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Understanding the Benefits of the New Section 199A Deduction

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Chapter 18

SECTION 199A DEDUCTION

18.1 Introduction to the Section 199A Deduction

The Tax Cuts and Jobs Act[2] added Section 199A to the Code.[3] That section provides individuals, estates and trusts conducting a trade or business directly or through a pass-through entity with a significant new deduction (the "Section 199A Deduction"), which in some cases may equal 20% of the net income from the trade or business. On August 8, 2018, the Internal Revenue Service ("IRS") issued Proposed Regulations (REG-107892-18)(the "Proposed Regulations") providing computational, definitional, and anti-avoidance guidance under Section 199A. The discussion below begins with an overview of the Section 199A Deduction, and then takes a more granular look layering in the multiple exceptions and limitations to the basic rules.

A. Persons Who Get the Tax Benefit: Section 199A provides a new deduction for a taxpayer other than a corporation[4] engaging in a trade or business either directly as a sole proprietor[5] or through a partnership, S corporation, or trust or estate that passes through income and loss to its beneficiaries (collectively referred to a Relevant Passthrough Entities, or "RPE").[6] A Section 199A Deduction may also be available with respect to qualified cooperative dividends.[7] This discussion focuses solely on the Section 199A as it applies to individuals conducting trades or businesses directly or through an RPE that is either a partnership or S corporation.

B. The Tax Benefit Defined: An individual's Section 199A Deduction is equal to 20% of the individual's qualified business income a defined in Paragraph 18.6 ("QBI")[8], limited, however, above certain income levels, to the greater of two caps, one of which is determined by reference to W-2 wages and the other by reference to W-2 wages and unadjusted tax basis immediately after the acquisition ("UBIA") of certain qualified property.[9] For individuals with taxable income below certain threshold amounts ($157,500 or $315,000 in the case

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[2] P. L. 115-97.

[3] Unless otherwise stated, all Section references are to the Internal Revenue Code of 1986, as amended.

[4] Section 199A(a). This would include a C corporation and presumably an S corporation to the extent it was subject to taxes under the Code, e.g., the tax imposed by Section 1374 on recognized built-in gain of an S corporation..

[5] This would include an individual that conducted the trade or business through an entity disregarded as an entity separate from the taxpayer, e.g., a wholly-owned LLC.

[6] Note that the Proposed Regulations define an RPE as a partnership (other than a publicly traded partnership) or an S corporation that is owned, directly or indirectly by at least one individual, estate or trust. Also, a trust or estate is treated as an RPE to the extent it passes through QBI (as defined below), W-2 wages (as defined below), and unadjusted basis of qualified property (as defined below), qualified REIT dividend (as defined below) or qualified REIT income (as defined below). Prop. Reg. Section 1.199A-1(b)(9). This Chapter does not address the application of Section 199A to trusts or estates.

[7] Section 199A(a)(2).

[8] The term qualified business income is defined in Section 199A(c)(1) and the Proposed Regulations as the net amount of qualified items of income, gain, deduction, loss with respect to any trade or business as determined under Section 199A(c) and Prop. Reg. Section 1. 199A-3. Section 199A(c)(1); Prop. Reg. Section 1.199A-1(b)(4).

[9] Section 199A(b). Prop. Reg. Section 1.199A-1(c).

of joint return filers)("Threshold Amounts")[10] the caps are ignored, i.e., the deduction is determined simply by reference to QBI.[11] For individuals with taxable income in excess of the Threshold Amount but not in excess of a ceiling ($207,500 or $415,00 in the case of joint return filers)("Ceiling Amount"), the cap limits are phased in, i.e., the amount of the deduction is subject to the limitation of the applicable cap the greater the individual's taxable income exceeds the Threshold Amount. Section 199A also provides for a 20% deduction of the individual's qualified REIT dividend and qualified publicly traded partnership income.[12] In no event may the deduction for eac trade or business exceed 20% of the individual's taxable income after all other deductions—including the standard deduction—and reduced further for net capital gains.[13]

C. Tax Benefit Is Limited to Certain Trades or Businesses: To qualify for the tax benefit, for individual's above the Ceiling Amount, the trade of business conducted by the individual or RPE generally must be a "qualified trade or business,"[14] ("QTB"), which generally is a trade or business other than one providing certain enumerated specified services ("SSTB") such as the practice of law or accounting.[15] For individuals with taxable income below the Threshold Amounts, however, the exclusion for SSTB is ignored.[16] For individuals with taxable income in excess of the Threshold Amounts but not in excess of the Ceiling Amount, the benefit of the Section 199A Deduction is phased out.[17]

D. Only QBI Is Included in Computing the Section 199A Deduction: QBI generally is equal to the individual's net operating income for the year from a domestic trade or business. The net income is reduced by certain items such as investment income and expenses, as well as capital gains and losses including Section 1231 gains and losses.[18]

E. Computing the Tax Benefit With Multiple Trades or Businesses: For individuals with taxable income equal to or less than the Threshold Amount, the QBI for all trades an and businesses (including a SSTB) is aggregated in computing the Section 199A Deduction, and the caps are ignored. For individuals with taxable income greater than the Threshold Amount, generally, the Section 199A Deduction is determined by reference to each separate trade or business, whether conducted directly or indirectly through an RPE, so that the individual must separately determine the QBI, W-2 wages and unadjusted basis of qualified property for each business.[19] As explained below, the individual may in certain instances choose to aggregate separate trades or businesses, other than SSTB, for purposes of calculating

[10] Section 199A(e)(2); Prop. Reg. Section 1.199A-1(b)(11). The Threshold Amounts are adjusted by cost-of-living adjustments. Prop. Reg. Section 1.199A-1(b)(11).

[11] Section 199A(b)(3); Prop. Reg. Section 1.199A-1(c).

[12] Section 199A(b)(1)(B); Prop. Res. Section 199A-1(c).

[13] Section 199A(b)(1); Prop. Reg. Section 1.199A-1(c)(1).

[14] Section 199A(c)(1). The term QTB is defined in Section 199A(d).

[15] Section 199A(d); Prop. Reg. Section 1.199A-3. The complete list of businesses included within the term specified service trade or business is found in Section 199A(d)(2) and Prop. Reg. Section 1.199A-5.

[16] Section 199A(d)(3); Prop. Reg. Section 1.199A-1(c)(1).

[17] Section 199A(d)3; Prop. Reg. Section 1.199A-1(d).

[18] Section 199A(c); Prop. Reg. Section 1.199A-1(b)(4).

[19] Prop. Reg. Section 199A-1(d)(2)(ii). Section 199A did not address aggregation of separate trades or businesses.

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