NTxEA Chapter of TxSEA
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Tax Cuts and Jobs Act (TCJA)

New Code Sec. 199A the "ACT"

Setting sail into the unknown!

What is the Tax Cuts and Jobs Act? (TCJA)

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 next year?

LOL

Simple? Post cards? Really?

Entity Choice Under Current Law

- C corporation
- Sole proprietorship
- S corporation
- Partnership

Entity Choice Under TCJA

- C corporation
- Sole proprietorship
- S corporation
- Partnership

Tax Rates Under Current Law

- C corporation – 50.47%
- Sole proprietorship – 42.8%
- S corporation – 42.8%
- Partnership – 42.8%

Tax Rates Under Current Law

- C corporation:
  - owners of a C corporation pay a combined total rate on the income earned by the business of 50.47% (35% + (65% * 23.8%)).

Tax Rates Under TCJA

- C corporation – 39.8%
- Sole proprietorship – 37%
- S corporation – 37%
- Partnership – 37%

Tax Rates Under TCJA

- C corporation – 39.8% (21% + (79% x 23.8%))
- Sole proprietorship – 37% x 20% deduction = 29.6%
- S corporation – 37% x 20% deduction = 29.6%
- Partnership – 37% x 20% deduction = 29.6%

What is the Qualified Business Income (QBI) deduction?

A 20% deduction, subject to a massive tangle of ***limitations, terms of art, thresholds, and phase-ins and phase-outs,*** with ***one or two*** critical definitions that could potentially jeopardize the whole thing!

Who qualifies for the QBI deduction?

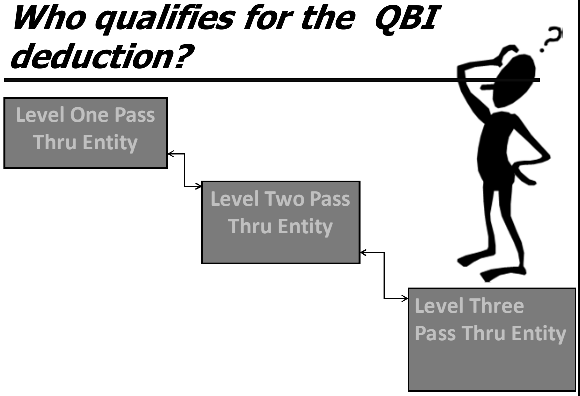
Å Sole proprietorships

Å S corporations and partnerships

Å Stand-alone rental properties reported on Schedule E

Å Trusts and estates that own an interest in a flow-through business

Who qualifies for the QBI deduction?



How does the 20% deduction work?

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.

What is Combined Qualified Business Income (QBI)?

As defined in Section 199A(c):

- ordinary income -- less ordinary deductions earned from a sole-proprietorship, S corporation, or partnership
- QBI does not include, however, any wages earned as an employee in that company
- Beginning in 2018, two people could 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

What is Qualified Business Income Deduction (QBID)?

1. THE SUM OF:
   - The LESSER OF:
     - 20% 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

What is ***NOT*** Combined Qualified Business Income (QBI)?

- Short-term capital gain or loss;
- Long-term capital gain or loss;
- Dividend income; or,
- Interest income
- Wages to the individual
- Guaranteed payments from the business
- Income that's not "effectively connected with the conduct of a U.S. trade or business"

Rental as Qualified Business Income

- What we know: clearly, the 20% deduction is intended to apply to rental income
- What we *don't* know:
  - The term "trade or business" is ***not*** well defined by tax law
  - Since there are a number of different interpretations of what constitutes a trade or business based on different Sections of the Code, which do we apply?
    - Code Sec. § 162 Trade or Business Expenses (highest standard)
    - Code Sec. § 1202 Partial Exclusion for Gain/Small business Stock
    - Code Sec. § 1411(c)(2) Trades & businesses which NII tax applies

Computing the QBI Deduction

- If ordinary income from an S-corp., partnership or sole proprietorship is $400,000 x 20% = $80,000
- **Limitations** :
  - **W-2**
    - 50% of *TP's allocable share* of the "W-2 wages" paid by the business, or
    - 25% of *TP's allocable share* of the "W-2 wages" paid by the business
    - PLUS 2.5% of *TP's allocable share* of the "unadjusted basis" immediately after acquisition of all "qualified property"

Computing the QBI Deduction

- Example: Jay is a 20% Owner of ABC, LLC
  - QBI = $1,500,000
  - W-2 wages = $500,000
  - Unadjusted Property Basis = $1,000,000

Computing the QBI Deduction

- Jay is entitled to a deduction equal to the LESSER OF:

	Total	Jay's Allocable Share (20%)	20% Deduction
QBI	$ 1,500,000	$ 300,000	$60,000

Computing the QBI Deduction

- And the GREATER OF:

	Total	Jay's Allocable Share (20%)	50% Limitation
W-2 Wages	$ 500,000	$150,000	$ 75,00

Computing the QBI Deduction

- or the TOTAL OF:

	Total	Jay's Allocable Share (20%)	25% Limitation	2.5% Limitation	Total
W-2 Wages	$ 500,000	$ 150,000	$ 37,500		$37,500
Unadjusted Property Basis	$ 100,000	$ 30,000		$750	$ 750
Total					$38,250

Computing the QBI Deduction

- Thus, Jay is entitled to a deduction of the <u>lesser of:</u>
  - $60,000, or

  the <u>greater of:</u>
  - $75,000, or
  - $38,250
  - Therefore, Jay's deduction = $75,000

Computing the QBI Deduction

Section 199A(b)(6)(A) "qualified property" =

- **Tangible property**
- **Used for production of QBI**

Computing the QBI Deduction

Depreciable period?

- Starts date in service
- Ends the LATER of:
  - 10 years, or
  - Last day of last full year in asset's regular depreciation period

Computing the QBI Deduction

Four Notes:

1. Section 199A(b)(2)(B)(ii) requires "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

Computing the QBI Deduction

Four Notes:

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 / her allocable share*
4. A partner in a partnership must allocate their share of asset basis in the same manner in which they are allocated depreciation expense from the partnership.

Computing the QBI Deduction

Q: What's the point of this second limitation, the one that allows for the 20% deduction up to 25% of the share of W-2 wages PLUS 2.5% of the share of the unadjusted basis of the property?

A: A prime example of how Capitol Hill makes the sausage

Computing the QBI Deduction

- Under the House bill, rental income would have been taxed at a top rate of 25% - ***if ALL*** income was "passive"

- Under the Senate bill, no differentiation between "passive' & "non-passive" – but was capped @ 50% of each owner's share or W-2 wages of business!

Computing the QBI Deduction

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

Computing the QBI Deduction

- Result: *Donnie's entitled to the LESSER OF:*
  - *20% of QBI of $1,500,000 ($300,000) or*
  - *2.5% of the unadjusted asset basis of $10,000,000 ($250,000).*

- *As a result, Donnie grabs a $250,000 deduction*

Computing the QBI Deduction

- Example: *Donnie owns a 100% interest in 20 commercial rental properties through 20 LLCs that pay no W-2 wages and an S-Corp that pays substantial W-2 wages. Why not group all of Donnie's business and rentals together?*

Computing the QBI Deduction

So the ACT is great for Donnie and his BIG landlord buddies, what about smaller landlords?

Computing the QBI Deduction

Example: Dean earns $150,000 from his small business LLC, but the business pays, only $10,000 of wages and has no significant property.

Computing the QBI Deduction

Computation:

- LESSER OF:
- QBI of $150,000 * 20%, or $30,000, or
- 50% of W-2 wages of $10,000, or $5,000

Computing the QBI Deduction

Section 199A(b)(3)(A) states:

IF TAXABLE INCOME =/< $315,000, then ignore the W-2 limitation!

But it phases out between $315,000 and $415,000

Computing the QBI Deduction

Example: Eric earns $200,000 from his S-Corp that paid $30,000 in wages, has no qualified property. Spouse Laura, earns $50,000 in wages and they jointly have $20,000 interest income; total income = $270,000.

Computing the QBI Deduction

Computation:

LESSER OF:

1. QBI of $200,000 * 20%, or $40,000, or
2. 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

Computing the QBI Deduction

OK, but what if the taxable income is between $315,000 and $415,000?

How is that computed?

STEP ONE: What would Eric's deduction have been if his taxable income was less than $315,000?

Determined by taking the LESSER OF:

- 20% of QBI of $300,000, or $60,000, or
- 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

STEP TWO:

W-2 limit doesn't apply on taxable income <$315,000 = $60,000 deduction

W-2 limit does apply on taxable income <$315,000 = GREATER OF:

1. 50% of $40,000 or $20,000, or
2. 25% of $40,000 plus 2.5% of $0, or $10,000.

STEP Three:

Eric gets a TOTAL RANGE of $100,000 of taxable income that the $40,000 benefit that should be reduced based on *how far **Eric** is into that $100,000 range*

STEP Three:

Taxable Income	$375,000
Less: Threshold	($315,000)
= Excess Taxable	$60,000
Excess Taxable	$60,000
÷ Phase in Range	$100,000
= % Benefit	60%

FLASH: NOT ALL BUSINESSES ARE ELIGIBLE FOR THE 20% DEDUCTION.

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."*

NOT ALL BUSINESSES ARE ELIGIBLE FOR THE 20% DEDUCTION.

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."

NOT ALL BUSINESSES ARE ELIGIBLE FOR THE 20% DEDUCTION.

Section 199A modifies the definition of "specified service businesses" found in Section 1202 in a couple of important ways:

1. It removes architects and engineers
2. It ignores Sections 1202(e)(3)(B) of additional disqualifying businesses: banking, insurance, financing, leasing, investing. Farming, any giving rise to depletion, any operation of hotel, motel or restaurant

NOT ALL BUSINESSES ARE ELIGIBLE FOR THE 20% DEDUCTION.

Therefore: 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 (SSB), you get *NO* deduction. If you're not an SSB, take 20% off the top!

Side Bar:

Section 1202 gives the holder of "qualified small business stock" (QSB) a 50% 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 previously in Sections 1202(e)(3)(A) and (e)(3)(B).

Side Bar:

Beginning September 2010, Section 1202 gives the holder of "qualified small business stock" a 100% exclusion from gain upon the sale of such stock that has been held for longer than five years.

NOT ALL BUSINESSES ARE ELIGIBLE FOR THE 20% DEDUCTION.

Remember:

"…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."

Example 1.

Larry is partner in a law firm. Larry is married, and has taxable income of $800,000. Larry '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. Larry is entitled to no deduction, because a law firm is a specified service business and Larry's taxable income exceeds $415,000, meaning he is completely phased-out of any possible deduction.

Example 2.

Same as in Example 1, except Larry'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 Larry 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, Larry can take a deduction of 20% of $200,000, or $40,000.

Example 3.

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

STEP ONE: What would Eric's deduction have been if his taxable income was less than $315,000?

Simple: at that level of income, the W-2 limits don't apply, and Eric would take a deduction of 20% of QBI or $300,000 or $60,000

STEP TWO:

W-2 limit **doesn't** apply on taxable income <$315,000 = $60,000 deduction

W-2 limit **does** apply on taxable income >$315,000 = GREATER OF:

1. 50% of $40,000 or $20,000, or
2. 25% of $40,000 plus 2.5% of $0, or $10,000.

STEP Two:

Taxable Income	$375,000
Less: Threshold	($315,000)
= Excess Taxable	$60,000
Excess Taxable	$60,000
÷ Phase in Range	$100,000
= % Benefit	60%

STEP Three:

Eric gets a TOTAL RANGE of $100,000 of taxable income that the $40,000 benefit that should be reduced based on *how far Eric is into that $100,000 range*

STEP Three:

Starting %	100%
Less: % from Step 2	-60%
Applicable %	40%

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

STEP Four:

- Eric's deduction is equal to the LESSER OF:
- 20% of QBI of $120,000, or $24,000,
- 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.

STEP Five:

- The excess of the deduction allowed to Eric 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).

STEP Six:

Taxable Income	$375,000
Less: Threshold	($315,000)
Excess Taxable	$60,000
Excess Taxable	$60,000
÷ Phase in Range	$100,000
= % Benefit	60%

STEP Seven:

20% of QBI Deduction	$ 24,000.00
Reduction in $24,000 Benefit due to Taxable > $315,000 (40% x $24,000=)	$ (9,600.00)
Final Deduction	$ 14,400.00

WHERE DO WE TAKE THE 20% DEDUCTION?

- NOT on 1040 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.
- Probably towards the top of 1040 page 2, as a deduction available to all taxpayers, similar to the standard deduction or personal exemptions

OTHER ISSUES

- AMT
- Self-employment
- Losses instead of profits
- NOLs
- Overall taxable income

OTHER ISSUES

- **AMT -**
  - Section 199A(f)(2) provides 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

OTHER ISSUES

- Self-employment:
  - Can't see any effect as deduction probably on 1040 page 2, as a deduction available to all taxpayers, similar to the standard deduction or personal exemptions

OTHER ISSUES

- Losses instead of profits:
  - If a loss in Year 1 from a QBI-type activity, *even if that loss is used in computing taxable income in Year 1* -- when get to Year 2, that QBI loss "carries over" and reduces Year 2 QBI *solely for purposes of computing the 20% of QBI deduction*

OTHER ISSUES

- NOLs
  - Not affected as Section 172(d) has been amended to provide that a net operating loss does NOT include the Section 199A deduction

OTHER ISSUES

- Overall taxable income
  - 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

Example

- Larry has $100,000 of QBI. In addition, Larry has:
  - $200,000 of long-term capital gains,
  - $20,000 of wages, and
  - $50,000 of itemized deductions, for taxable income of
  - $270,000. Larry'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.

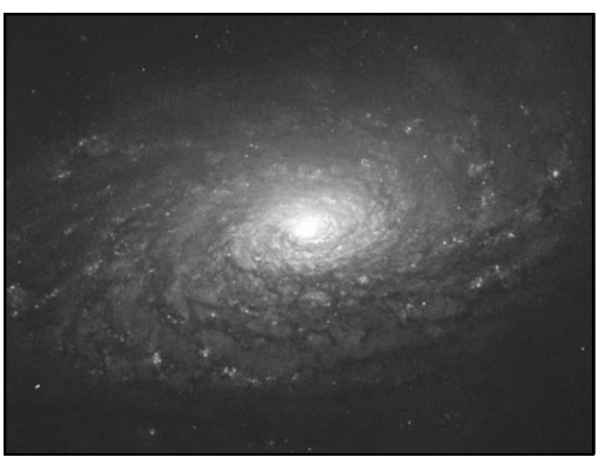
PLANNING ISSUES

- 4 things a Law/Tax Firm could do
  - **Set up a C-Corp**
  - **Associates as Partners**
  - **Separate partnership to license name**
  - **Do nothing**

Reasonable S-Corp Compensation

- Contact:
  - https://rcreports.com

- Tell Paul I referred you



Questions?

Thank You!