NEW CODE SECTION 199A
DEDUCTION FOR QUALIFIED BUSINESS INCOME OF PASS-THRU ENTITIES

I. Overview

For tax years beginning after December 31, 2017 and before January 1, 2026, new Code section 199A provides that an individual taxpayer (including a trust or an estate) generally may deduct 20 percent of qualified business income from a partnership, S corporation or sole proprietorship, as well as 20 percent of aggregate qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income. A limitation based on W-2 wages and/or capital applies to taxpayers with taxable income over certain thresholds. In addition, the deduction generally is disallowed for owners of specified service trades or businesses with taxable income over those same thresholds.

The deduction is not allowed in computing adjusted gross income; instead, it is allowed as a deduction reducing taxable income. Also, the deduction is available to both non-itemizers and itemizers.

II. Qualified Business Income

A. Definition

The term "qualified business income" means, for any taxable year, the net amount of "qualified items" of income, gain, deduction, and loss with respect to any "qualified trade or business" of the taxpayer. Thus, for the deduction to be in play for any non-REIT income a taxpayer is required to have income made up of "qualified items" from a "qualified trade or business."

For partnerships, each partner takes into account his or her allocable share of each qualified item of income, gain, deduction, and loss, while S corporation shareholders take into account his or her pro rata share of such items.

1. ***Qualified Trade or Business***

The term means any trade or business other than (1) a specified service trade or business or (2) the trade or business of performing services as an employee.

a) *Specified Service Business*

This term includes any trade or business involving the performance of services:

(1) In the fields of health, law, 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 one or more of its employees or owners. (Engineering and architecture services are specifically excluded without explanation); and

(2) That consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. For this purpose a security and a commodity have the meanings provided in the rules for mark-to-market accounting method for dealers in securities (sections 475(c)(2) and 475(e)(2), respectively).

b) *Exception for Certain Taxpayers with Modest Service Income*

(1) General Rule

If a taxpayer's taxable income does not exceed the "threshold amounts", *i.e.*, \$157,500 (for single filers) or \$315,000 (for joint filers), then income from any specified service trade or business of the taxpayer is excepted from the general deduction disallowance rule and therefore remains considered income arising from a qualified trade or business.

(2) Phase-in of the limitation

The general exclusion rule phases in beginning with taxable income in excess of the threshold amounts and over the next $50,000 (for single filers) and $100,000 (for joint filers) such that at $207,500 (single) and $415,000 (joint) the entire eligibility for the deduction is eliminated.

The phase-out operation is tortured and is designed to limit the amount of the qualified business income eligible for deduction rather than a direct reduction of the deduction. The taxpayer takes into account his or her "applicable percentage" of each tested requirement including (a) qualified items of income, gain, deduction, or loss, and (b) allocable W-2 wages and the unadjusted basis of qualified property (hereafter discussed). The "applicable percentage" is 100 percent reduced by the percentage equal to the ratio by which the excess of the taxable income of the taxpayer over the threshold amount bears to the applicable phase-out range ($50,000 single/$100,000 joint).

Example: S, a single filer, earns $175,000 from his law firm practice. Because he is over the $157,500 threshold, he is subject to the phase-in limitation. His applicable percentage of 65% is determined as follows: 175,000 – 157,500 = 17,500; 17,500/50,000 = 35%; 100% - 35% = 65%. This generally means that 65% of S's income from his law practice, $113,750 is eligible for the 20% deduction, not the full $175,000.

2. ***Qualified Items***

a) *Domestic Business Requirement*

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business in the United States, within the meaning of Code section 864(c).

b) *Investment Items Excluded*

The following "investment items" do not constitute qualified items:

(1) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss;

(2) Dividends, income equivalent to a dividend, or payments in lieu of dividends;

(3) Interest income other than that which is properly allocable to a trade or business;

(4) The excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade of business;

(5) The excess of foreign currency gains over foreign currency losses from section 988 transactions, other than transactions directly related to the business needs of the business activity;

(6) Net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary income (*i.e.*, not treated as capital assets); and

(7) Any amount received from an annuity that is not used in the trade or business of the business activity.

Observation: The reach of the exclusion in subsection (b)(1) above remains unclear. On its face, it would appear to encompass gain from the asset sale of a business held by a pass-through entity or sole proprietorship. However, the use of the word "gain" in the general definition of "qualified business income" and *"qualified items" creates doubt as to the intent of its reference in light of the broadly worded exclusion.*

3. **Items Excluded from Qualified Business Income**

    a) Qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income.

    b) The following are also excluded from the definition of qualified business income:

        (1) Any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer;

        (2) Any guaranteed payment (described in Code section 707(c)) for services rendered with respect to the trade or business; and

        (3) To the extent provided in regulations, any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services (as described in Code section 707(a)).

III. <u>Computation of the Deduction</u>

A. General Rule

A taxpayer otherwise eligible for the 20 percent baseline deduction faces another hurdle in that the taxpayer's deduction for qualified business income for the taxable year is only allowed to the extent of the sum of the following:

1. The lesser of the "combined qualified business income amount" for the taxable year ***or*** an amount equal to 20 percent of the excess of the taxpayer's taxable income over any net capital gain and qualified cooperative dividends, plus

2. The lesser of 20 percent of qualified cooperative dividends or taxable income (reduced by net capital gain).

Note: In all cases the deduction may not exceed the taxpayer's taxable income for the tax year *exclusive* of net capital gain.

"Combined qualified business income amount": This equals the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.

B. **Deduction for each Qualified Trade or Business**

The deductible amount for each qualified trade or business is the ***lesser of***:

1. 20 percent of the taxpayer's qualified business income with respect to the trade or business; or

2. The greater of:

   a) 50 percent of the W-2 wages with respect to the trade or business (the "Wage Limitation"); or

   b) The sum of 25 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property (the "Capital Limitation").

C. **Wage and Capital Limitations**

1. *W-2 Wages*

   a) General Rules

   W-2 wages are total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer.

   W-2 wages do not include (1) any amount which is not properly allocable to the qualified business income as a qualified item of deduction or (2) any amount which was not properly included in a return filed with the Social Security Administration on or before the 60th day after the dude date (including extensions) for such return.

b) Application to Partnerships and S Corporations

For partnerships, each partner is treated as having W-2 wages for the taxable year equal to the partner's allocable share of W-2 wages of the partnership, required to be determined in the same manner as the partner's share of the partnership's wage expenses. For S corporations, each shareholder is treated as having W-2 wages for the tax year equal to the shareholder's pro rata share of W-2 wages of the S corporation.

2. *Qualified Property Definitions and Rules*

a) Qualified Property

Means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the tax year.

b) The Depreciable Period

Means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date 10 years after that date or (2) the last day of the last full year in the applicable recovery period that would apply to the property under Code section 168 (without regard to Code section 168(g)).

c) Additional Rules

(1) In the case of property that is sold, the property is no longer available for use in the trade or business and is not taken into account in determining the limitation.

(2) Regulatory guidance is required for:

(a) Applying the limitation in cases of a short taxable year or where the taxpayer acquires, or disposes of, a major portion of a trade or business or the major portion of a separate unit of a trade or business during the year;

(b) Determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions; and

(c) Applying rules similar to the rules under Code section 179(d)(2) to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision and to provide anti-abuse rules.

d) <u>Application to Partnerships and S Corporations</u>

For partnerships, each partner is treated as having unadjusted basis immediately after acquisition of qualified property for the tax year in an amount equal to such partner's allocable share of the unadjusted basis immediately after acquisition of qualified property, determined in the same manner as the partner's allocable share of depreciation. For S corporations, each shareholder is treated as having unadjusted basis immediately after acquisition of qualified property for the tax year in an amount equal to such shareholder's pro rata share of depreciation.

3. *Exception to the Wage and Capital Limitations*

a) <u>General rule</u>

If a taxpayer's taxable income does not exceed the "threshold amounts", *i.e.*, $157,500 (for single filers) or $315,000 (for joint filers), the Wage and Capital Limitations do not apply to such taxpayer, meaning the deductible amount for each of the taxpayer's qualified trades or businesses is equal to 20% of the qualified business income with respect to each trade or business.

b) Phase-in of Wage and Capital Limitations

The application of these limitations phases in for a taxpayer with taxable income in excess of the threshold amounts, plus $50,000 (for single filers) and $100,000 (for joint filers). The phase-in applies as follows:

For any qualified trade or business, the taxpayer compares (1) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business with (2) the greater of (i) 50 percent of the W-2 wages with respect to the trade or business or (ii) the sum of 25 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

If the amount under (2) is less than the amount under (1), the taxpayer's deductible amount is the amount determined under (1) reduced by the same proportion of the difference between the two amounts as the excess of the taxable income of the taxpayer over the threshold amount bears to the $50,000/$100,000.

Example: H and W file a joint return on which they report taxable income of $335,000. W has a qualified trade or business that is not a specified service business, such that 20 percent of the qualified business income with respect to that business is $15,000. W's share of wages paid by the business is $20,000, such that 50 percent of the W-2 wages with respect to the business is $10,000. The $15,000 amount is reduced by 20 percent ($335,000 - $315,000/$100,000 = 20 percent) of the difference between $15,000 and $10,000, or $1,000. They take a deduction for $14,000.

D. **Treatment of Net Qualified Business Loss**

If the net amount of qualified business income from all qualified trade or businesses during the tax year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Any deduction allowed in a subsequent year is reduced (but not below zero) by 20 percent of any carryover qualified business loss.

Example: S has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in year 1. S carries over a qualified business loss of $30,000 to year 2. In year 2, S has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the deduction for year 2, S reduces the 20 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 20 percent of the $30,000 carryover qualified business loss.

IV. Qualified REIT Dividends, Cooperative Dividends, and Publicly Traded Partnership Income

A deduction is allowed for 20 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the tax year. This deduction is determined without regard to the Wage and Capital Limitations that apply to qualified business income.

V. Comprehensive Example

H and W file a joint return on which they report taxable income of $335,000 (determined without regard to this provision). H is a partner in a qualified trade or business that is not a specified service business ("qualified business A"). W has a sole proprietorship qualified trade or business that is a specified service business ("qualified business B"). They also received $10,000 in qualified REIT dividends during the tax year.

H's allocable share of qualified business income from qualified business A is $200,000, such that 20 percent of the qualified business income with respect to the business is $40,000.[1] H's allocable share of wages paid by qualified business A is $50,000 such that 50 percent of the W-2 wages with respect to the business is $25,000.[2] As their taxable income is above the threshold amount for a joint return, the application of the wage limit for qualified business A is phased in. Accordingly, the $40,000 amount is reduced by 20

[1] $200,000*.20 = $40,000.
[2] $50,000*.5 = $25,000.

percent[3] of the difference between $40,000 and $25,000, or $3,000.[4] H's deductible amount for qualified business A is $37,000.[5]

W's qualified business income and W-2 wages from qualified business B, which is a specified service business, are $125,000 and $60,000, respectively. Their taxable income is above the threshold amount for a joint return. Thus, the exclusion of qualified business income and W-2 wages from the specified service business are phased in. W has an applicable percentage of 80 percent.[6] In determining includible qualified business income, W takes into account 80 percent of $125,000, or $100,000. In determining includible W-2 wages, W takes into account 80 percent of $60,000, or $48,000. W calculates the deductible amount for qualified business B by taking the lesser of 20 percent of $100,000 ($20,000) or 50 percent of includible W-2 wages of $48,000 ($24,000).[7] W's deductible amount for qualified business B is $20,000.

Their combined qualified business income amount of $59,000 is comprised of the deductible amount for qualified business A of $37,000, the deductible amount for qualified business B of $20,000, and 20 percent of the $10,000 qualified REIT dividends ($2,000). Their deduction for the tax year is $59,000 (because 20 percent of their taxable income for the year, $67,000, exceeds $59,000, their deduction is not limited by this).

[3] ($335,000-$315,000)/$100,000 = 20 percent.

[4] ($40,000 - $25,000)*.2 = $3,000.

[5] $40,000 - $3,000 = $37,000.

[6] 1 - ($335,000-$315,000)/$100,000 = 1 - $20,000/$100,000 = 1 - .2 = 80 percent.

[7] Although the their taxable income is above the threshold amount for a joint return, the wage limit is not binding as the 20 percent of includible qualified business income of qualified business B ($20,000) is less than 50 percent of includible W-2 wages of qualified business B ($24,000).