computations to work through. But let's start with this concept: starting January 1, 2018, anyone who generates "qualified business income" will be entitled to take a deduction of 20% of that qualified business income on their tax return. That is, until the limitations set in.

Let's start by showing how the formula works, and then we'll break it all down, piece by piece.

The deduction is equal to the SUM OF:

1. The LESSER OF:
    - the "combined qualified business income" of the taxpayer, or
    - 20% of the excess of taxable income over the sum of any net capital gain
2. PLUS the LESSER OF:
    - 20% of qualified cooperative dividends, or
    - taxable income less net capital gain.

Next, let's simplify things a touch. We're going to focus our attention on the first half of the provision,and leave the "cooperative dividends" section for another day. That leaves us with this:

The deduction is equal to the SUM OF:

1. The LESSER OF:
    - the "combined qualified business income" of the taxpayer, or
    - 20% of the excess of taxable income over the sum of any net capital gain
2. ~~PLUS the LESSER OF:~~
    - ~~20% of qualified cooperative dividends, or~~
    - ~~taxable income less net capital gain.~~

Next, let's look the the formula for the first bullet: the determination of the "combined qualified business income" of the taxpayer, and then we'll start tearing this provision to pieces:

Combined qualified business income is *actually not income*, but rather a deduction. It is:

1. THE SUM OF:
    - The LESSER OF:
        - 20% of of the taxpayer's "qualified business income" or
        - THE GREATER OF:
            - 50% of the W-2 wages with respect to the business, or
            - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property.
2. PLUS:
    - 20% of qualified REIT dividends
    - qualified publicly traded partnership income.

**Q:** I don't understand a single thing you just wrote. Please tell me this gets better.

**A:** Have some patience, man. We just got started. Let's knock out the easy part first, by starting with the second half of the equation. Starting January 1, 2018, you will be able to take a 20% deduction against your 1) REIT dividends, and 2) qualified publicly traded partnership income.

A "qualified REIT dividend" is any dividend from a real estate investment trust that isn't either:

- a capital gain dividend, or
- a qualified dividend.

"Qualified publicly traded partnership income" is the net amount of any qualified business income (defined below) from a PTP, plus any gain on the sale of a PTP interest that is included in your ordinary income.

**Q:** That's helpful and all, but I"m really not here to read about REITs and PTPs. I want to understand the *first half of the equation,* where we can deduct 20% of our income from sole proprietorships, S corporations and partnerships. Can we get to that now?

**A:** Why, yes. Yes we can. Let's focus on this part for the rest of our time together. You will be entitled to deduct, beginning in 2018, the LESSER OF:

- 20% of of the taxpayer's "qualified business income" or
- THE GREATER OF:
    - 50% of the W-2 wages with respect to the business, or
    - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property.

Let's take it line-by-line, starting with the definition of "qualified business income."

### Qualified Business Income

**Q:** Give it to me. What is "qualified business income?"

**A:** Will do, but first things first: if I'm going to have to type out "qualified business income" over and over again, I'm going to lose interest in writing this article in a hurry. So let's agree to use "QBI" for short, shall we?

QBI is actually pretty simple; it's defined in Section 199A(c) as the "ordinary" income -- less ordinary deductions -- you earn from a sole-proprietorship, S corporation, or partnership. QBI does not include, however, any wages you earn as an employee. This means that, yes, beginning in 2018, you could have two people doing the exact same job -- one as an independent contractor and one as an employee -- with the self-employment income of the former being considered QBI (and thus eligible for a 20% deduction), while the wages earned by the latter would not be eligible for the 20% deduction.

**Q:** So why would anyone want to be an employee going forward? Why won't everyone just rearrange their relationship with their employer to become an independent contractor?

**A:** Good question. First, keep in mind, you can't just call yourself whatever you like. The IRS employs factors to determine who is an employee and who is an independent contractor, so it can ensure it's collecting payroll taxes from the truly responsible party. The primary factor is the "degree of control" the service recipient has over the service provider; in other words, if you're required to work 9-5 every day down at the cracker factory, well, you're an employee, regardless of what you might call yourself.

And don't forget, there are advantages to being an employee. For starters, your employer is on the hook for half of the payroll taxes; become an independent contractor, and you're paying the full 15.3% of Social Security and Medicare tax up to the Social Security wage base ($128,400 in 2018), and then the full 2.9% on income above that threshold.

In addition, employees are eligible for a host of fringe benefits that can be provided by an employer. Tax-free health insurance and employee game rooms can be tough to walk away from. Before you go rushing off to become an independent contractor to save some loot, you've got to take those things into consideration.

**Q:** Fair enough. So let's go back to someone who owns an interest in an S corporation or a partnership. Do you just add up all of the lines on the Schedule K-1 and call the result "QBI" eligible for the deduction?

**A:** Absolutely not. QBI does NOT include the following items of investment income:

- short-term capital gain or loss;
- long-term capital gain or loss;
- dividend income; or
- interest income.

If you are a shareholder or a partner in a flow-through business, it is important to note that QBI also doesn't include any wages or guaranteed payments received from the business. To illustrate, if you own 30% of an S corporation that pays you $40,000 of wages and allocates you $80,000 of income, your QBI from the S corporation is ONLY the $80,000 of income; the $40,000 of wages do not count. And as we'll talk about (much) later, if you're a shareholder in an S corporation who provides significant services and you *don't* pay yourself any wages, the IRS may *treat you* as if you took wages anyway, in which case this "reasonable compensation" will not be treated as QBI.

QBI also doesn't include any income that's not "effectively connected with the conduct of a U.S. trade or business," but that's a rabbit hole I"m not willing to go down in this article.

So in summary, when starting the process for determining the amount of the deduction, begin by adding up all of the items of income and deduction on a Schedule K-1 OTHER THAN the aforementioned bullet points. That's your QBI.

**Q:** QBI has "business" smack dab in the middle of it. Does that mean that to be eligible for the deduction, the activity has to rise to the level of a "business?" I know that is kind of a nebulous standard in the tax law, and I thought a lot of rental properties don't really count as a "business" for many purposes. Does that mean that if I own a single rental property in my individual capacity that I report on Schedule E, and that property produces income, I won't be entitled to a 20% deduction against the income?

**A:** You know...you're smarter than you look. Here's what we know: clearly, the 20% deduction is intended to apply to rental income, because a last-minute change was made to the limitation on the deduction (as discussed in detail below) specifically to accommodate rental owners.

But here's what we *don't* know:

Section 199A(c)(c) requires only that QBI be earned in a "qualified trade or business," and that language is a bit scary. Why? Because as crazy as it sounds, the term "trade or business" is not well defined by the tax law. In fact, there are a number of different interpretations of what constitutes a trade or business for different purposes of the Code. The highest standard, however, is that of a "Section 162" trade or business, and in order for an activity to achieve this standard, the business must be regular, continuous, and substantial.

Over 100 years of judicial precedent has not provided much insight into whether a rental activity rises to the level of a "Section 162 trade or business." The determination depends on many factors: How long is the lease? Is the lease gross or triple net? What type of property is being leased?

As you've probably guessed, this new statutory language is rife with peril. When Section 199A(d) requires that QBI be earned in a "trade or business," does it mean a "Section 162 trade or business?" And even if it doesn't, because it doesn't specifically say it DOESN'T require a Section 162 trade or business, will the courts interpret "trade or business" in Section 199A to *mean* a Section 162 trade or business?

And if that's the case, will some rental activities NOT rise to the level of a Section 162 trade or business --as is currently the case under the law -- precluding owners of the activities from claiming the 20% deduction?

I wish I could provide a more concrete conclusion, but this is the tax law we live in. For example, the net investment income tax rules of Section 1411 also refer regularly to the concept of a "trade or business," but those regulations: 1. make clear that they are referring to a Section 162 trade or business, and 2. take great pains to allow rental owners to not HAVE to try and navigate a century's worth of muddled case history in order to determine whether their rental activities rise to the level of a Section 162 trade or business.

Section 199A, however, is in its infancy. We don't have regulations. We only have a blanket reference to a "trade or business," which without further clarity, I would think HAS to be interpreted to mean a Section 162 trade or business. Which means, yes, certain rental activities may not meet this definition -- for example, a triple-net lease where the owner has almost no regular involvement -- thereby denying the owner a 20% deduction.

**Q:** Man, am I ever sorry that I asked. How about we agree to check back in on that one when the IRS offers some explanation, OK? Good. So once I've got QBI, I just multiply by 20%, right? If my share of ordinary income from an S corporation or partnership or sole proprietorship is $400,000, I just take $400,000 * 20% and deduct the resulting $80,000 on my tax return, right?

**A:** Not quite. You computed the $80,000 correctly, but your work has just begun. This is when the limitations kick in.

**W-2 Limitations**

**Q:** Wait a second...what are these limitations you speak of?

**A:** There are several. Some are quantitative, others are business based. Let's start with the numerical limitations. You are only entitled to deduct 20% of QBI up to a limit. That limit is the GREATER OF:

- 50% of *your allocable share* of the "W-2 wages" paid by the business, or
- 25% of *your allocable share* of the "W-2 pages" paid by the business PLUS 2.5% of *your allocable share* of the "unadjusted basis" immediately after acquisition of all *"*qualified property.*"*

**Q:** Those limitations contain a lot of italics and terms in quotations. That means this is a giant pain in the ass, isn't it? Why does it have to be this way?

**A:** That's *two* questions, so you're still not getting the gist of this Q&A thing, but here goes:

First, yes, these limitations are a pain in the ass.

Second, there is a good reason why those limitations exist -- they are intended to prevent abuse of the new system. Consider the following illustration:

I'm a partner at a BIG, PRESTIGIOUS ACCOUNTING FIRM. I am also, however, an employee; one who collects a wage. Now, let's just assume that my annual wage is $800,000 (it is not). With the new rules coming down and offering a 20% deduction against my income, what would prevent me from quitting my current gig, and then having my firm engage the services of "Tony Nitti, Inc." a brand new S corporation I've set up specifically to facilitate my tax shenanigans? Now, my firm pays that same $800,000 to my S corporation, and my S corporation simply allows that income to flow through to be as QBI. I, in turn, take a 20% deduction against that income, reducing my income to $640,000. See the problem?

My role at my firm hasn't changed. I provided accounting services before, I provide accounting services now. But before, I was receiving wages taxed at ordinary rates as high as 37%. Now, by converting to an S corporation and foregoing wages in favor of QBI, I am now paying an *effective rate* on that income of only 29.6% (37% * 80%). That's not fair, is it? Compensation for services should be taxed at the same rate, whether it's coming to me as a salary or flow-through income.

To prevent these abuses, Congress enacted the W-2 limitations. Because, in my example, Tony Nitti, Inc. does not pay any wages, in both scenarios my limitation would be a big fat ZERO, meaning I get no deduction. Like so:

My deduction is the LESSER OF:

1. 20% of $800,000, or $160,000, or
2. The GREATER OF:
    1. 50% of W-2 wages, or $0, or
    2. 25% of W-2 wages, or $0, plus 2.5% of the unadjusted basis of the LLC's assets, or $0, for a total of $0..

**Q:** That actually does make some sense. Now that you've explained *why* the limitations exist, maybe you could explain how they work, particularly all of those terms you put in italics an quotes. For example, why did you italicize *your allocable share* over and over again?

**A:** Because it has been my experience that you only learn through repetition, that's why. And here's the thing: I've already heard people make the mistake of suggesting that a shareholder's or partner's limitation is based on 50% or 25% of the TOTAL W-2 wages paid by the business. That would only be the case if you happen to be the sole owner of the business. If you're not, then you have to first determine your *allocable share* of the W-2 wages.

**Q:** This is going to require some clarification. First, what exactly are W-2 wages? Do things like management fees or payments to independent contractors count? And then, how does a  shareholder or partner determine his or her share of the partnership's W-2 wages?

**A:** Let's take those one by one. First, W-2 wages are exactly that: wages paid to an employee, INCLUDING any elective deferrals into a Section 401(k)-type vehicle or other deferred compensation. W-2 wages do NOT INCLUDE, however, things like payments to an independent contractor or management fees, because new Section 199A(b)(4)(C) clearly states that an amount is not a W-2 wage for these purposes unless it shows up on a payroll tax return.

Next, how we do determine a shareholder or partner's allocable share of W-2 wages? For a shareholder in an S corporation, it's a piece of cake: Section 1366 and Section 1377 require that all items of an S corporation be allocated pro-rata, on a per-share/per-day basis.

Things get a bit more tricky for a partner in a partnership, however, because partnerships can -- subject to the substantial economic effect rules of Section 704(b) -- "specially allocate" different items of income, gain, loss and deduction among its partners at different percentages. Thus, without concrete guidance, it would be unclear how a partner in this type of partnership determines their share of the W-2 wages.

Luckily, Section 199A(f)(1) tells us that a partner's share of a partnership's W-2 wages is, quite logically, determined in the same manner as his share of the partnership's wage deduction. Thus, if you are own a 20% capital stake in a partnership, but under the terms of the agreement you are allocated 80% of any depreciation but only 30% of Schedule K-1, Line 1 ordinary income, then because you are being allocated 30% of the partnership's wage deduction via your Line 1 allocation, you are stuck being allocated only 30% of the partnership's W-2 wage expense for the purposes of these limitations.

Here's an example:

*A is a 30% owner of ABC, LLC. The LLC produced total ordinary income of $3,000,000. The LLC paid total W-2 wages of $1,000,000, and the total adjusted basis of property held by ABC, LLC is $100,000. A is allocated 30% of all items of the partnership.*

A is entitled to a deduction equal to the <u>LESSER OF</u>:

| | **Total** | **A's Allocable Share (30%)** | **20% Deduction** |
|---|---|---|---|
| QBI | $3,000,000 | $900,000 | **$180,000** |

And the <u>GREATER OF</u>:

| | Total | A's Allocable Share (30%) | 50% Limitation |
|---|---|---|---|
| W-2 Wages | $1,000,000 | $300,000 | **$150,000** |

or the TOTAL OF:

| | Total | A's Allocable Share (30%) | 25% Limitation | 2.5% Limitation | Total |
|---|---|---|---|---|---|
| W-2 Wages | $1,000,000 | $300,000 | $75,000 | | $75,000 |
| Unadjusted basis of property | $100,000 | $30,000 | | $750 | $750 |
| **Total** | | | | | **$75,750** |

Thus, A is entitled to a deduction of $150,000, the lesser of:

- $180,000, or
- the greater of:
    - $150,000 or
    - $75,750.

**Q:** I noticed that the second limitation is based not only on W-2 wages, but also the partner's or shareholder's allocable share of 2.5% of the "unadjusted basis" of "qualified property." Explain.

**A:** That's more of an order than a question, but here goes. Let's start with "qualified property:" this is defined in Section 199A(b)(6)(A) as any tangible property, subject to depreciation (meaning inventory doesn't count), which is held by the business at the end of the year and is used -- at ANY point in the year -- in the production of QBI. But there's a catch: if you're going to count the basis towards your limitation, the "depreciable period" of the period could not have ended prior to the last day of the year for which you are trying to take the deduction.

The depreciable period -- and I've seen a LOT of confusion about this -- starts on the date the property is placed in service and ends on the LATER OF:

- 10 years, or
- the last day of the last full year in the asset's "regular" (not ADS) depreciation period.

To illustrate, assume S Co. purchases a piece of machinery on November 18, 2014. The machinery is used in the business, and is depreciated over 5 years. Even though the depreciable life of the asset is only 5 years, the owners of S Co. will be able to take the unadjusted basis of $10,000 into consideration for purposes of this second limitation for ten full years, from 2014-2023, because the qualifying period runs for the LONGER of the useful life (5 years) OR 10 years.

Consider the same facts, only the asset is a non-residential rental building that is depreciated over 39 years. The shareholders of S Co. will be able to take their share of the building's basis into consideration from 2014-2052, the last full year of the asset's depreciation schedule.

Four quick notes:

1. The basis taken into consideration is "unadjusted basis," meaning it is NOT reduced by any depreciation deductions. In fact, Section 199A(b)(2)(B)(ii) requires that you take into consideration the basis of the property "immediately after acquisition."
2. Any asset that was fully depreciated prior to 2018, unless it was placed in service *after* 2008, will not count towards basis.
3. Just as with W-2 wages, a shareholder or partner may only take into consideration for purposes of applying the limitation 2.5% *his or her allocable share* of the basis of the property. So if the total basis of S corporation property is $1,000,000 and you are a 20% shareholder, your basis limitation is $1,000,000 * 20% * 2.5% = $5,000.
4. If you are a partner in a partnership, you must allocate your share of asset basis in the same manner in which you are allocated depreciation expense from the partnership. So go back to my earlier example where a partnership allocated W-2 wages, and the partner owned 20% of the capital of a partnership, was allocated 80% of depreciation, and only 30% of Schedule K-1, Line 1, ordinary income or loss. While that partner would be allocated 30% of the W-2 wages paid by the partnership, he or she would be allocated 80% of the unadjusted basis of the property, because that is the percentage of depreciation he is allocated.

**Q:** That's a lot to take in. I've gotta' ask: I understand that the point of the "50% of W-2 wages" limitation was to prevent abuses where people forego salary for tax-favored flow-through income, but what's the point of this second limitation, the one that allows for the 20% deduction up to 25% of your share of W-2 wages PLUS 2.5% of your share of the unadjusted basis of the property?

**A:** That second limitation, my friend, is a prime example of how the sausage really gets made on Capitol Hill. Follow along:

Under the House bill, owners of S corporations and partnerships would have gotten a top 25% tax rate on their income. Unfortunately, the only way to get the 25% rate on ALL income was to be a "passive owner." Who are passive owners? Those that either:

1. Own rental real estate, or
2. Own non-rental businesses, and don't show up at work enough to "materially participate."

Thus, under the House bill, rental income would have been taxed at a top rate of 25%.

The Senate bill, however, took a different tack in trying to bestow a benefit on flow-through business owners. Rather than incentivize people to work *less* with the promise of a 25% tax rate, the Senate offered the deduction we're dealing with now, without differentiating between "passive" and "nonpassive" business owners. But in the initial Senate bill, the deduction would have simply been capped at 50% of each owner's share of the W-2 wages of the business; this "share of property basis" rule didn't exist.

And here's the problem with that: most large rental activities don't pay W-2 wages; instead, they tend to pay management fees to a management company. As a result, if the law hadn't been massaged, owners of large rental empires would have gotten no 20% deduction, meaning they would be paying 37% on their rental income as opposed to 25% under the House bill. And that wasn't going to fly.

So at the 11th hour, the conference committee added in this SECOND limitation, allowing for a 20% deduction up to the GREATER of:

1. 50% of W-2 wages, or
2. 25% of W-2 wages PLUS 2.5% of unadjusted basis of property.

This made ~~President Trump~~ ~~Senator Corker~~ rental owners very happy, because they were suddenly eligible for a deduction they otherwise wouldn't' have gotten. To illustrate:

*A owns a 50% interest in a commercial rental properties through an LLC. A's share of the rental income of the LLC is $1,500,000. The LLC pays no W-2 wages, rather, it pays a management fee to an S corporation A controls. The management company pays W-2 wages, but also breaks even, passing out no net income to A. A's share of the total unadjusted basis of the commercial rental property is $10,000,000.*

*Until mere days before the final legislation was agreed upon, A would not have been entitled to a 20% deduction against his $1.500,000 of QBI, because he ran up against the 50% of W-2 wages limitation ($0). After the 11th hour change, however, A is now entitled to a deduction - assuming the rental activities rise to the level of a Section 162 business, as discussed above -- equal to the LESSER OF:*

1. *20% of QBI of $1,500,000 ($300,000) or*
2. *2.5% of the unadjusted asset basis of $10,000,000 ($250,000).*

*As a result, A grabs a $250,000 deduction that was very nearly nil.*

**Q:** Couldn't all this be avoided if someone was permitted to elect to group all of their businesses or rental activities together? For example, say someone owns 20 rental properties through 20 different LLCs -- with none of them paying W-2 wages -- but also owns a property management company that pays SIGNIFICANT W-2 wages. Why can't they just elect to group the 20 rentals with the management company, pulling in the W-2 wages for purposes of the limitation?

**A:** It's an interesting point, but as of right now, it certainly appears that the 20% deduction will be required to be computed with respect to each separate business owned by the individual. For starters, Section 199A(b)(1)(A) requires that the deduction be computed for "each" qualified trade or business. And then there's the fact that the provision works in terms of "businesses," rather than "activities," so it appears that Section 199A would not be able to leverage off of the existing elective grouping regime of Section 469 that applies to "activities." So for now, at least, I think we can count on computing the deduction for each separate business.

**Q:** Understood. So the bill is good for big landlords, but what about the little guy? What if I earn $150,000 from my small business LLC, but the business pays, for example, only $10,000 of wages and has no significant property? Am I limited to taking only a $5,000 deduction, equal to the LESSER OF:

1. QBI of $150,000 * 20%, or $30,000, or
2. 50% of W-2 wages of $10,000, or $5,000

**A:** At first blush, that's exactly what would happen. But the new law isn't *just* about trying to help the Monte Burns of the world; it offers something to your average Joe Sixpack as well, in the form of an exception to the W-2 limit.

**Exception to W-2 Wage Limitations**

**Q:** Hey, I'm an average Joe Sixpack! Kindly explain how this exception would work.

**A:** Here goes: Section 199A(b)(3)(A) provides that if your TAXABLE INCOME for the year -- not adjusted gross income, not QBI, but TAXABLE INCOME -- is less than the "threshold amount" for the year, then you can simply ignore the two W-2-based limitations. The "threshold amounts" for 2018 are $315,000 if you are married, and $157,500 for all other taxpayers. These amounts will be indexed for inflation starting in 2019. And quite obviously, you determine taxable income WITHOUT factoring in any potential 20% deduction that we're discussing here.

**Q:** Interesting. I'm married; so if I my taxable income is less than $315,000 -- and it is -- I get to just take a deduction of 20% of QBI and call it a day?

**A:** That's it? Let's look at an example:

*A has QBI of $200,000 from an S corporation that paid a total of $30,000 of W-2 wages and that has no qualified property. A's spouse has $50,000 of W-2 income, and A and B have interest income of $20,000. Thus, total taxable income is $270,000.*

*Normally, A's deduction would be limited to $15,000, the LESSER OF:*

1. 20% of QBI of $200,000, or $40,000, or
2. The GREATER OF:
    1. 50% of W-2 wages of $30,000, or $15,000, or
    2. 25% of $30,000 plus 2.5% of $0, or $7,500.

While normally, A's deduction would be limited to $15,000, because A's taxable income is $270,000 -- which the last time I checked, is less than $315,000 -- the two limitations are disregarded, and A simply takes a deduction equal to 20% of QBI, or $40,000.

**Phase-In of W-2 Limitations**

**Q:** That's great news. But you know where I'm heading with this, don't you? Next year I expect my S corporation to make more money, pushing me over $315,000 in taxable income. Now what? Do I have to deal with the W-2 limitations again?

**A:** That, my friend, depends on *how much* you go over that $315,000 limit. This is where some math will be required.

Section 199A(b)(3)(B) provides that once your taxable income exceeds the threshold ($315,000 if married filing jointly; $157,500 for everyone else), you have to start factoring in the W-2 limitations, but *not all at once.* Rather, the W-2 limitations will be "phased in" over the next $100,000 of taxable income (if you're married filing jointly, or $50,000 for everyone else).

It's a multi-step process, but if you break it down piece by piece, it makes sense. Let's look at an example:

*A and B are married. A earns $300,000 from an S corporation. A's share of the W-2 wages paid by the S corporation is $40,000. A's share of the unadjusted basis of qualified property held by the S corporation is $0. B earns wages from her job, so that taxable income for A and B in 2018 is $375,000.*

How do we compute A's deduction?

**Step 1:** We start by asking the following question: what would A's deduction have been if his taxable income was less than $315,000? This is simple: at that level of income, the W-2 limits wouldn't apply, and A would take a deduction of 20% of QBI of $300,000 or $60,000.

**Step 2:** If A were given a $60,000 deduction because taxable income was less than $315,000, how big of a break would the law have been giving A compared to a situation where the W-2 limits applied in full? Stated another way, how does A's $60,000 deduction compare to what it WOULD have been if the W-2 limits did apply? If they applied, A's $60,000 deduction would have been limited to the GREATER OF:

- 50% of $40,000 or $20,000, or
- 25% of $40,000 plus 2.5% of $0, or $10,000.

So if the W-2 limitations HAD applied, A would have been entitled to a deduction of only $20,000. This means that if taxable income had been $315,000 or less, the new law would have given A a break in the form of $40,000 of additional deduction ($60,000 - $20,000). This is known as the "excess amount" in Section 199A(b)(3)(A)(ii), but I just want you to think of it as the "get out of jail free" card the new law gives you when your taxable income is below the thresholds.

Once your taxable income is *above* the threshold, however, you start to lose the benefit of that "get out of jail free" card, bit-by-bit, over the next $100,000 of taxable income ($50,000 if you're not married filing jointly). But by how much?

**Step 3:** Look at it this way: A gets a TOTAL RANGE of $100,000 of taxable income -- from $315,000 to $415,000 -- before his $40,000 "get out of jail free" card is totally eliminated. So it makes sense that the $40,000 benefit should be reduced based on *how far you are into that $100,000 range*. It works like so: you start by determining by how much your taxable income exceeds your threshold:

| | |
|---|---|
| Taxable income: | $375,000 |
| Less: threshold: | ($315,000 ) |
| **Excess taxable income:** | **$60,000** |

A has gone $60,000 of the way through a $100,000 phase in range. Next, we put it into percentage terms. Here is how much of his "get out of jail free" card of $40,000 A should no longer be entitled to;

| | |
|---|---|
| Excess taxable income: | $60,000 |
| Divided by: Total phase-in range | $100,000 |
| **Percentage of benefit A should lose:** | **60%** |

**Step 4:** A started with a benefit of $40,000: a $60,000 deduction when a $20,000 W-2 limit would have otherwise applied. Now that A has burned through 60% of

that phase-in range, he should lose 60% of that $40,000 benefit, or $24,000. Thus, as a final step, we reduce A's $60,000 deduction by the amount of the "get out of jail free" card that he has lost because his income is too high:

| | |
|---|---|
| 20% of QBI deduction: | $60,000 |
| Reduction in $40,000 benefit because income is over $315,000: | ($24,000) |
| **Final deduction** | **$36,000** |

Thus, A is entitled to a deduction of only $36,000.

To prove the system works, look what happens if taxable income was $415,000, but everything else remained the same:

**Step 1:** Tentative deduction would still be $60,000

**Step 2:** Excess amount -- think, "get out of jail free" card -- would still be $40,000 ($60,000 - $20,000)

**Step 3:** Excess taxable income amount would now be $100,000 ($415,000 - $315,000) and thus the amount by which A has burned through the phase-in range would be 100% ($100,000/$100,000).

**Step 4:** As a result, A must reduce his $40,000 "get out of jail free" card by 100%, or $40,000. This leaves him with a deduction of $20,000 ($60,000 - $40,000 reduction).

Because A is left with a deduction of $20,000, the system works. Remember, $20,000 is the amount A would have been entitled to deduct if the W-2 limit had applied in full, which it should once taxable income hits $415,000. My work is done here.

**Q:** That *is* pretty neat, but we're not done yet. Now that I understand these W-2 limits, I'm still a bit confused. What would prevent Mr. Big FANCYPANTS LAWYER from quitting his job as an employee, and having his $700,000 salary be paid into an S corporation he sets up. The S corporation can then pay him $200,000 in W-2 wages, and let the remaining $500,000 flow-through as income eligible for the 20% deduction. He wouldn't run into a W-2 limit problem, because 20% of $500,000

($100,000) is not greater than 50% of W-2 wages ($100,000). Hasn't this lawyer just converted $500,000 of W-2 income into $400,000 of QBI?

**A:** That's an exceedingly long question, but at least it shows that you're following along. Yes, at this point in the game, it looks like the lawyer can do that, but you have to understand something: NOT ALL BUSINESSES ARE ELIGIBLE FOR THE 20% DEDUCTION.

**Treatment of "Specified Service Trades or Businesses"**

**Q:** Wait...certain *businesses* can't take the deduction? Which ones?

**A:** This, my friend, is likely to become one of the more prevalent --and impactful -- questions in all of the tax law over the coming years. It starts like so: Section 199A(d)(1) makes clear that there are two "trades or businesses" that are not eligible for the 20% of QBI deduction:

1. Anyone who is in the business of being an employee (yes, being an employee is considered being in a business), and
2. Any *"specified service trade or business."*

Then, Section 199A(d)(2)(A) defines a "specified trade or business" in reference to Section 1202(e)(3)(A), which includes the following:

> "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."

**Q:** OK, I recognize most of those businesses. But now I must ask: why? What's the point of handpicking these businesses and saying, "NO DEDUCTION FOR YOU."

**A:** While the businesses selected may seem arbitrary at first blush, they actually makes sense. In each business, the people who make up the business -- whether they be lawyers or accountants or doctors -- only offer clients or customers one thing: services. They don't sell goods. They don't build stuff. They simply provide services.

And when viewed through that lens, it makes sense to eliminate these businesses from qualification for the 20% deduction. After all, when someone provides services, the payment they receive in return should be taxed as wages, or at least at the same rates as wages (i.e., ordinary income). So if you have an entire *business* that does nothing but provide services, it should follow that all of the income generated by the business should be taxed the same way wages would be taxed -- as ordinary income.

Go back to the previous example about the lawyer. Lawyers provide services; that's it; that's all. So if you allow a lawyer to form an LLC to collect what was once wages, and then get a 20% deduction against that income, you have allowed a service provider to convert what would have been wages taxed at a top rate of 37% into tax-favored QBI taxed at an effective rate of 29.6%. And that ain't right.

Looking at it from the opposite direction, if you own an S corporation or partnership that *isn't* engaged in a "specified service trade or business" -- like a fast-food restaurant -- then it follows that some of the income generated by the business isn't necessarily attributable to the *skill and services* of the employees and owners. Some of the revenue, rather, is generated from the highly efficient deep fryer. The alluring ambiance. The primal pleasure of consuming nearly a pound of fried beef in one sitting. So Congress can justify giving a special deduction -- and therefore a lower effective tax rate -- to these types of businesses because the argument can be made that some of the income allocated to the owners is not a return on the efforts of those owners and their employees, but rather on the capital the owners invested in the business to buy the equipment that in turn created part of the revenue.

**Q:** You know...that *does* kind of make sense. So the owners of the following businesses get no deduction: accounting, law, health, archit...

**A:** Stop right there. Section 199A modifies the definition of "specified service businesses" found in Section 1202 in a couple of important ways:

- It removes architects and engineers from the businesses barred from taking the 20% deduction. Why? These types of businesses were eligible, in limited circumstances, for a Section 199 "manufacturer's deduction" before that provision was eliminated as part of the new law. This is because, unlike accountants and lawyers, architects and engineers are an integral part of actually, you know...*building something*. As an accountant, I create nothing, unless you could a 10,000 word missive on just *one provision* of the new tax law "something."

- The definition of disqualified businesses for purposes of Section 199A ignores Sections 1202(e)(3)(B), which adds additional types of businesses to those in Section 1202(e)(3)(A) as the types of businesses barred from using Section 1202 (which we'll get into in a moment). Those types of businesses listed in (e)(3)(B), which are disqualified under Section 1202 but NOT under Section 199A, include:

    - banking,
    - insurance,
    - financing,
    - leasing,
    - investing,
    - farming,
    - any business giving rise to depletion,
    - any business of operating a hotel, motel, (Holiday Iiiin), or restaurant.

- So at this point, those bulleted businesses ARE eligible for the 20% of QBI deduction. But then Section 199A(d)(2)(B) adds MORE businesses that don't qualify for the 20% deduction, namely, the business of investing and investing management, trading, or dealing in securities, partnership interests, or commodities. So now those businesses are back OUT of the Section 199A deduction.

**Q:** So if I'm following you correctly, whether a business is a "specified service business" is going to be critical under the new law; after all, if you are a specified service business, you get no deduction. If you're not, 20% off the top, right?

**A:** Yes, it's going to be VERY important. And here's the problem: despite the fact that Section 1202 was enacted in 1993, we have almost no available guidance from regulations, administrative rulings, or judicial precedent to help us determine what is and isn't a "service business" for purposes of Section 1202. Here's why:

Section 1202 gives the holder of "qualified small business stock" an exclusion from gain upon the sale of such stock that has been held for longer than five years. Part of the requirements for qualifying as QSB stock is that the corporation can't be engaged in one of the service businesses described above in Sections 1202(e)(3)(A) and (e)(3)(B).

Thus, one would think that with a 24-year history, the "service business" requirement of Section 1202 would be well-worn territory. But the reality is, taxpayers didn't care about or use Section 1202 until 2010. Why? For all QSB stock issued up to 2010, the exclusion from gain was only 50%, with the other 50% of gain taxed at 28%. This meant that sellers of QSB stock paid tax on the gain at an effective rate of 14%, and since most taxpayers pay tax on long-term capital gains at 15%, prior versions of Section 1202 only conferred a 1% benefit on taxpayers. Hence, the provision wasn't used a whole heck of a lot.

Starting with stock issued in September of 2010, however, the exclusion of gain from QSB stock held more than 5 years increased to 100%. While this change makes the exclusion significantly more valuable, its relatively recent addition to the Code means that the new, improved version of Section 1202 didn't start to reap dividends to shareholders until September 2015. This, in turn, means that we're *just about* at the point where Section 1202 arguments should start showing up in the Tax Court. As a result, we may start seeing some debate about what constitutes a service business for purposes of Section 1202(e)(3)(A) -- and now, Section 199A -- and quite frankly, we're going to need it.

The definitional debate has already gone crazy on the interwebs. For example: what do we do about an insurance business? Section 1202(e)(3)(B) included "insurance" among its disqualified businesses, but then Section 199A chose to link its definition of disqualified businesses only to Section 1202(e)(3)(A). Does this mean that insurance businesses are good to go under Section 199A?

Maybe, but wait...what type of "insurance" business is Section 1202 referring to? The business of *selling* insurance, or the business of actually *creating* insurance package? I honestly have no idea, and I doubt many others do either. But we're going to have to find out.

**Q:** That does sound like a bit of a problem. But for now, we should just assume that lawyers, doctors, accountants, etc... are out and can't get the deduction?

**A:** You should know better than that. Nothing is that simple. Listen up: even if you're in one of those prohibited "specified service businesses," you can claim the 20% deduction, *provided your taxable income is less than $315,000 (if you're married filing jointly, $157,500 for all other taxpayers).*

**Q:** Those are the same thresholds as the ones we used for the W-2 limitations, right? So does that mean the phase-in rule is the same, where the ability to take the deduction for owners of "specified service businesses" is eliminated over a span of $100,000 of taxable income for married taxpayers?

**A:** You got it. But before we get into the phase-in rule for service businesses, let's just look at a couple of simple examples:

*Example 1: A is partner in a law firm. A is married, and has taxable income of $800,000. A's share of the income of the law firm is $700,000, his share of the W-2 wages of the law firm is $100,000, and his share of the unadjusted basis of the assets of the business is $20,000. A is entitled to no deduction, because a law firm is a specified service business and A's taxable income exceeds $415,000, meaning he is completely phased-out of any possible deduction.*

*Example 2: Same as in Example 1, except A's taxable income is $300,000, his share of the income of the law firm LLC is $200,000, his share of the W-2 wages is $60,000, and his share of the assets of the LLC is $40,000. Even though A is a lawyer, he may take the deduction because his taxable income is below $315,000, the start of the phase-in threshold. As a result, A can take a deduction of 20% of $200,000, or $40,000.*

***Q:*** But wait...in Example 2, 50% of A's share of the W-2 wages of the law firm is only $30,000. Shouldn't his $40,000 deduction be limited to $30,000 under the first W-2 limitation?

**A:** Great catch, but as is usually the case, you're wrong. Remember, when taxable income is less than $315,000, *the W-2 limitations don't apply*. As a result, A is entitled to the full $40,000 deduction.

**Phase-Out of Deduction for Specified Service Businesses**

**Q:** I follow those examples, but I'm almost afraid to ask: what happens to a lawyer, doctor, accountant, etc...if taxable income starts to exceed $315,000 for a married couple?

**A:** Yeah, I wish we could skip that whole thing, but this is where the magic happens. Just like with the W-2 limitation, the "get out of jail free" card Congress gives owners of specified service businesses -- the ability to take the 20% deduction -- starts to disappear once taxable income exceeds $315,000 for married taxpayers ($157,500 for everyone else), and is completely gone by the time taxable income hits $415,000 ($207,500).

To illustrate, assume the following example. It should seem familiar, as it was the same fact pattern we used before for a non-specified service business.

*A and B are married. A earns $300,000 from an S corporation. A's share of the W-2 wages paid by the S corporation is $40,000. A's share of the unadjusted basis of qualified property held by the S corporation is $0. B earns wages from her job, so that taxable income for A and B in 2018 is $375,000. This time, A is a lawyer, so his $300,000 of income from his S corporation is from a disqualified "specified service business."*

**Step 1:** We start by determining what A's deduction would have been if his taxable income had been less than $315,000. This is determined by taking the LESSER OF:

1. 20% of QBI of $300,000, or $60,000, or
2. the GREATER OF:
   - 50% of W-2 wages of $40,000, or $20,000, or
   - 25% of $W-2 wages of $40,000 + 2.5% of basis of property of $0, or $10,000.

But wait...don't forget that if taxable income is less than $315,000, not only does A get to take the deduction despite being a lawyer, in addition, the W-2 limits don't apply at that level of income. Thus, while A would generally be entitled to a deduction of only $20,000 in this case, had taxable income been $315,000 or less, he would have gotten the full $60,000.

Because taxable income is greater than $315,000, however, we must now determine how much of that $60,000 deduction A has to give up.

**Step 2:** We begin by figuring out, once again, how much of his $100,000 "phase-in" threshold A has exceeded, although now it's probably more accurately described as a "phase-out" threshold. The math looks the same as before:

| | |
|---|---|
| Taxable income: | $375,000 |
| Less: threshold: | ($315,000 ) |
| **Excess taxable income:** | **$60,000** |

A has gone $60,000 of the way through a $100,000 phase-in range. Putting this into percentage terms, here is how much of the benefit A should lose:

| | |
|---|---|
| Excess taxable income: | $60,000 |
| Divided by: Total phase-in range | $100,000 |
| **Percentage:** | **60%** |

**Step 3:** Thus, A should lose 60% of his benefit. Section 199A(d)(3)(B) accomplishes this by requiring A to compute his "applicable percentage," which is simply 100% - the percentage from Step 2:

| | |
|---|---|
| Starting Percentage | 100% |
| Less: percentage from Step 2: | (60%) |
| **Applicable percentage** | **40%** |

Now that we've determined the applicable percentage, A is only entitled to take into consideration, in computing his deduction, the applicable percentage of his allocable share of QBI, W-2 wages, and basis of assets. Like so:

| | **Allocable Share** | **Applicable % (40%)** |
|---|---|---|
| QBI | $300,000 | $120,000 |
| W-2 Wages | $40,000 | $16,000 |
| Basis of Assets | $0 | $0 |

Next, we determine A's deduction under the general rules using these new numbers:

**Step 4:** A's deduction is equal to the LESSER OF:

1. 20% of QBI of $120,000, or $24,000,
2. or the GREATER OF:
    - 50% of W-2 wages of $16,000, or $8,000, or
    - 25% of W-2 wages of $16,000 , or $4,000, plus 2.5% of basis, or $0, for a total of $4,000.

Thus, A's tentative deduction is $8,000. BUT DON'T FORGET...the W-2 limit doesn't apply if taxable income is less than $315,000, and is phased in as income goes from $315,000 to $415,000. So believe it or not, we now have to jump through those hoops as well. On to Step 5, which starts by figuring out the "get out of jail free" card the new law would have given A if the W-2 limit didn't apply at all:

**Step 5:** The "get out of jail free" card is the excess of the deduction allowed to A in the absence of a W-2 limit over what the deduction would be if the limit applied in full force. Thus, it is $16,000 ($24,000-$8,000).

Next, we have to reduce that excess benefit based on how much A's taxable income exceeds $315,000.

**Step 6:** A gets a TOTAL RANGE of $100,000 of taxable income -- from $315,000 to $415,000 -- before his $16,000 "get out of jail free" card is totally eliminated. So it makes sense that the $16,000 benefit should be reduced based on *how far A is into that $100,000 range.*

| | |
|---|---|
| Taxable income: | $375,000 |
| Less: threshold: | ($315,000 ) |
| **Excess taxable income:** | **$60,000** |

A has gone $60,000 of the way through a $100,000 phase-in range. Putting this into percentage terms, here is how much of his "get out of jail free" card of $16,000 A should no longer be entitled to;

| | |
|---|---|
| Excess taxable income: | $60,000 |
| Divided by: Total phase-in range | $100,000 |
| **Percentage of benefit A should lose:** | **60%** |

**Step 7:** A started with a benefit of $16,000: a $24,000 deduction when a $8,000 W-2 limit would have otherwise applied. Now that A has burned through 60% of that phase-in range, he should lose 60% of that $16,000 benefit, or $9,600. Thus, as a final step, we reduce A's $24,000 deduction by the amount of the "get out of jail free" card that he has lost because his income is too high:

| | |
|---|---|
| 20% of QBI deduction: | $24,000 |
| Reduction in $24,000 benefit because income is over $315,000: | ($9,600) |
| **Final deduction** | **$14,400** |

A's final deduction is $14,400. Once again, we know the system works, because if A's taxable income had been $415,000 or greater, his "applicable percentage" in Steps 2 and 3 would have been $0.

| | |
|---|---|
| Taxable income: | $415,000 |
| Less: threshold: | ($315,000 ) |
| **Excess taxable income:** | **$100,000** |

Then, the percentages:

| | |
|---|---|
| Excess taxable income: | $100,000 |
| Divided by: Total phase-in range | $100,000 |
| **Percentage:** | **100%** |

| | |
|---|---|
| Starting Percentage | 100% |
| Less: percentage from Step 2: | (100%) |
| **Applicable percentage** | **0%** |

Finally, we take his applicable percentage of QBI and wages:

| | **Allocable Share** | **Applicable % (40%)** |
|---|---|---|
| QBI | $300,000 | $0 |
| W-2 Wages | $40,000 | $0 |
| Basis of Assets | $0 | $0 |

Since QBI and W-2 wages are reduced to zero, A gets no deduction, which he shouldn't once taxable income exceeds $415,000.

**Q:** Let's put this all together: You said the W-2 limits are in place so that people can't convert wages into tax-favored QBI. Then, you said that certain service businesses can't use the deduction at all. But then you said that the W-2 limits don't apply AND service businesses can use the deduction when taxable income is less than $315,000 for married taxpayers ($157,500) for all others. So what is stopping an accountant who gets $300,000 in wages from setting up an S corporation as you mentioned, having the $300,000 paid to the S corporation, paying NO wages out of the S corporation, and converting $300,000 of wage income into $240,000 of QBI?

**A:** First of all, congratulations on your applied knowledge. Impressive. But this is where the inconsistencies of the current law take hold. Theoretically, you *could* form an S corporation to do exactly what you just proposed, but there's one issue: S corporations are required to pay wages to any shareholder who is also an officer and provides "significant services" to the corporation. This "reasonable compensation" standard has been around for decades, because Revenue Ruling 59-221 provides that S corporation flow-through income is NOT subject to self-employment tax. As a result, ever since 1959, S corporation shareholders have had tremendous motivation to forego compensation in exchange for distributions in order to save on payroll taxes. The IRS, of course, wants to collect its share of payroll taxes, so it will frequently attack S corporation shareholders who withdraw no wages but take substantial distributions, forcing them to reclassify a portion of distributions to salary and pay the corresponding payroll taxes.

And as you may have noticed, way up above, we said that QBI does NOT include "reasonable compensation" paid to the shareholder. This means that even if an accountant DID set up an S corporation to take $300,000 of what were once wages and pass them through as QBI, even though according to Section 199A this would fly, the IRS could come in and say that some or all of the $300,000 is reasonable compensation, which is NOT treated as QBI. So, for example, if the IRS reclassified $120,000 of the S corporation's income as reasonable compensation, only $180,000 of the S corporation's income would be eligible for the QBI treatment.

The same risk, however, does not exist with partnerships, because: 1. partnerships cannot pay wages to partners, only guaranteed payments, and 2. There is generally no "reasonable compensation" standard for partnerships, because partnership income is usually subject to self-employment tax. Therefore, a partner has nothing to gain by foregoing guaranteed payments in exchange for an increased share of flow-through income, because there would be no payroll tax savings.

Thus, it follows, an accountant or attorney COULD set up an LLC, rather than an S corporation, and convert up to $315,000 of wages into QBI. Of course, over time, the IRS could seek to establish the same type of reasonable compensation standard for partnerships that currently exists for S corporations, minimizing or closing this potential loophole.

**Q:** So if I'm following you, setting up an LLC could be a loophole. Until it's not. Got it. Anything else I should know?

**A:** A few things, yes. Let's take a look.

**Ancillary Issues**

**Q:** We figured out how to compute the 20% deduction. But where do we actually take it?

**A:** This is an interesting one: the deduction will NOT be on Page 1 -- as a deduction in computing adjusted gross income -- nor will it be an "itemized deduction" deducted on Schedule A and only available to those who itemize. Rather, it looks like the deduction will take its place on the top of Page 2 as a deduction available to all taxpayers, similar to the standard deduction or personal exemptions.

**Q:** Does it reduce a taxpayer's self employment income?

**A:** I don't see how it could, since, as discussed immediately above, it will show up as a deduction on Page 2 of the Form 1040.

**Q:** What about the individual alternative minimum tax? Can you take the 20% of QBI deduction against AMT taxable income?

**A:** Based on my reading, you certainly can. Section 199A(f)(2) provdes that when computing alternative minimum taxable income, you determine qualified business income" without taking into consideration any AMT adjustments or preferences as provided in Sections 55 -59. To me, this simply means that QBI is the same for AMT as it is for regular tax, and thus, the 20% deduction is computed the same way. And since the determination of alternative minimum taxable income starts with taxable income, and the amended Code provides no specific add-back to AMTI for the 20% deduction, I say we're good to go.

**Q:** Let's say my sole proprietorship, S corporation, or partnership generates a *loss*. There would obviously be no 20% deduction -- since there's no income -- but what happens to that loss in the next year if there *is* QBI in the following year?

**A:** It appears that when you have a loss in Year 1 from a QBI-type activity, *even if that loss is used in computing taxable income in Year 1* -- when you get to Year 2, that QBI loss "carries over" and reduces Year 2 QBI *solely for purposes of computing the 20% of QBI deduction*. To illustrate:

*A owns 50% of an S corporation. In 2018, the S corporation allocates a $100,000 loss to A. Because A materially participates in the S corporation, he is able to use the $100,000 loss in full to offset his wife's $200,000 of wages.*

*In 2019, the S corporation allocates $200,000 of income to A. While A would generally start the process of determining his Section 199A deduction by taking 20% of $200,000, Section 199A(b)(6) provides that in determining A's QBI deduction for 2019, the $200,000 of income must be reduced by the $100,000 of loss from 2018. Thus, while A will still include the full $200,000 of S corporation income in his taxable income in 2019, his deduction will be limited to $20,000 (20% * $100,000) rather than $40,000 (20% * $200,000).*

**Q:** What if I have a Section 199A deduction in a year I have a net operating loss? Does the deduction add to my NOL?

**A:** Nope. Section 172(d) has been amended to provide that a net operating loss does NOT include the Section 199A deduction.

**Q:** That *is* interesting. Any other weird rules/limitations I should know about?

**A:** Yes. Let's come full circle to where we started and remember that it's not just enough to determine the deduction subject to the rules described above. Once you've navigated the specified service business rules, the W-2 and adjusted basis limitations, and the phase-ins and phase-outs, you have to remember that there is also an overall limitation based on taxable income.

About 10,000 words, ago, we laid out the first rule of Section 199A. Under Section 199A(1)(a), once you've determined the 20% deduction, you've got to deal with an overall limitation, where the deduction is equal to the LESSER OF:

- the combined "qualified business income" of the taxpayer, or
- 20% of the excess of taxable income minus the sum of any net capital gain

Remember, the combined qualified business income is the 20% deduction we determined above, PLUS qualified REIT dividends PLUS income from a publicly traded partnership. But we can ignore those latter two items for our purposes; I'd prefer to look at the second element of the limitation, where the deduction is limited to 20% of the excess of taxable income over net capital gain. When will this limitation matter? Consider the following example:

A has $100,000 of QBI. In addition, A has $200,000 of long-term capital gains, $20,000 of wages, and $50,000 of itemized deductions, for taxable income of $270,000. A's deduction is limited to the lesser of:

- 20% of QBI of $100,000, or $20,000, or
- 20% of ($270,000-$200,000), or $14,000.

Thus, A's deduction is limited to $14,000. Why? Because while A has taxable income of $270,000 -- including $100,000 of QBI -- $200,000 of that taxable income will be taxed at favorable long-term capital gains rates. Thus, there is only $70,000 to be taxed at ordinary rates, meaning the 20% deduction should be limited to $70,000 of income; after all, you don't want to give a 20% deduction against income that's already taxed at a top rate of 23.8%!

**Q:** You've outdone yourself today. But since all of this law is brand new, there's really no way for me to check your math. How do I know you're right?

**A:** That's kind of the point. With no regulations, no form instructions, and most unfortunate of all, no one who helped craft the bill or vote on the thing who actually *understands what it says,* it may be a while before clarify is forthcoming. So for now, I"m all ya' got.

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