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Choice of Entity Calculus Modified by Tax Reform in Light of the Qualified Business Income Deduction: IRC Section 199A

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On December 22, 2017 President Trump signed H.R. 1 into law, bringing sweeping changes to tax law. This new law was known as the Tax Cuts and Jobs Act (TCJA) — that is, until a parliamentarian noticed that the bill needed to qualify as a reconciliation bill and thus could not have a fancy name. Nevertheless, we tax practitioners became attached to the name and acronym so we continue the convention here.

Below we offer insight on a single aspect of the TCJA known as the *Qualified Business Income Deduction*, aka the *Small Business Deduction*, the *20% Flow-Through Deduction* and our favorite name — the *Universal Employment for Tax Advisors Provision*.

For those who appreciate simplicity, here is the minimum of what you need to know:

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 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.

To determine whether and how the basic rules described above actually apply to a particular taxpayer,

a little more substance, and many more acronyms, are needed.

Business owners, including businesses owned as a sole proprietorship, partnership, limited liability company taxed as a partnership, S-corporation, estate or trust may be entitled to an income tax deduction equal to 20 percent of the owner's qualified business income ("QBI" because no tax discussion is complete until you have mastered some acronyms). The question of personal eligibility for the QBI deduction turns on four questions:

1. Does the activity in question constitute a qualified trade or business (yup, that's a "QTB")?
2. Does the activity fall with specified service trade or business (yup, an "SSTB") for which the QBI deduction is potentially limited or eliminated?

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3. Does the taxpayer's taxable income (from all sources) exceed statutory income thresholds, triggering additional limitations on the QBI deduction tied to wages paid or depreciable assets owned by the trade or business?
4. What income qualifies as "qualified business income"?

Qualified Trade or Business

New section 199A appears to incorporate a broad definition of *trade or business* that hopefully will allow most businesses to qualify as a QTB. However, until further guidance is provided by the IRS, there is an unanswerable question of when passive investment activities and passive real estate ownership constitutes a QTB. One of the authors is cynical and believes that passive triple net leased real estate, managed by a separate (and usually related) entity, will qualify as a QTB because that is how President Trump operates his real estate empire. The other author is more of a strict constructionist and expects that the definition of a QTB will be consistent with the general definition of a trade or business applied for federal income tax purposes.

Qualified Business Income

QBI is basically income from operations, but its computation isn't always straightforward. QBI starts with income, gain, and loss derived from U.S. qualified business and trade activity and includes qualifying REIT dividends and income from publicly traded partnerships. Wages and salary do not qualify as QBI. Investment interest, dividends, and capital gains also do not qualify as QBI. The QBI deduction as calculated cannot exceed the excess of the taxpayer's taxable income less net capital gains. The calculation of the QBI recognizes that a taxpayer may have more than one trade or business and requires the separate determination of QBI and the limits separately for each trade or business. A parallel rule allows a "QBI" deduction under section 199A for income from an agricultural or horticultural cooperatives.

Specified Service Trade or Business Phase-out

Section 199A limits the benefit of the QBI deduction for most businesses in any service industry (lawyers, accountants, doctors, and other professions in which the principal asset of the business is the reputation or skill of the businesses employees, but not architects and engineers). Taxpayers with QBI income from any of the specified service industries may still claim the QBI deduction but the deduction is phased out if the taxpayer's taxable income exceeds $157,500 for single taxpayers (or $315,000 if the taxpayer is married filing joint returns). The phaseout of the QBI deduction is complete when the taxpayer's taxable income exceeds $207,500 ($415,000 on joint returns).

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High Income Taxpayer Phase-out

Section 199A further differentiates taxpayers into three bands based on their taxable income, and the QBI deduction is calculated differently for each band.

- For taxpayers whose income is below the *threshold amount* ($157,500 or $315,000 for married couples filing joint returns), the QBI deduction is 20 percent of the taxpayer's QBI. As we learned above, taxpayers in this band receive the deduction even if their income is from an SSTB.

- For taxpayers whose taxable income is above the *phase-out* limit ($207,500 or $415,000), the eligible QBI deduction is the *lesser* of (x) 20 percent of operating income or (y) the *greater* of (i) 50 percent of the W-2 wages paid by the qualified trade or business (including wages paid to the taxpayer) (the "Wage Limit") or (ii) the sum of 25 percent of the W-2 wages (as so defined) plus 2.5 percent of the unadjusted basis of qualified depreciable property used in the qualified trade or business (the "Wage/Basis Limit"). For this purpose, the term "unadjusted basis" is generally equivalent to cost basis. See below for a cleaner presentation of the mathematical formula with a few additional nuances.

- For taxpayers whose taxable income exceeds the threshold amount but is less than the complete phase-out amount (the "phase-out range"), computing the QBI deduction gets complicated: (a) If the taxpayer's applicable Wage Limit or Wage/Basis Limit exceeds the 20 percent QBI amount, then the taxpayer's QBI deduction is based on the taxpayer's 20 percent QBI amount; or (b) If the taxpayer's 20 percent QBI amount is greater than the taxpayer's applicable Wage Limit or Wage/Basis Limit, then the taxpayer's 20 percent QBI amount is used to calculate the QBI deduction but the 20 percent QBI amount is reduced ratably based on the ratio of the taxpayer's taxable income in excess of the applicable threshold amount. In other words, for higher income taxpayers, the QBI deduction is limited to the lesser of 20 percent QBI or the applicable Wage Limit or Wage/Basis Limit. But, in the phase-out range, the 20 percent QBI amount, if applicable (i.e., the 20 percent QBI amounts is greater than the applicable Wage Limit or the Wage/Basis Limit), will be reduced ratably based on the taxpayer's taxable income over the threshold amount. Got that?

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Section 199A Deduction: Income Levels and Limitations

	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/Asset 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/Asset Basis Limit are phased in for income between $315,000 and $415,000

(For other taxpayers, the income phase-out ranges are $157,500 and $207,500)

All told, the QBI deduction represents a potentially significant tax reduction for owners of businesses, excluding only the shareholders of C Corporations from its scope. Of course, the new income tax rate of 21 percent for C Corporations is a significant tax reduction in itself. These competing tax reductions make choice of entity and other business structural decisions critical to taxpayers.

Complicated? Sure. But now that you have mastered the rules, the flow chart on the following page will walk you through the determination of whether a taxpayer can benefit from this legislative largess. Thereafter, we explain the formula for computing the amount of the deduction in a way that should make sense in the overwhelming majority of situations.

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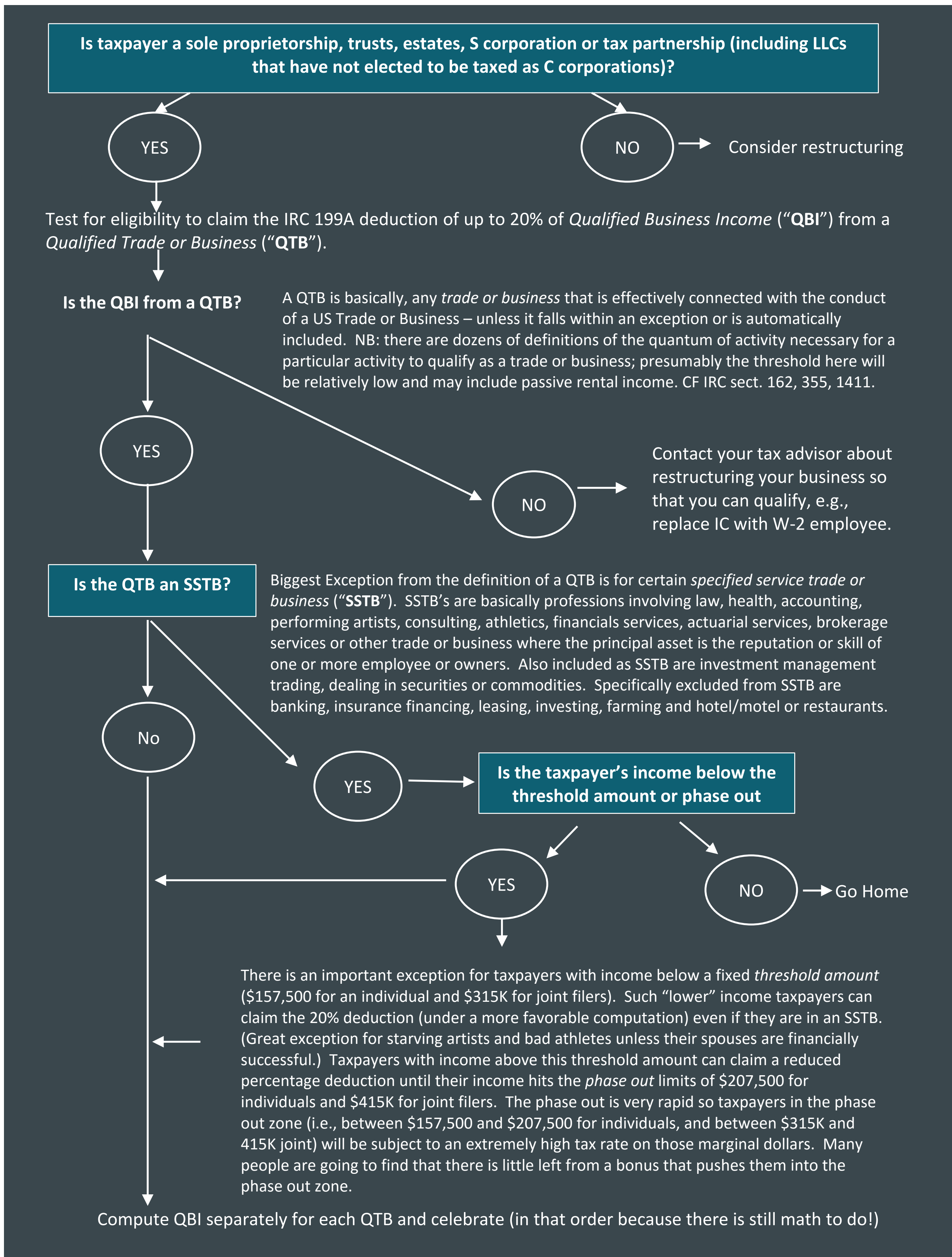

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Computation of the Deduction Under IRC 199A(a) — (Ignoring Thresholds/Phase-outs and Other Complications):

For taxpayers with income over the phase out amount, the deduction is applied to the sum of (1) + (2):

(1) The *lesser* of

(A) *Combined Qualified Business Income* (CQBI)[1], or

(B) 20 percent of the excess of taxable income over the sum of net capital gain plus qualified co-op dividends

Plus (+)

(2) The *lesser* of

(A) 20 percent of qualified coop dividends, or

(B) Taxable income determined without regard to net capital gain

CQBI, per 199A(b)(1), equals the *sum* of

(A) The *deductible amount* (DA) for each QTB

Plus (+)

(B) 20 percent of qualified REIT dividends and qualified publicly traded partnership income

The DA per 199A(b)(2) for each QTB is the *lesser* of:

(A) 20 percent of the taxpayer's QBI with respect to such QTB,

OR

(B) The greater of:

(i) 50 percent of wages paid by the QTB,

OR

(ii) 25 percent of such W-2 wages, and 2.5 percent times the *unadjusted* basis in tangible (i.e., not IP) depreciable (i.e., not inventory) property for the 10 years (for assets with depreciable life of 10 years or less) or for the regular (not ADS) depreciation life for real property — even if the asset is immediately deductible under the new IRC 179 rules or capital cost recovery acceleration rules).

QBI thus excludes net Capital G/L, all other dividends, interest and other investment related income and losses.

[1] For clarity, the definition of CQBI has nothing to do with income at all — it is the sum of certain *deductions* for *each* QTB.

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Statutory Scheme Yields Strange Results Based on the Form of Business Chosen and Whether Business Uses Independent Contractors or Employees

QBI excludes amounts paid as reasonable compensation to shareholders as W-2 salary or guaranteed payments paid to members (and, only to the extent provided in regulations reasonable compensation that would otherwise be payable to a partner in exchange for services).

This rule means that the amount of a particular taxpayers Section 199A deduction can be materially different depending on the form of business through which the QTB is conducted. For example, assume an architect (not an SSTB but filing a single income tax return) earns $500,000 of QBI by modifying and selling homes she designed long ago. Her QTB has no W-2 employees but her QBI is determined after paying $100,000 to a half dozen independent contractors. She is over the phase-out limit so the math should be easy, right? If the taxpayer is a sole proprietor then she can't pay herself a wage so her IRC 199A deduction is zero because of the 50 percent Wage Limit.

If this taxpayer is well advised, she might hire those same independent contractors as part time employees (reducing the hourly IC amounts to reflect the added employment taxes imposed on employers), in which case she would be entitled to a $50,000 section 199A deduction ($100,000 of wages*50 percent is less than $500,000 QBI*20 percent). If she doesn't want to deal with employees, her tax advisor could recommend that she operate the identical QBI through an S corporation and pay herself a reasonable salary of $140,000, leaving $360,000 of QBI. She is well above the phase-out threshold for taxpayer's filing a single return. In that case, she is entitled to a $70,000 tax deduction (50 percent of her $140,000 of wages is slightly less than 20 percent*of her $360,000 of QBI). Alternatively, she could operate via an S corporation with the same $140,000 of reasonable compensation, and convert those ICs into employees, and thereby increase her section 199A deduction to $72,000 (20 percent*360,000 is less than 50 percent of $240,000 of wages).

And if this same taxpayer operates through a partnership and her share of partnership income was the exact same amount but she receives $140K of guaranteed payment because partners are not allowed to be employees? The guaranteed payment is excluded from QBI which reduces her QBI to $360,000 but in the absence of any wages the deduction is again zero.[2]

Of course, if our architect is employed by a company in which she is not an owner, then she gets no deduction. What if our architect had instead gone to law school and earned the exact same amounts under the exact same structures? She would get no deduction because law is one of the SSTBs — those specified trades or business described in small print in the middle of that complicated flow chart above — that are not eligible for the deduction unless their income is below the phase out amount.

[2] Tony Nitti's recent article in *Forbes* does a wonderful job demonstrating the absurd consequences of this rule. Nitti, T., *The New "Qualified Business Income Deduction" varies Based on Your Business Type – or Does It?,* Forbes, Jan. 4, 2018.

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Other Problems With New IRC 199A

1. What is reasonable compensation outside of the corporate context since there is virtually no jurisprudence? What happens in a partnership (including an LLC taxed as a partnership) where the IRS has repeatedly said that a partner cannot be paid W-2 wages so the wage limitation effectively precludes any 199A deduction! Or a sole proprietorship?

2. Determining the quantum of activity sufficient to constitute a QTB, especially for an otherwise passive real estate business or one that contracts for management (even with a related party)?

3. Defending the policy of taxing some people at 80 percent of what other people are taxed because they are in different lines of business. E.g., the owner of the car wash may pay 20 percent less tax than the speech therapist even if they earn the same amount of income. Or the owner of the restaurant may pay a lower tax rate than the bartender. Imagine the audit when the accountant earning $315,000 per year is paying a 20 percent lower tax rate than the IRS agent.

4. The inevitable outcry when taxpayers in a SSTB with income below the phase out amount, but above the threshold amount, discover that their marginal dollars are taxed at federal tax rates as high as 85 percent.

5. The absence of principle/policy behind this deduction (other than the demand of the small business lobby) will make regulation hard and compliance whimsical.

6. Complexity added to choice of entity analysis and need for periodic re-examination. S corporations may again prove preferable to LLCs because they clearly allow reasonable compensation.

7. Importance of combining assets to maximize the QTB asset base on which the 2.5 percent amount is imposed. Move that private jet into the company!

* * *

We know we threw a lot at you. Should you have any questions regarding the new tax law, we strongly encourage you to consult legal counsel.

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