

Sec. 199A Business Income Deduction

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The purpose of this newsletter is to briefly summarize the tax benefits of the qualified business income deduction, also known as the Sec. 199A deduction, and highlight the tax planning opportunities for closely-held businesses. This deduction was created by the 2017 Tax cuts and Jobs Act and is still undergoing modifications and interpretations. This summary is not intended to provide an intricate analysis of Sec. 199A. Sec. 199A is complex with limitations, exceptions to limitations, phase-ins, phaseouts, and we are still waiting for further guidance from the IRS on many critical issues.

Summary

- Sec. 199A allows individuals and trusts that are owners of sole proprietorships, disregarded entities, partnerships and S corporations a deduction of 20% of *qualified business income* earned in a *qualified trade or business*.
- *Qualified business income* is the net amount of qualified items of income, gain, deduction, and loss with respect to a *qualified trade or business* that are effectively connected with the conduct of a business in the United States. However, capital gains and losses, certain dividends, interest income, W-2 income, amounts received as reasonable compensation from

an S corporation and amounts received as guaranteed payments from a partnership are excluded from *qualified business income*.

- *Qualified trades and businesses* include all trades and businesses except the trade or business of performing services as an employee and *specified service trades or businesses*. A *specified services trade or business* is a trade or business involving the performance of services in law, accounting, financial services, consulting and several other service businesses, or where the business's principal asset is the reputation or skill of one or more owners or employees.
- Single taxpayers with taxable income less than \$157,500 and married taxpayers with taxable income less than \$315,000 still qualify for the 20% deduction even if they operate a *specified service trades or businesses*.

Eligible Taxpayers

- Sole proprietorships (Form 1040, Schedule C, Profit or Loss From Business)
- Single member limited liability companies classified as disregarded entities for Federal tax purposes (Form 1040, Schedule C, Profit or Loss From Business)
- Real estate investors (Form 1040, Schedule E, Supplemental Income and Loss)
- Any entity classified as a partnership for Federal tax purposes (Form 1065)
- Any entity classified as an S corporation for Federal tax purposes (Form 1120S)

Sec. 199A Formula for Taxable Income of Less Than \$157,500 (\$315,000 for Married Filing Jointly)

- Sec. 199A deduction with respect to any *qualified trade or business* is 20% of the taxpayer's *qualified business income*.
- Examples
 - Taxpayer's sole proprietorship has \$100,000 of *specified service income* and \$20,000 of deduction, resulting in taxable income of \$80,000. Taxpayer's Section 199A deduction is $\$80,000 * 20\% = \$16,000$.

- Taxpayer's limited liability company taxed as a disregarded entity has \$100,000 of **qualified business income** and \$20,000 of deduction, resulting in taxable income of \$80,000. Taxpayer's Section 199A deduction is $\$80,000 * 20\% = \$16,000$.
- Taxpayer is an employee, but not an owner, of a qualified business. Taxpayer receives a salary of \$100,000. Taxpayer is not entitled to a Sec. 199A deduction against the wage income because Taxpayer is not engaged in a qualified trade or business.
- Taxpayer is the sole shareholder-employee of an S corporation. Taxpayer's S corporation has \$100,000 in **net qualified business income** after paying \$50,000 in W-2 wages to himself. Taxpayer's Section 199A deduction is $\$100,000 * 20\% = \$20,000$.
- Key Takeaways
 - If the Taxpayer has taxable income less than \$157,500 (\$315,000 for married filing jointly) then an analysis of whether the business is a **specified service trade or business** is unnecessary because the taxpayer will still qualify for the Sec. 199A deduction.

Sec. 199A Formula for Taxable Income of More Than \$157,500 (\$315,000 for Married Filing Jointly)

- Sec. 199A deduction with respect to any qualified trade or business is the lesser of –
 - 20% of the taxpayer's **qualified business income** with respect to the **qualified trade or business**, or
 - the greater of-
 - 50% of the W-2 wages with respect to the **qualified trade or business**, or
 - (25% of the W-2 wages with respect to the **qualified trade or business**) + (2.5% of the **unadjusted basis** immediately after acquisition of all **qualified property**).
- The W-2 wage limitation (highlighted in yellow above) only applies to taxpayers with taxable income of more than \$157,500 for the year (\$315,000 for married filing jointly) and the deduction is completely phased out for taxpayers with taxable income of more than \$207,500 (\$415,000 for married filing jointly).
- W-2 wages include all W-2 wages, not just those paid to the Taxpayer as a shareholder-employee.

- Key Takeaways
 - If the Taxpayer has taxable income more than \$157,500 (\$315,000 for married filing jointly) then an analysis of whether the business is a *specified service trade or business* is critical because the taxpayer will NOT qualify for the Sec. 199A deduction if the business is a *specified service trade or business*.
 - If the Taxpayer has taxable income more than \$157,500 (\$315,000 for married filing jointly) the legal structure of the Taxpayer's business (e.g. sole proprietorship, S corporation, etc.) and the allocation of W-2 wages make a significant impact to Sec. 199A (see below for examples).

Planning Opportunities for Closely-held Businesses

- The purpose of the example below is to demonstrate the tax savings available to closely-held businesses through tax planning.
- Sole Proprietorship vs. S corporation
 - Taxpayer operates a *qualified trade or business* as a sole proprietor and has \$500,000 of *qualified business income* but does not pay any W-2 wages. Taxpayer's Sec. 199A deduction is the lesser of 50% of the W-2 wages ($50\% * 0 = 0$) or 20% of the *qualified business income* ($20\% * \$500,000 = \$100,000$). So Taxpayer's Sec. 199A deduction is \$0.
 - Same facts as above, except Taxpayer operates as an S corporation. Taxpayer pays himself W-2 wages of \$200,000. Taxpayer's Sec. 199A deduction is the lesser of 50% of the W-2 wages ($50\% * \$200,000 = \$100,000$) or 20% of the *qualified business income* ($20\% * \$300,000 = \$60,000$). So Taxpayer's Sec. 199A deduction is \$60,000. We note that Taxpayer would also save self-employment taxes in this example as well.