Corporate Tax Update

QUALIFIED BUSINESS DEDUCTION

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Section 199A

- Section 199A will allow owners of sole proprietorships, S corporations and partnerships to take a 20% deduction against their income from the business.
    - Reduces top effective rate to 29.6% (new 37% rate x a 20% reduction).
- Effective for tax years ending after Dec. 31, 2017 and before Jan. 1, 2026.
- 20% deduction allowed for trusts and estates that own an interest in a flow-through business.

Qualified Business Income (QBI)

- Net amount of qualified items of income, gain, deduction and loss with respect to the qualified trade or business of the taxpayer (Generally NI from your business).
- QBI does not include investment income
  - Capital gains and losses
  - Dividend income
  - Interest Income
- QBI does not include income not effectively connected with a U.S. trade or business.
- QBI does not include W-2 wages (including shareholder wages) or guaranteed payments.

Status of Rental Real Estate

- Additional guidance is needed to determine which rental real estate activities rise to the level of a trade or business.
- Groupings and other re-characterizations under passive activity rules are not applicable at this time.
- QBI is not dependent upon passive, significant participation, non-passive or materially participating status.

Qualified Business Income Deduction Limitations

- Specified Service Trade or Business (SSTB)
- Wage and investment limitations

  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.
- Overall Limit - The deduction is limited to 20% of the excess of taxable income over the sum of any net capital gain.

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Lower Income Taxpayers

If your taxable income (NOT AGI) is less than the "threshold amount" for the year then you can ignore the wage and investment limitations and whether or not the business is a specified service trade or business.

- Taxable income threshold
  - $157,500 for individual taxpayers.
  - $315,000 for married taxpayers filing jointly.
- Phase-in range
  - $207,500 for individual taxpayers.
  - $415,000 for married taxpayers.

Business Income (QBI)

Proposed regulations provide some additional guidance

- 481 adjustments are QBI but only if the adjustments included in QBI post 12/31/17.
- The QBI deduction does not reduce net earnings from self-employment.
- The QBI deduction does not reduce net investment income.
- The QBI deduction is the same for both Regular and AMT taxes.
- The QBI deduction is applicable to income from fiscal year pass-throughs if their taxable year begins before January 1, 2018 and ends after December 31, 2017.

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Netting - §1.199A-1(d)(2)(iii)(A)

If an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI.

- The W-2 wages and unadjusted basis of qualified property from the trades or businesses, which produced net negative QBI are not taken into account in determining wage and investment limitations and are not carried over to the subsequent year.

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Carryover - §1.199A-1(d)(2)(iii)(B)

- If total QBI < 0, §199A deduction for QBI is 0.
- Carries over to subsequent years and is treated as negative QBI from a separate trade or business.
- Does not affect deductibility of the loss for other code provisions.
- W-2 wages and unadjusted basis of qualified property from the trade or business that produced the net negative QBI are not taken into account in subsequent years.

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Wage and Investment Limitations

For each trade or business, the 20% QBI deduction is generally limited to 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.

Wages

- **Wages:** W-2 wages generally equal the sum of wages subject to wage withholding, elective deferrals and deferred compensation paid by the partnership, S corporation or sole proprietorship during the tax year.
- Does not include payments to independent contractors or management fees.
  - Three methods to calculate wages:
    - Unmodified Box Method
    - Modified Box 1 Method
    - Tracking Wages Method
- Third Party Payers: Common law employees or officers of a taxpayer can be included in the limitation calculation even if another person pays and reports the wages.
  - Professional Employer Organization

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Qualified Property

- **Qualified Property:** Tangible depreciable property that is placed in service but has not been in service for greater than the LATER OF:
    - 10 years, or
    - The last day of the last full year in the asset's "regular" depreciation period.
- Specific rules in proposed regulations:
    - Improvements: Treated as separate qualified property.
    - Bonus Depreciation AND Section 179 Expense: The UBIA is determined before these adjustments.
    - Tax Credits: The qualified property basis is determined before any basis adjustments related to tax credits.
    - 734(b) or 743(b) Special Basis Adjustment: Not included as qualified property.
    - Anti-Abuse rules.

Wages and Investment Limitation - Example

FACTS:

- Sarah, a single taxpayer, owns a Sch C business.
- She has net business income of $750,000.
- She paid wages of $50,000.
- She has $750,000 of qualified property.
- Assume her taxable income is above threshold.

RESULT:

- Sarah’s tentative QBI deduction is $150,000 (20% of $750,000).
- Her deduction is limited to the greater of $25,000 (50% of wages) or $31,250 (25% of $50,000 wages plus 2.5% of $750,000 qualified property).
- Her final QBI deduction is $31,250.

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Specified Service Trades or Businesses (SSTBs) - Background

- The pass-through deduction came about to provide owners of pass-through businesses with a tax rate reduction commensurate with the rate reduction afforded to C-Corporations.
- Unlike C-Corporations, income allocated to pass-through owners can be, and in many cases is, the direct result of personal services performed by the owners – services that would, in a C-Corporation setting, be captured as compensation.
- This was the main policy issue facing the pass-through deduction – how to preclude owners of pass-through businesses from utilizing the reduced rate against income attributable to personal services – income that would, in any other context, be compensation.

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Treatment of SSTBs

Section 199A(d) makes it clear that Specified Service Trades or Businesses are not eligible for the 20% of QBI deduction:

- Include the performance of services in the following fields:
  - Health
  - Law
  - Accounting/Actuarial science
  - Performing arts
  - Consulting
  - Athletics
  - Financial and Brokerage services
- Specifically makes engineering and architecture exempt.
- Proposed regulations have provided some clarification.

Specified Service Trade or Business – De Minimis Exception

- Business has gross receipts of $25 million or less: The business is not considered a SSTB if <10% of the gross receipts are attributable to services in an SSTB.
- Business has gross receipts of more than $25 million: The business is not considered a SSTB if <5% of the gross receipts are attributable to services in an SSTB.

“Cracking”

- **Cracking** - Stripping out the qualified business activities from a SSTB into a separate company to get the 20% deduction.
- Proposed regulations address this issue.
  - Business provides > 80% of its property or services to a SSTB and the two businesses share 50% or more common ownership, BOTH business are considered SSTBs.
  - Business provides < 80% of its property or services to a SSTB and the two businesses share 50% or more common ownership, any income earned from the property or services provided to a SSTB is ineligible for the 20% deduction.

Aggregation

- Aggregated trades or businesses must combine QBI, W-2 wages and UBIA of qualified property prior to making the calculations regarding limitations.
- Individuals who choose to aggregate must consistently report the aggregated trades or businesses in all subsequent tax years.

Aggregation

- Proposed regulations:
  - Will most likely be changes based on comments.
  - Common Control (tight attribution rules).
  - Must disclose aggregation.
  - None of the businesses can be an SSTB.
  - Must satisfy 2 of the following 3 factors:
    - Provide products and services that are the same or customarily offered together.
    - Share facilities or significant centralized business elements (i.e. personnel, accounting, legal, manufacturing, purchasing, human resources, or IT resources).
    - Operate in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

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Aggregation - Example

Facts:

- Brad and Julie file a joint return
- Taxable income is over threshold
- Brad owns 100% of two businesses, Business X and Y
- Julie owns Business Z
- Businesses are not SSTBs
- None of the businesses hold qualified property
- They are **eligible to aggregate**
- Business X: $1 million of QBI, $500,000 of W-2 wages
- Business Y: $1 million of QBI, no W-2 wages
- Business Z: $2,000 of QBI, $500,000 of W-2 wages

Result:

- Limitations are applied on an aggregated basis
- Tentative QBI deduction is $400,400 ($2,002,000 X 20%)
- Wage limitation is $500,000 ($1,000,000 X 50%)
- Without aggregation, QBI deduction would have been $200,400

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Section 199A – Other Items

- Substantial understatement penalty - a taxpayer who claims the Code Sec. 199A deduction may be subject to the 20 percent accuracy-related penalty for a substantial understatement of income tax if the understatement is more than the greater of five percent (not 10 percent) of the tax required to be shown on the return for the tax year, or $5,000.
- Required Disclosures – if not separately stated factor assumed to be zero
  - Is it an SSTB?
  - Qualified business income.
  - Wages.
  - Investment in qualified property.

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AICPA Comments on Proposed Regulations

- Uniform definition of trade or business, especially related to rental real estate.
- Allow for proration between SSTB and non-SSTB income instead of “cliff.”
- Use existing attribution rules instead of creating a new family attribution rule for aggregation.
- Allow for aggregation at the entity level.
- Confirm that certain deductions for self-employed individuals do not reduce QBI (SE health, qualified retirement contributions, half of SE tax, etc.).

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