



Practical Considerations & Clarification on 199a and QBI

Tax Cuts and Jobs Act 2018

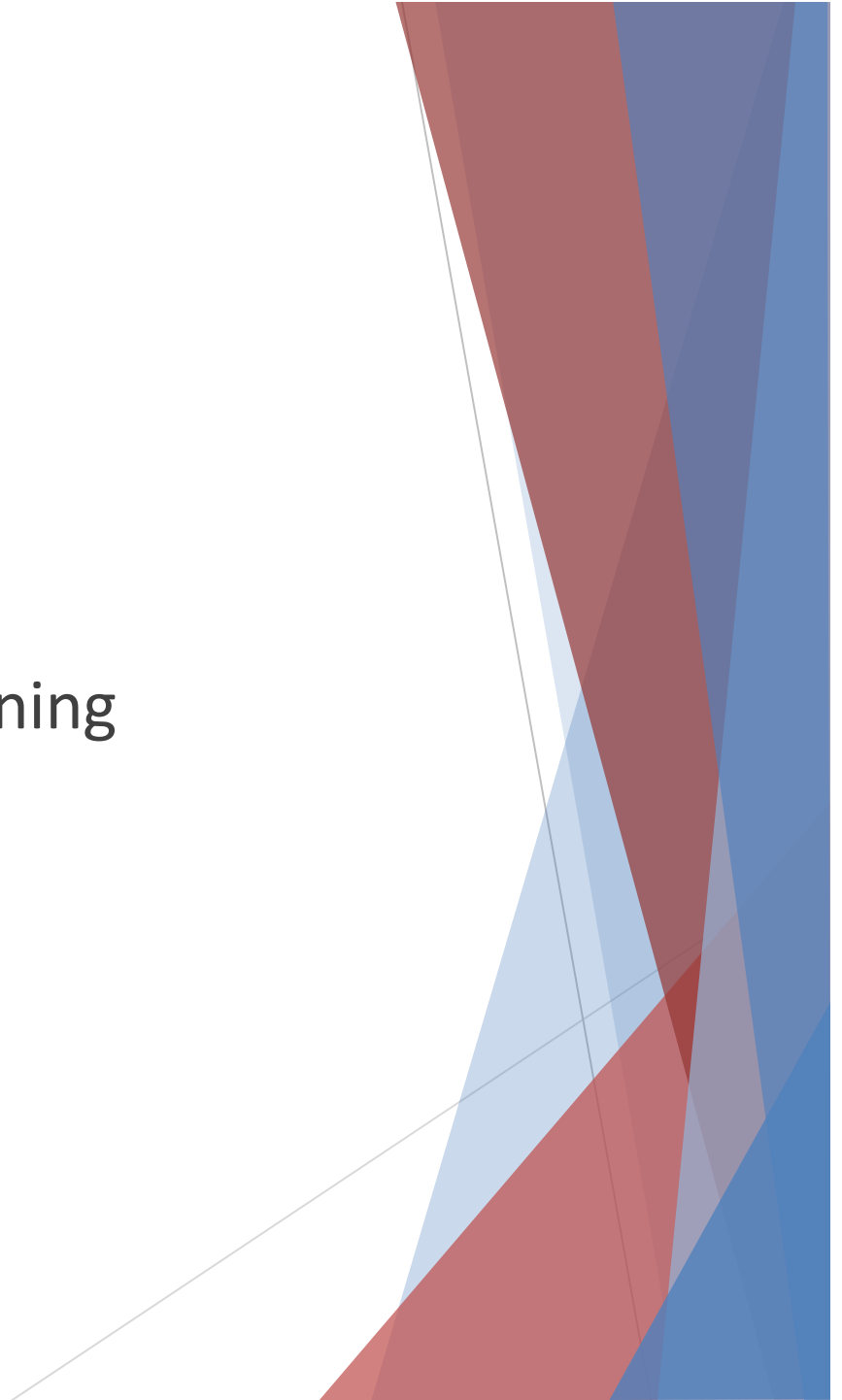
Accounting Day

Note

- ▶ These slides are for informational purposes only and should not be construed as legal advice or forming an attorney-client relationship.

Summary

- ▶ Section 199A Basics
- ▶ Practical Problems and Planning



Tax Cuts and Jobs Act

- Takes affect January 1, 2018
- Many provisions, especially for individuals, end within 10 years

Section 199A

The Section 199A deduction is in effect for tax years beginning after December 31, 2017 and before January 1, 2026 – it is scheduled to sunset

The IRS issued final regulations under Sec. 199A on Jan. 18.

Sec. 199A – Review Basics

- Sec. 199A provides taxpayers other than C-Corps a deduction of 20% of “qualified business income” (QBI), subject to certain limitations (i.e. wage and capital formula limits) to provide owners of pass-through businesses a similar tax cut since the top C-Corp tax rate decreased to 21% from 35%.
- Various limitations: SSTBs, W-2 and Unadjusted basis.

Section 199A

- 20% deduction for Qualified Business Income (QBI)
 - QBI = "ordinary" income less ordinary deductions you earn from a sole-proprietorship, S corporation, or partnership.

QBI is not

- ▶ short-term capital gain or loss;
- ▶ long-term capital gain or loss;
- ▶ dividend income;
- ▶ interest income; or
- ▶ guaranteed payments.

However, you can take 20% of dividends from REITs and PTP, if holding period requirement is satisfied.

Example

- ▶ Samantha makes \$200,000 in net business income from her sole proprietorship but also deducts \$5,000 for self-employed health insurance, \$35,000 for self-employment taxes and \$30,000 for a SEP IRA. Her deduction is the lessor of 20% of \$200,000 (net business income) or 20% of her taxable income.
- ▶ Assume she has no other income, $\$200,000 - \$5,000 - \$35,000 - 30,000 - 12,000 \text{ SD} = \$118,000$, her Section 199A deduction is limited to \$23,600. Her actual taxable income will be \$94,400 and tax will be \$16,946 which is 18% effective rate and 14% to her actual taxable income \$118,000.
- ▶ C Corporation rate of 21% plus additional tax on dividends is a lot more.

Section 199A Limitations

- Specified Service and Trade or Business:
 - any trade or business involving the performance of services 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 1 or more of its employees.

Section 199A Limitations

- Specified Service and Trade or Business:
 - If taxable income is less than \$157,500 / \$315,000 then the 20% deduction is fully available.
 - If taxable income is greater than \$157,500 / \$315,000 but less than \$207,500 / \$415,000 then a partial deduction is available.
 - If taxable income is greater than \$207,500 / \$415,000 no deduction.

Specified Service Business

DEDUCTION %	SINGLE	MARRIED
20%	\$157,500	\$315,000
18%	\$162,500	\$325,000
16%	\$167,500	\$335,000
14%	\$172,500	\$345,000
12%	\$177,500	\$355,000
10%	\$182,500	\$365,000
8%	\$187,500	\$375,000
6%	\$192,500	\$385,000
4%	\$192,500	\$395,000
2%	\$202,500	\$405,000
0%	\$207,500	\$415,000

Section 199A Limitations

- Other Businesses:
 - If taxable income is less than \$157,500 / \$315,000 then the 20% deduction is fully available.
 - If taxable income is greater than \$157,500 / \$315,000 but less than \$207,500 / \$415,000 then a partial deduction is available with the W-2 and depreciable asset limit calculations phase in.
 - If taxable income is greater than \$207,500 / \$415,000 then the 20% deduction is compared to the full W-2 and depreciable asset limit calculations

Section 199A Limitations

- When you make over the phaseout amount your
- 199A deduction =
 - Lesser of 20% of taxable income or
 - 20% of QBI or
 - The Greater of 50% of all the W-2 wages with respect to the qualified trade or business, or
 - the sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

Section 199A Limitations

- Example 1:
- A single Farmer whose net business income is \$300,000, pays total wages \$50,000. 20% QBI = \$60,000, 50% of W-2 = \$25,000, and 2.5% qualified property = 0. His 199A deduction is limited to \$25,000.
- Example 2:
- A single Landlord who rented out his real estate. Net business income is \$300,000, pays no wages, and the unadjusted basis of his property is 2 million. 20% QBI = \$60,000, 50% of W-2 = 0, 2.5% of his property = \$25,000. His 199A deduction is limited to \$50,000.

Sec. 199A – Qualified Property Defined

- ▶ Tangible depreciable property that is:
 1. Held by, and available for use in, the qualified trade or business at the close of the taxable year
 2. Used in production of QTB at any point during the tax year
 3. For which the “depreciable period” has not ended before the end of the taxable year

Depreciable period: the later of 10 years after put into service or Section 168 recovery period.

Rental Activity

- ▶ Final Regulation: Safe Harbor
 1. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
 2. For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed per year with respect to the rental enterprise.
 3. The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services.

Rental Activity – Cont.

- ▶ Rental services: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.
- ▶ The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

Practical Solutions: C Corporation election

- Startup Companies
 - Low wage
 - Needs Cash within the company
 - No distributions
- Avoid some SSTB for companies
- Regulation for any trade or business with gross receipts of \$25 million or less, if more than 10 percent of gross revenue comes from a SSTB activity then the entire business will be treated as a SSTB and subject to the 199A limitations. For businesses above the \$25 million mark in gross revenue, if just 5 percent or more of the revenue comes from a SSTB activity then the entire business is treated as such.

SSTB Planning

- ▶ If service income only accounts for small portion of the entire QBI. You should have separate it out to avoid SSTB designation for the entire business. However you have to be aware of aggregation rules.
- ▶ Trades or Businesses conducted through one or more legal entities can be Aggregated if:
 - ▶ Same person or group of persons owns directly or indirectly (including related party rules) 50% or more of each Trade or Business to be aggregated and
 - ▶ Trades or Businesses satisfy at least 2 of the following tests:
 - ▶ They provide products or services that are the same or customarily offered together
 - ▶ They share facilities or share significant centralized business elements (HR, accounting, legal, manufacturing, purchasing, IT)
 - ▶ They are operated in coordination with or reliance on one or more of the businesses in the aggregated group (i.e. supply chain interdependence)

Practical Solutions: Converting LLC/Sch C to S Corporation - Wages

- Maximize deduction.
- Pay reasonable compensation.

S Corporation planning

- Increase compensation:
 - Maximize 199A deduction.
 - Avoid reasonable compensation audits from EDD and IRS.
 - Pay family member wages.
 - Change independent contractors to employees. (also avoid audit risks.)

Not SSTBs

- Real Estate Brokers
- Insurance Brokers
- Originators of Loans (as long as sales of loans is only “negligible”)
- Health Clubs/Spas
- Pharmaceutical Companies
- Stenographers, Printers, Delivery Services (support legal, but no legal expertise needed)
- Broadcasters, Studios, Disseminate content
- Nursing homes and skilled facilities if all services provided are contracted out.

Questions?

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