

# New 20% Business Deduction

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Presented by: Jordan Empey + Judy Kaltenbacher

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# New 20% Business Deduction

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## What

- A new, non-cash 20% business deduction
- Watch for five key limitations

## Who

“Pass-Through” entities:

- Sole Proprietorships (Schedule C)
- S Corporations
- Partnerships
- Trusts + Estates

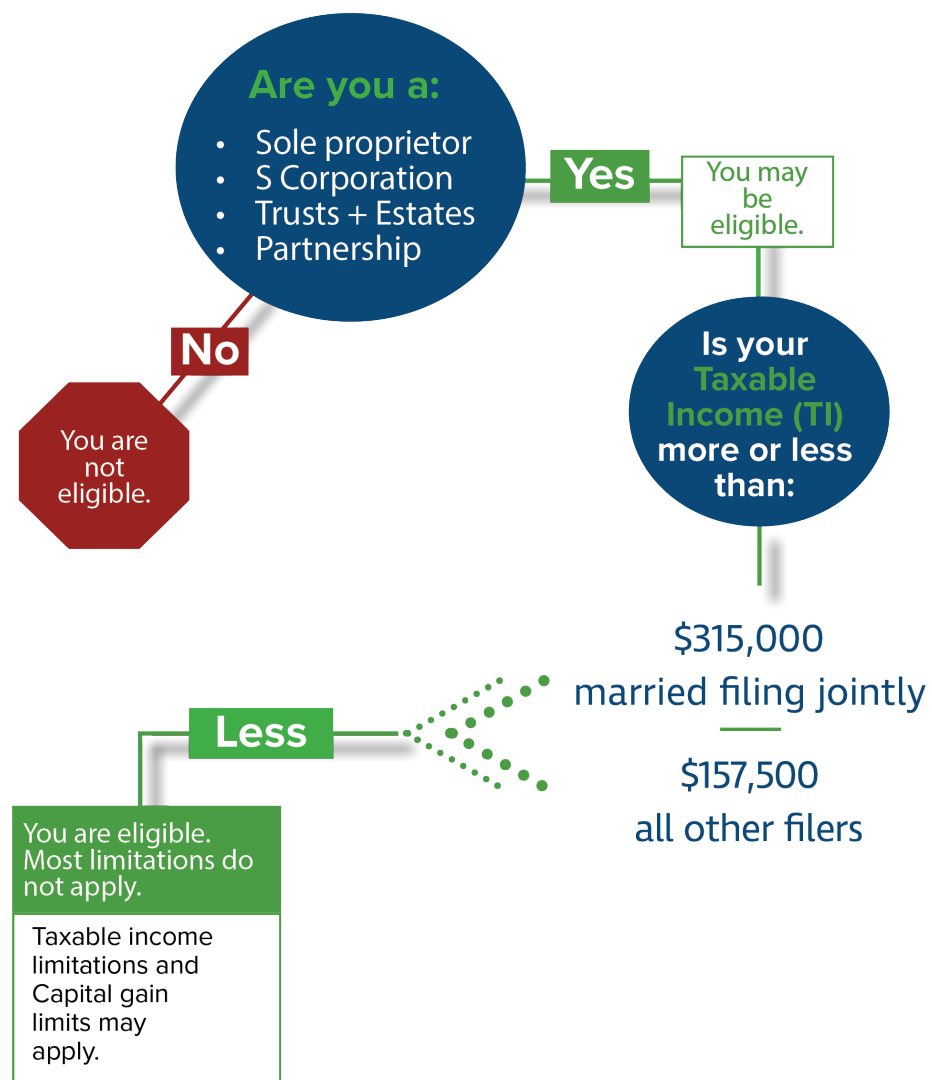
## When

Effective January 1, 2018

# Why?

Type of Business	Prior Law	Tax Cuts and Jobs Act
C Corporations	<b>50.47%</b> [35% corporate tax + (65% x 23.8% Dividend tax rate)]	<b>39.8%</b> [21% + (79% x 23.8% )]
Pass-Through	<b>40.8%</b> (includes 1.2% phase out of itemized deductions)	<b>29.6%</b> 37% x 20% deduction
C Corporation v. Pass-Through	<b>10% difference</b>	<b>10% difference</b>

# Are you eligible?



# Qualified Business Income (QBI)

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QBI is the net amount of qualified items of income, gain, deduction and loss with respect to any qualified trade or business of the taxpayer.

- It is a brand-new deduction
- New guidance issued Aug 2018
- Your accountant's experience and expertise will be key.
- QBI most often found on:
  - Schedule C
  - K-1's
  - Schedule E (rental activity)



# What does **NOT** qualify as QBI?

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## Qualified Business Income does **NOT** include:

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- Investment income items:
  - Short-term capital gain or loss
  - Long-term capital gain or loss
  - Dividend income
  - Interest income
- Any foreign income
- Wages earned as an employee
- Any reasonable compensation wages or guaranteed payments received from a pass-through business

# QBI and Rental Properties

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- Rental properties are meant to qualify, but which rental properties? What counts as a “qualified trade or business”?
  - Must rise to the level of a “trade or business” which is not well defined in the tax law.
- Self-rentals – August 2018 regulations clarified
- No carve out for real estate professionals ... final regs?

**“It’s only been 100 years or so, and we still don’t have a definition of a trade or business.”**

– David Kirk, Chief Counsel of the IRS



# When is a Rental a Trade or Business

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## Gilford v. IRS (1953)

The rental of multiple properties (in one entity), in which the owner was not hands on, was a trade or business.

The court focused on the amount of work required by the management agent, saying:

“...if such management was a “trade or business,” the taxpayer was so engaged although she acted only through an agent.”



# When is a Rental a Trade or Business

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## Fackler v. Commissioner (1941)

Was the rental of a single-family commercial building a Trade or Business. The court said:

“Where the owner of depreciable property devotes it to rental purposes and exclusively to the production of taxable income, the property is used by him in a trade or business...”



# When is a Rental a Trade or Business

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**Hazard v. Commissioner (1946)**

**Stratton v. Commissioner (1958)**

Is the rental of a single-family residence a trade or business?

“This Court has repeatedly held that the renting of improved real estate constitutes the carrying on of a trade or business, regardless of whether or not the taxpayer engaged in any other trade or business...”



# When is a Rental a Trade or Business

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Jephson v. Commissioner (1938)

Even the ***attempted*** rental of a property (that was not formerly a primary residence) has been held to be a trade or business.

# When is a Rental a Trade or Business

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## Neill v. Commissioner (1942)

Triple-net lease is not a trade or business.

- Factors to consider:
  - Nature of property.
  - Number of tenants.
  - Length of lease.
  - How the property was acquired.
  - Level of involvement by owner.



A triple net lease requires a tenant to pay the landlord rent and to be directly responsible for property taxes, insurance, and maintenance.

Tony Nitti, CPA

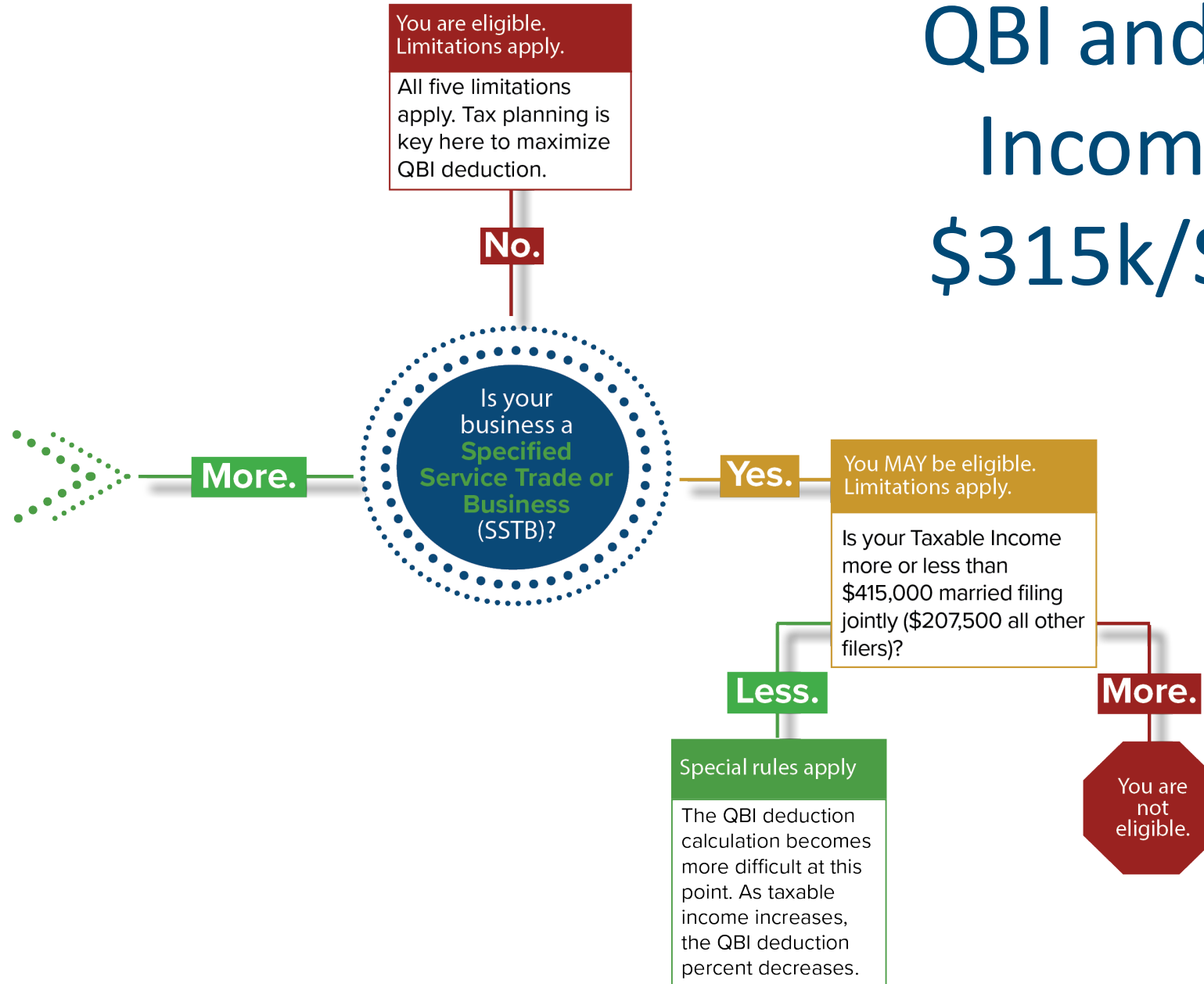
*Tax Geek Tuesday*

“New Section 199A, however, is **anything but simple**, and the 20% deduction **is far from guaranteed** to business owners.

Claiming the new deduction requires **navigating a tangle** of limitations, terms of art, thresholds, and phase-ins and phase-outs.”

# QBI and Taxable Income over \$315k/\$157.5k

\$315,000  
married filing jointly  
\$157,500  
all other filers





# These are the “BIG FIVE” limitations



Applies to all.

1. Taxable Income
2. Capital Gain



Applies at certain  
Taxable Income  
levels.

3. Service Company
4. W-2 Test
5. Asset Test

# 1. Taxable Income Limitation

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- **Taxable income applies to everyone at all income levels**
- **New QBI deduction is limited if:**
  - 20% of Taxable Income is less than QBI deduction
- **Taxable Income thresholds of the “new rich”**
  - \$315,000 – Married Filing Jointly (MFJ)
  - \$157,500 – all other filing status
    - W-2 and asset test begin
    - Service Businesses particularly impacted





## Meet Sam

- Sam has \$600,000 of QBI
- Deduction equals \$120,000  
(600,000 X 20%)

# Sam's Taxable Income Limitation

*Sam's taxable income is \$150,000*

*\*Itemized deductions play a key role in this calculation*

Qualified Business Income (QBI)	\$600,000
20% QBI Deduction	\$120,000
20% Taxable Income	\$30,000
Deduction <b>limited</b> by taxable income	\$30,000

## 2. Capital Gain Limitation

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- If you have a large capital gain, it will eat away at your deduction.
- If capital gain exceeds taxable income, you lose the benefit of QBI (NO double dipping!)
- The limitation is calculated as 20% of your taxable income after subtracting your “net capital gain”

# 3. Specified Service Trade or Business Limitation

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The term “qualified trade or business” means any trade or business other than:

- A specified service trade or business (SSTB).
- The trade or business of performing services as an employee.



# 3. SSTBs Limitation

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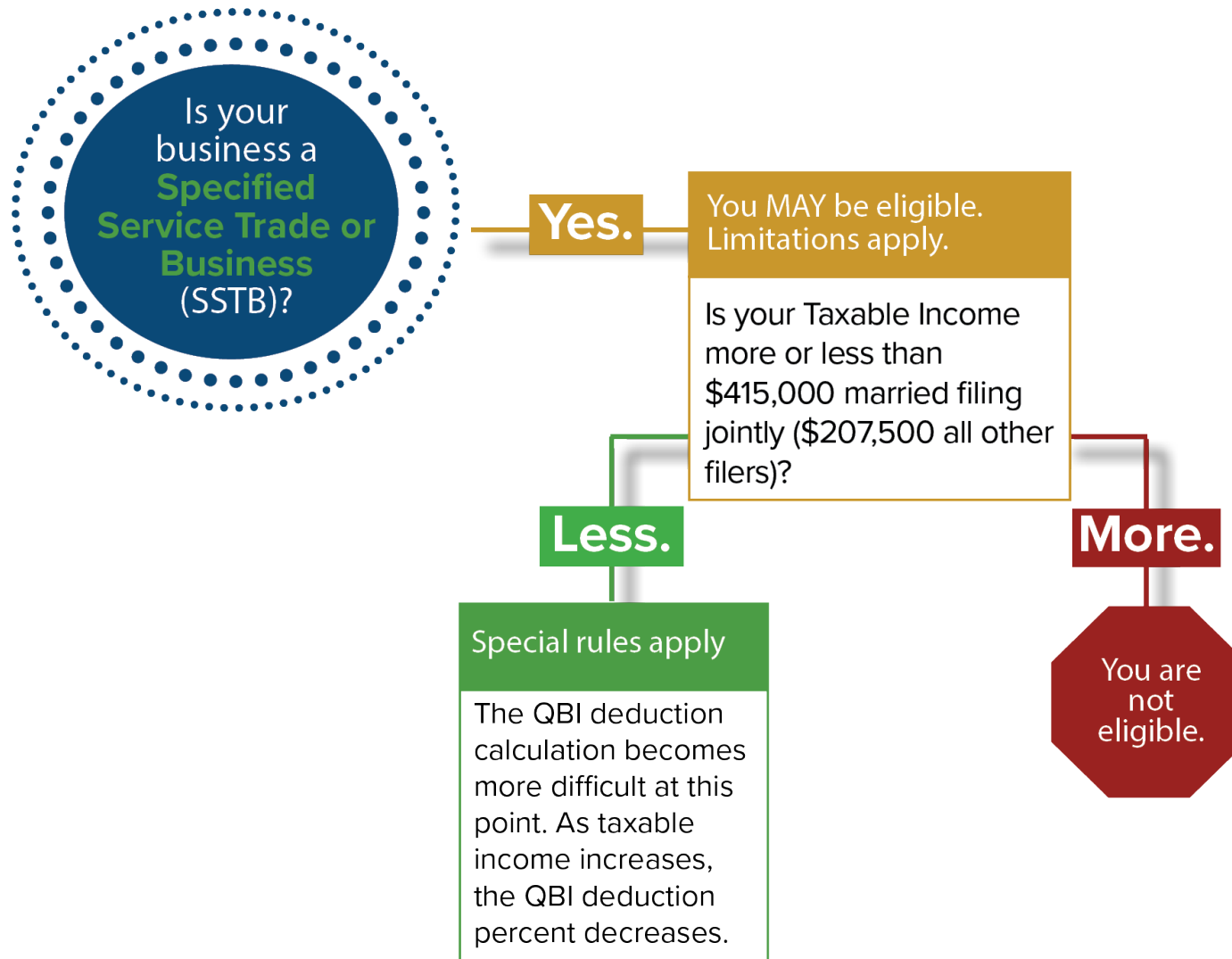
## Businesses operating in the fields of :

- Health
- Law
- Accounting
- Financial Services
- Consulting
- Investment Management
- Brokerage services
- Performing Arts
- Athletics
- Catch-all Businesses

**Catch-all Businesses:** Trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. **Great taxpayer news:** the August 2018 proposed regs **narrowly interpreted this category.**



# SSTB and TI over \$315k/\$157.5k



# SSTBs Carved Out/Ignored

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- Real Estate Brokers
- Property Managers
- Architects
- Engineers
- Health Clubs
- Health Spas
- Banking
- Insurance
- Financing
- Leasing
- Farming
- Any business giving rise to depletion
- Any business operating a hotel, motel, or restaurant



# Meet Jane

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# Example One: Jane, partner in a law firm

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- Jane Law is a partner in a law firm. Jane is married and has a taxable income of \$800,000. Jane's share of the law firm income is \$600,000 and her W-2 wages of the law firm is \$100,000.
- Jane is entitled to no deduction, because a law firm is a specified service business and Jane's taxable income exceeds \$415,000, meaning she is phased-out of any possible deduction.

## Example Two: Jane, partner in a law firm

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- Jane Law is a lawyer in a law firm. Jane is married and has a taxable income of \$300,000. Jane's share of the law firm income is \$200,000 and her W-2 wages of the law firm is \$60,000.
- Jane is entitled to the QBI deduction, because Jane's taxable income is less than \$315,000, meaning her share of the law firm income, \$200,000, is eligible for the 20% deduction of \$40,000.

### 3. SSTBs Limitation

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If a business is mentioned on the “specified trade business” list, they may claim the 20% deduction, provided their taxable income is:

- Less than \$315,000 MFJ, \$157,500 for all other taxpayers.
- If over \$315,000 (\$157,500), but under \$415,000 (\$207,500), a partial deduction may be claimed.
- Over \$415,000 (\$207,500) the deduction phases out completely.
- New from August 2018 regs
  - SSTB De Minimis rule
  - Cracking rules

## 4. W-2 Limitation

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1. W-2 limitation only applies if you exceed threshold amounts (\$315k MFJ & \$157.5k all other filers)
2. How do you figure out your W-2 limitation amount?
  - Notice 2018-64 three methods
3. It's key to remember that you don't get the entire company's W-2 amount, instead your W-2 limitation amount is allocated as follows:
  1. S-Corps are pro-rata
  2. Partnerships follow the methodology for allocating ordinary income to partners.



# W-2 Limitation Example

- Sam has income of \$600,000 from a **non-service** S-Corp and his allocable share of W-2 income is \$44,000. The taxable income for the year is \$150,000.

QBI	\$600,000
Potential 20% QBI Deduction	\$120,000
50% of W-2 Limitation	\$22,000
20% of Taxable Income Limitation	\$30,000
Deduction limited to lesser limitation = W-2 limitation	\$22,000

## 5. Asset Test Limitation

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QBI Deduction is **THE LESSER OF:**

- 20% of the taxpayer's "qualified business income" or



**THE GREATER OF:**

50% of the W-2 wages with respect to the business

or

25% of wages plus 2.5% of unadjusted basis of qualified property immediately after acquisition(UBIA)

## 5. Asset Test Limitation

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- **Unadjusted basis** – not reduced by any depreciation deductions
- **Qualified property** – tangible property subject to depreciation, held by the business at the end of the year, used in the production of QBI

# Example of Asset Test Limitation

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Pam owns a 50% interest in commercial rental properties through an LLC. Pam's share of the rental income of the LLC is \$1,500,000. The LLC pays no W-2 wages, rather it pays a management fee to an S corporation Pam controls. The management company pays W-2 wages, but also breaks even, passing out no net income to Pam. Pam's share of the total unadjusted basis of the commercial rental property is \$10,000,000.

# Example of Asset Test Limitation

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Pam is entitled to a deduction of \$250,000, assuming the rental activities rise to the level of a trade or business equal to the lesser of 1 or 2:

1. 20% of QBI of \$1,500,000 (\$300,000) or
2. The greater of:
  - a) 50% of W-2 wages (\$0) or
  - b) 25% of W-2 wages (\$0) plus 2.5% of the unadjusted asset basis of \$10,000,000 (\$250,000).

# QBI Summary Points

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- For income above the threshold, limitations may apply.
- All QBI calculated will be combined and reported on Form 1040.
- Each taxable entity will have to calculate QBI and limitations.
- QBI income and losses are netted at the individual level (Form 1040).
- **Bummer:** Net QBI losses are carried to offset future year QBI income.
- Applies only for income tax purposes and is determined without regard to alternative minimum tax (AMT) adjustments.

# August 2018 Proposed Regulations

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## Updates applicable to all:

- Section 1231 gain/loss (i.e., gain/loss from business assets or real estate). **Very unfriendly for taxpayers!**
- New trade or business grouping guidelines
  - General rule QBI is separate for each trade or business
  - Could lead to limited QBI deduction without grouping
- Fiscal year businesses can take QBI deduction
- The QBI deduction does not reduce basis

*What will the  
final regulations  
say?!?*



# August 2018 Proposed Regs

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## Updates applicable to SSTBs, W-2 and Asset tests:

### SSTBs

- De Minimis
- Catch-all
- See appendix for clarification regarding service industry qualifications

### For W-2 tests for wages

- Employee Deferrals
- PEO wages count

### Asset tests

- Special rules for asset tests for Like-Kind Exchanges

# Unanswered questions after proposed regulations

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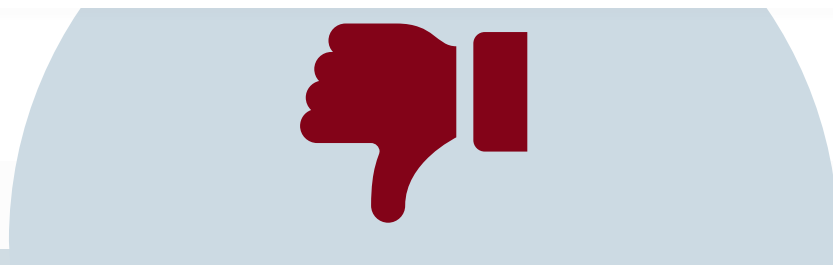
- Rental real estate!!!
- Interaction with self-employment tax
- What “else” will reduce QBI?
  - Unreimbursed partner expenses?
  - Health insurance
  - Nondeductible items



# Prepare for required additional reporting!



- **Relevant passthrough entities (RPE), must disclose:**
  - ✓ If it is engaged in more than one trade or business.
  - ✓ If any business is an SSTB.
  - ✓ Total QBI, W-2 wages and UBIA allocated to each owner for each business.
  - ✓ Any REIT dividends/PTP income.
  - ✓ Failure to disclose means the owner's share is presumed to be zero!
- **Owner/1040: Must disclose grouping elections.**



# Tips to Prepare for 2018 Tax Reform

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- New requirements = new questions and documentation
  - For example, if you have wages, please provide W-3's.
- Plan to submit tax information as soon as possible, even if you're waiting on more information
- Utilize end-of-year planning. We cannot change your 2018 tax liability after Dec 31, 2018.
- To maximize your QBI deduction, be prepared to answer more questions.
- Expect delays from the IRS during filing season, possibly resulting in more extensions

# Year-End Planning Opportunities

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- Can you be an independent contractor?
- Managing taxable income
  - Retirement plan
  - Asset purchases
  - Timing of income & expenses critical
- Consider married filing separately
- Compensation and assets could be key
- Maximize potential QBI versus excess limitations among entities
- Identify service and non-service activities
- Leverage opportunities

## Additional Information

# Specified Service Trade or Business

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- The determination of whether a business is an SSTB is made at the business level. Reg. S1.199A-6(b)(3): an RPE must separately identify and report on the Schedule K-1 issued to its owners whether any business engaged in directly by the RPE is an SSTB.
- This is very important. Consider the following example:

*A is a CPA. A works for an engineering firm S corporation, but performs all accounting functions, which IS an SSTB. The determination of the nature of the business is done at the S corporation level. Because engineering is not an SSTB, on the K-1 the S corporation provides A, it will not designate the business as an SSTB. Thus, A should not be prohibited from claiming the S199A deduction.*

# Field of Health

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- Disqualified:
  - Doctors, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologist, and other similar healthcare professionals who provide medical services “directly to a patient.”
- Not disqualified:
  - Health clubs, health spas, personal trainers, Pilates instructors, etc., or research, testing and manufacturing and/or sales of pharmaceuticals and medical devices.
- Unanswered questions:
  - Those who are skilled medical professionals but who might not treat patients directly: radiologist?
  - Those who treat patients directly but have varying licensing requirements: chiropractors, naturopaths, acupuncturists, massage therapists, etc.



# Field of Law

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- Disqualified:
  - Lawyers, paralegals, legal arbitrators, mediators, judges, anyone with skills unique to the field of law.
- Not disqualified:
  - Stenographers, printers
- Unanswered questions:
  - Stanley case: Lawyer owns 5% of a property management LLC, does mostly property management, but also acts as in-house counsel. Shouldn't be in field of law. Should be in field of property management.

# Field of Accounting

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- Disqualified:
  - Accountants, enrolled agents, return preparers, financial auditors, bookkeepers.
- Not disqualified:
  - We're all doomed.

# Field of Performing Arts

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- Disqualified:
  - Those who “create” Art, like actors, singers, musicians, entertainers, directors.
- Not disqualified:
  - Those who broadcast or otherwise disseminate video or audio of performing arts to the public.
- Unanswered questions:
  - What is Howard Stern?
  - Famous DJ that only plays other peoples’ music?
  - Authors? Seems OK to me.
  - Stunt men? Body doubles?

# Field of Consulting

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- Disqualified:
  - Those who provide professional advice and counsel to clients to assist the client in achieving goals and solving problems. Includes lobbyists.
- Not disqualified:
  - Does not include consulting that is embedded into the sale of goods or services that is not separately billed for.
- Unanswered questions:
  - Could a tax preparer charge \$5,000 for a “copy of Form 1040” and then “throw in the tax prep consulting for free?” to avoid an SSTB. Of course not for many reasons, not the least of which is that the tax prep work, even though not separately charged for, is an SSTB.

# Field of Consulting

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*Ex. D is in the business of licensing software to customers. D discusses and evaluates the customer's software needs with the customer. The taxpayer advises the customer on the particular software product it licenses. D is paid a flat price for the software license. After the software is sold, D helps to implement the software for no extra fee. D is engaged in the trade or business of licensing software; not consulting. This is not an SSTB.*

# Field of Athletics

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- Disqualified:
  - Athletes, coaches, team managers.
- Not disqualified:
  - Maintenance and operation of equipment or facilities used for athletic events.
  - Broadcasting or disseminating video or audio of a sporting event.
- Unanswered questions:
  - Why is the owner of a sports team barred? The team is not in the business of participating in sporting events; the athletes are. The team merely showcases the athletes.

# Field of Financial Services and Investment Management

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- Disqualified:
  - Financial advisors, investment bankers, wealth planners, retirement advisors.
- Not disqualified:
  - Banks!
- Disqualified:
  - Receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments.
- Not disqualified:
  - Property management!

# Field of Brokerage Services

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- Disqualified:
  - A person who arranges transactions between a buyer and seller with respect to securities as defined in S475 for a commission or fee.
- Not disqualified:
  - Real estate brokers.
- Unanswered questions:
  - Sounds like insurance brokers and the like are OK.



# The Catch-All

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- An SSTB includes: “Any trade or business where the principal assets of such trade or business is the reputation or skill of one or more of its employees or owners.”
- This was very concerning prior to the proposed regulations.
- The proposed regulations, however, interpret this VERY narrowly.

# The Catch-All

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- A business will only be a “trade or business where the principal assets of such trade or business is the reputation or skill of one or more of its employees or owners” if:
  - A person receives fees, compensation, or other income for endorsing products or services,
  - A person licenses or receives fees, compensation or other income for the use of an individual’s image, likeness, name, signature, voice, trademark, or other symbols associated with the individual’s identity, or
  - A person receives fees, compensation, or other income for appearing at an event on radio, television, or another media format.

# The Catch-All

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- Ex. H is a well known chef and the sole owner of many restaurants. H is so well known, H receives \$500,000 in endorsement income for the use of his name on a line of cookware.
- Proposed regs: The business of endorsements is an SSTB. The restaurants, however, are not an SSTB, even though the chef is extremely skilled and famous. This is great news.
- But query: What if the endorsement income is collected by an entity that owns one of the restaurants? Is the endorsement treated as a separate business, so that only it is treated as SSTB income, and the income from the restaurant is preserved as non-SSTB income? Can we use the de minimis rule (discussed shortly) to make the endorsement income non-SSTB income?

# De Minimis Rule

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- A business will not be an SSTB if:
- Gross receipts are less than \$25M for the year,
- Less than 10% of the gross receipts are attributable to the performance of services in one of the disqualified fields.

Ex. S Co., an S corporation, earns \$20M in 2018 from the sales of computer software. It also earns \$2M from separately-billed consulting revenue from helping the clients implement the software. While the consulting work is an SSTB (it was separately charged for), because the revenue from the work is less than 10% of the total revenue, it is ignored and none of the business is from an SSTB.

# De Minimis Rule

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- A business will not be an SSTB if:
- Gross receipts are greater than \$25M for the year,
- Less than 5% of the gross receipts are attributable to the performance of services in one of the disqualified fields.

Ex. S Co., an S corporation, earns \$50M in 2018 from the sales of computer software. It also earns \$2M from separately-billed consulting revenue from helping the clients implement the software. While the consulting work is an SSTB, because the revenue from the work is less than 5% of the total revenue, it is ignored and none of the business is from an SSTB.

# De Minimis Rule

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- Do we read the de minimis exception in the opposite? If a business has more than a de minimis amount of SSTB revenue, does:
  - The ENTIRE business become treated as an SSTB, or
  - Is that SSTB revenue significant enough that the business may qualify as its own trade or business for purposes of S199A? The -2 and -3 regs state that an RPE can have more than one trade or business for S199A purposes.

Ex: AB LLC generates \$10M in revenue from the sales of software in 2018, and \$5M from consulting related to that software. Because the prohibited consulting services comprise 33% of the total revenue, the de minimis exception is exceeded. Does that make the entire business an SSTB, or does the LLC now have two different trades or businesses, only one of which is an SSTB?

- There is support that it should be treated as two separate trades or businesses in the example at Reg. S1.199A-5(c)(3), where a dermatologist also sold skin care products out of the same LLC. They were treated as separate trades or businesses in that example, even though the skin care line was less than 5% of the dermatology revenue.

# Identify W-2 wages for the year

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***Unmodified box method.*** This method is the lesser of the total entries in box 1 of all forms W-2 filed with the Social Security Administration (SSA) by you with respect to your employees OR the total entries in box 5 of all forms W-2 filed with SSA by you with respect to your employees.

***Modified box 1 method.*** To use this method, total the amounts in of all forms W-2 filed with the SSA by you with respect to your employees. Next, subtract any amounts included in box 1 of forms W-2 that are *not* wages for federal income tax withholding purposes. Now, add to that the total amounts reported in box 12 of forms W-2 with respect to your employees that are properly coded D, E, F, G, and S.

***Tracking wages method.*** To use this method, total the amounts of wages subject to federal income tax withholding that are paid to your employees and that are reported on forms W-2 that you filed with SSA for the calendar year, and add the amounts reported in box 12 of forms W-2 with respect to your employees that are properly coded D, E, F, G, and S.