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How IRC 199A and the New 20-Percent Tax Deduction for Small Businesses Works (or Doesn’t) for Sole Proprietors

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Tax Reform Update

By now our reading public is familiar with the newly created deduction under IRC § 199A. Indeed, many of you have already spoken with your tax adviser and they may have suggested converting your LLC (if taxed as a partnership) or sole proprietorship into a Subchapter S corporation. Below we offer guidance on why that may or may not be a worthwhile endeavor.

For background, let’s quickly review the rules under IRC § 199A for claiming the new deduction; those wanting more detail should consult our article on the subject.

(The Minimum of) What You Need to Know About IRC 199A

Many business owners (other than those in personal service industries) will receive a deduction equal to the *lesser* of: (i) 20 percent of their earnings from business operations, i.e., excluding investment gains and interest income, or (ii) 50 percent of W-2 wages paid.

The owners of most real estate businesses in which the income is taxed to the business owners (through partnerships, LLCs, etc.) will offset their

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taxable rental income by the *lesser* of (i) 20 percent of their earnings from operations, i.e., excluding investment gains and interest income, or (ii) the sum of (x) 25 percent of W-2 wages paid, plus (y) 2.5 percent times the cost of depreciable assets.

Taxpayers below certain income *threshold amounts* ($157,500 single; $315,000 joint) are entitled to deduct 20 percent of their business income without regard to the wage or asset-based limits described above and without regard to the nature of their business. Taxpayers with income above the threshold amounts but below the *phase-out* amounts ($207,500 single; $415,000 joint) receive a ratable share of the deduction.

For those who appreciate the visual of a matrix:

Individual Taxable Income From all sources	Most Service Businesses	Other Businesses
Taxable income less than $315,000 (married, joint return)	Deduction = 20% of QBI (see statute for further refinements to the QBI deduction)	Deduction = 20% of QBI (see statute for further refinements to the QBI deduction)
Taxable income greater than $415,000 (married, joint return)	No Deduction	Deduction limited to the greater of Wage Limit or Wage/Basis Limit
Taxable income greater than $315,000 but less than $415,000 (married, joint return)	Deduction phased out ratably for income between $315,000 and $415,000	Wage Limit and Wage/Basis Limit are phased in for income between $315,000 and $415,000

For other taxpayers, the income threshold ends at $157,500 and the phase-out ends at $207,500.

Thus, it is clear that the best and easiest way to take advantage of this new deduction is to simply make less than $157,500 if you are single or

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$315,000 if you file jointly. You can even claim the deduction by adding $50,000 to the first number or $100,000 to the second number, though you will need to do some math to figure out precisely how much you will benefit.[1]

Challenges for Those With Taxable Income Above the Aforementioned Thresholds and Phase-outs

There are two obstacles created for those having taxable income above these threshold and phase-out amounts.

First, in order to take advantage of the deduction you will have to own a business that *falls outside* the definition of a specified service trade or business (SSTB). SSTBs are generally defined to include professions involving law, health, accounting, performing artists, consulting, athletics, financials services, actuarial services, brokerage services *or other trade or business where the principal asset is the reputation or skill of one or more employees or owners*. Also included as SSTB are investment management trading, and dealing in securities or commodities. Specifically excluded from the scope of SSTB are banking, insurance financing, leasing, investing, farming, and hotel/motel or restaurants as well as architects and engineers.

So, unless your service business is expressly carved out of the SSTB definition, the question is whether you are in a trade or business where the principal asset is the reputation or skill of one or more employees or owners. Those in the consulting or other service industry need to think about how their web site and elevator pitch differentiates their services from others in the market place. Many will no doubt realize that their business simply isn't among those that Congress intended to benefit from the new statute.

Those service businesses not clearly eliminated by their own marketing material may discover that the IRS will ultimately issue guidance that interprets the "reputation or skill" language broadly to include business contacts. But for now, it is reasonable to assume that if people are calling on you because it's you, and your expertise, skill or personality is what distinguishes you from the guy next door, then there is a serious risk that

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you fall within this specialized group and thus are ineligible for taking advantage of the IRC § 199A deduction.

Second, remember that for taxpayers with income over the phase out amount (and for those with income between the threshold amount and the phase-out amount who are computing a ratable deduction), the deduction is capped at the *lesser* of

(i) 20 percent * qualified business income or

(ii) The *greater* of

a) 50 percent of W-2 wages paid, or

b) The sum of (x) 25 percent of W-2 wages paid, plus (y) 2.5 percent times the cost of depreciable assets (subject to various time limits).

How IRC 199A Might Excite or Frustrate Taxpayers

Let's illustrate how these rules will work and then we can address whether incorporating and making an S election is an idea worth considering.

Assume dentist Debbie rents her dental chair and equipment in a larger dental clinic and her rent covers all the peripheral expenses, such as a scheduling assistant and a dental hygienist who bills his services separately. If dentist Debbie is a sole proprietor, she has no W-2 wages.[2] She is clearly in the health profession and thus in a SSTB. So, we do not even have to think about whether patients come to dentist Debbie for her skill or reputation. If dentist Debbie is single and making $150,000 after paying her rent (i.e., less than $157,500), she is entitled to a deduction equal to $30,000 (20 percent * 150,000) and thus pays federal income tax on $120,000 of her $150,000 in income.

In the second year of her practice, dentist Debbie's earnings double to a healthy $300,000 a year, so now she is well over the phase-out limit described above and forfeits any deduction under IRC 199A. Unless of course Debbie gets married and her spouse earns less than $15,000, in which case her deduction increases to $50,000 (20 percent * $250,000) because the family income is less than the threshold amount. Dentist

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Debbie and her new spouse now pay federal income tax on $250,000 of Debbie's $300,000 income.

Now, let's consider dentist Debbie's brother, landscaper Larry, who is unmarried and in the first year of his landscaping practice. Larry didn't go to dental school but instead pursued his passion as a landscaper and operates his business as a sole proprietorship. Unless Larry is a distinguished landscaper, he might be able to argue that it is not his personal skill or reputation for which people are paying. Assuming the same first year income as his sister of $150,000, landscaper Larry can likewise take full advantage of the IRC 199A deduction and pays the same tax on the same net income as his sister.

Year two is also good for Larry and, like his sister, Larry's income doubles to $300,000. Even though landscaping is not clearly treated as an SSTB, unless Larry gets married to a low-earning spouse, he too would forfeit the benefit of the IRC 199A deduction. But why you ask? Because for taxpayers over the phase-out amount ($207,500 for a single filer), the IRC 199A deduction is computed based on the *lesser* of 20 percent of the taxpayer's taxable income from the qualified business or 50 percent of the W-2 wages paid. Since Larry is self-employed as a "sole proprietor" in the language of tax law and doesn't have any employees, he has zero W-2 wages and therefore his IRC § 199A deduction is zero.

If Larry pays any independent contractors for assistance in his business — for example, someone who helps with marketing or bookkeeping — Larry might consider converting those independent contractors to employees, even if they are only part time. Of course, many people in Larry's position don't want employees because of the hassle.

But Larry's mother didn't raise a fool, so Larry calls Tommy, his tax advisor. Tommy suggests that Larry might benefit from incorporating his sole proprietorship, making a Subchapter S election, and paying himself a reasonable salary.[3] (Larry might not want to deal with employees, but having his corporation hire him seems like a reasonable cost to pay if it means that he can claim a material tax benefit.)

Corporations, including (especially!) those subject to S elections must pay owner-employees "reasonable compensation." Fifty percent of the wages Larry pays himself as reasonable compensation will support the

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IRC § 199A deduction — up to 20 percent of the net (after-wages) income from his qualified business.

Tommy tax advisor then asks Larry what would be a reasonable compensation. Larry refuses to spend money retaining a compensation consultant. With the help of the internet, Larry discovers that the average landscaper earns $80,000/year, so Larry suggests that should constitute a reasonable compensation level. Paying himself $80,000 from the $300,000 income from his landscaping business would leave the S corporation $220,000 that would flow through to Larry in addition to his reasonable compensation, so Larry's pre-tax income remains the same. Larry does the math: 20 percent of $220,000 equals $44,000. Fifty percent of $80,000 equals $40,000. Because the IRC 199A deduction is the lesser of those two equations, Larry is limited to a $40,000 tax deduction. But wait, there's more Tommy explains: Larry would now pay self-employment taxes only on the $80,000 salary and not on the $220,000 of flow-through income from his S corporation. Larry is liking this proposal even more and is happy to call it a day and get out of Tommy's office.

Tommy tax advisor then channels Lieutenant Columbo and asks one more question, "If the average compensation of a landscaper is $80,000, why does Tommy earn $300,000 from his business?" Larry starts to explain that his skill and reputation allow him to charge higher rates, and remembers that those traits probably make Larry an SSTB that would eliminate (or at least materially curtail) the IRC 199A deduction if his income is above the threshold amount. Larry landscaper shrugs his shoulders and suggests that maybe he is just lucky.

Tommy didn't just fall off the turnip truck, so he asks the corollary to the "reasonable compensation of the owner" question — What is a reasonable level of profit for a corporation that has no other employees and no material assets other than a lawnmower? If Larry's S corporation had material capital invested in the business, or employees off of whose sweat the business could profit, then maybe Larry's S corporation could justify its $220,000/year of net profit. But the S corporation has only one employee, Larry, and even Larry is hard-pressed to argue that he would have accepted a job at any landscaping company for $80,000 when he is making $300,000 as a sole proprietor.

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Always a little aggressive when it comes to taxes, Larry asks Tommy whether "they" couldn't just claim the $80,000 reasonable compensation amount and see if the IRS objects. Tommy explains that the 20 percent accuracy related penalty in the Tax Code was amended to add a special provision to discourage just such behavior. A penalty is imposed whenever a taxpayer who claims the IRC 199A deduction has a substantial understatement in tax liability that exceeds the greater of $5,000 or 5 percent of the tax "required" (i.e., after audit or litigation) to be shown on the return (instead of the usual 10 percent threshold) unless the original return position is supported by "substantial authority."

In the end, Tommy and Larry decide that, absent some justification for material earnings at the S corporation, his "reasonable compensation" would probably be pretty close to the total income of the S corporation, and thus too high to justify the cost and distraction of setting up and maintaining a subchapter S corporation.

Dentist Debbie hears the news from her brother Larry and wonders if her situation is any different, so she puts in a call to Tommy the tax advisor. First, the tax advisor reminds Debbie that since she is married her $300,000 deduction already supports the maximum IRC 199A deduction (20 percent * $300,000) without regard to whether any wages have been paid because Debbie is under the phase-out amount. Debbie is delighted — she earns the same income as her brother Larry but pays 20 percent less tax even though she is in an SSTB!

However, Debbie then explains that her spouse is a deadbeat who doesn't earn a living, so she is thinking of getting a quick divorce that could be final before year-end. Tommie tells Debbie that divorce might be a good life decision, but Debbie would then be out of luck in the tax world because her earnings would be above the phase-out amount for single filers. "Even if I incorporate my dental practice and make an S election?" Debbie inquires. "Afraid so," Tommy replies, "incorporating would be a waste of money regardless of reasonable compensation since your taxable income would still be over the threshold." Debbie, in an exasperated tone, suggests that maybe she will postpone divorce until next January so she can take advantage of the IRC 199A deduction in the current year. Postponing divorce[4] may be an acceptable life choice, but Tommy explains that Debbie still doesn't need to incorporate because W-2 wages are only important for dentists (and other SSTBs) above the

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threshold amount but below the phase-out amount; below the threshold amount Debbie is entitled to the full deduction without regard to W-2 wages paid and above the phase-out amount she is not entitled to claim a deduction regardless of any W-2 wages she pays.

Debbie and Larry call Tommy one last time and ask if there is anything they can do to take advantage of IRC 199A. Tommy responds that they could both stop working and go on vacation when their incomes hit the threshold amount. Debbie and Larry now appreciate how tax policy can influence behavior.

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If you have any questions regarding the new tax law, please don't hesitate to contact a member of our Tax Team.

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[1] Some taxpayers may now discover enhanced benefits of nonqualified deferred compensation arrangements that reduce their taxable income to enable them to take advantage of the IRC 199A deduction. Of course reducing taxable income of the qualified business also lowers the amount of the deduction.

[2] References herein to a sole proprietor include individuals who operate their business via a single member LLC (without an election to be taxed as a corporation) and those who just consider themselves independent contractors. Further, much of this discussion would apply equally well to partners of a partnership that has pays little or no W-2 wages relative to net income.

[3] Incorporation for tax purposes includes organizing as an LLC but electing to be taxed as a corporation. An S election can be made at the same time.

[4] Tommy makes a note to separately explain to Debbie, that under TCJA, alimony will be treated completely differently for divorces finalized in and after 2019. So if Debbie is going to have to pay spousal support or alimony

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to her low-income spouse, it is probably better tax wise to finalize her divorce in 2018.

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