ADVANCED PLANNING BULLETIN

BUSINESS | RETIREMENT | FINANCIAL | ESTATE

MARCH 2018

Northwestern Mutual

Explaining the Section 199A Pass-Through Tax Deduction

Summary

New Section 199A permits pass-through business owners to deduct up to 20% of their income derived from the pass-through business. The rules for being able to take the deduction and how to calculate it are complex and unclear. Although IRS guidance is expected, an understanding of the mechanics of the deduction and the rules as written will help business owners and their tax advisors make necessary decisions before then.

Overview

The 2017 Tax Act brought with it a new deduction for owners of pass-through businesses (i.e., S corporations, partnerships, sole proprietorships). The new Section 199A enables a taxpayer to deduct up to 20% of qualified business income (QBI) earned from a qualified trade or business. The deduction is in effect for tax years 2018 through 2025.[1] To determine whether, and to what extent, a business owner is able to take advantage of the deduction, the business owner must navigate a labyrinth of definitions, limitations, computations, and uncertainty.

On February 7, the IRS added Section 199A computational, definitional, and anti-avoidance guidance to its 2017-2018 Priority Guidance Plan. Historically, the Priority Guidance Plan served to identify projects that the IRS was going to work on during the year, but did not place deadlines for the completion of the project.[2] However, the 2017-2018 Guidance Plan explicitly states that the IRS hopes to complete the projects identified in the plan by June 30, 2018. While we wait for guidance from the IRS, business owners and their tax advisers will need to make their own decisions as to how to apply Section 199A to their income.

Premise of Section 199A

Section 199A permits business owners to deduct up to 20% of their business income, subject to the following limitations:

- The total deduction cannot exceed 20% of a taxpayer's "taxable income."[3]
- Any income from specified service businesses only qualifies for the deduction if the owner's taxable income is less than certain threshold amounts.[4]

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[1] I.R.C. §199A(i).
[2] *See, e.g.,* 2016-2017 Priority Guidance Plan, www.irs.gov/uac/Priority-Guidance-Plan (Aug. 15, 2016).
[3] I.R.C. §199A(a)(1)(B).
[4] I.R.C. §199A(d)(2) & (3).

- If an owner's taxable income exceeds certain threshold amounts, then the wages paid by each eligible business and the cost of property owned by each eligible business will impact the amount of the deduction.[5]

The computation of the pass-through tax deduction is made up of a series of steps and questions that have to be asked. The underlying premise of the deduction is that the amount of income eligible for the deduction must be calculated on a per business basis. Once the eligible QBI deduction amount is determined for each business owned by a particular taxpayer, the total deduction that can be taken is limited to 20% of that taxpayer's taxable income.

The matrix below lays out the analysis that needs to be done depending on the taxable income of the taxpayer. The applicable taxable income thresholds are adjusted for inflation annually.[6]

<table>
<tr><th>Type of Business (done on a per business basis)</th><th>Taxable Income
MFJ: < $315K
Single: < $157,500</th><th>Taxable Income
MFJ: $315K to $415K
Single: $157.5K to $207.5K</th><th>Taxable Income
MFJ: > $415K
Single: > $207.5K</th></tr>
<tr><td>Service Business</td><td rowspan="2">20% of QBI</td><td rowspan="2">Percentage of 20% of QBI can be deducted</td><td>$0</td></tr>
<tr><td>Non-Service Business</td><td>Lesser of:
• 20% of QBI
OR
• greater of
◦ 50% of W-2 Wages
or
◦ 25% of W-2 Wages + 2.5% of qualified property cost</td></tr>
</table>

* The combined pass-through tax deduction cannot exceed 20% of taxable income.

Key definitions

Taxable Income	Gross income – permissible deductions – net capital gain[7]
Qualified Business Income	Net income effectively connected with a US trade or business (excludes capital gains, dividends, commodities, etc..), excludes reasonable comp/guaranteed payments[8]
Specified Service Business	Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, or dealing in securities, partnership interests or commodities, or in which the principal asset of the business is the reputation or skill of 1 or more of its owners or employees[9]
W-2 Wages	Paid to employees and reported to SSA[10]

[5] I.R.C. §199A(b)(2) & (3).
[6] I.R.C. §199A(e)(2)(B).
[7] I.R.C. §§199A(a)(1)(B) and 63(a) & (b).
[8] I.R.C. §§199A(a) and 864(c).
[9] I.R.C. §§199A(d)(2) and 1202(e)(3)(A).
[10] I.R.C. §199A(b)(4).

Qualified Property	Depreciable tangible property acquired within the last 10 years, or if the property's recovery period is longer than 10 years within the recovery period[11]
Acquired cost of property	Unadjusted cost basis of the property[12]

Calculation of the Section 199A deduction

The Section 199A deduction is equal to the total of the QBI deduction for each qualified trade or business, to the extent that it doesn't exceed 20% of the taxpayer's taxable income.

1. Step 1 – Determine eligibility of the business owner for the deduction. The deduction is available to any individual, trust or estate that receives QBI. QBI can be generated from a partnership, S corporation or sole proprietorship.

2. Step 2 – Calculate the taxpayer's taxable income. The taxpayer's taxable income determines (1) whether income from a particular business is eligible for deduction at all; (2) the formula to use for calculating the deduction; and (3) the overall limit on the amount of the pass-through tax deduction.

3. Step 3 – Identify the appropriate formula for calculating the QBI tax deduction.

    a. *If taxable income is less than $315,000 if married filing jointly ($157,500 if single).*

       The QBI deduction is equal to the business's QBI multiplied by 20% with respect to each qualified trade or business that the taxpayer receives income from.

    b. *If taxable income is greater than $415,000 if married filing jointly ($207,500 if single).*

        i. Determine whether any business from which the taxpayer receives business income is a specified service business. If a business is a specified service business, then the income from the business will not be eligible for the deduction.

        ii. For any business that is NOT a specified service business:

            1. **Calculate the wage or property limit**. The wage or property limit is equal to the greater of the following two amounts.

                a. 50% of W-2 Wages; or

                b. (25% of W-2 Wages) + (2.5% of the cost of qualified property)

            2. **Compare (i) the wage or property limit and (ii) 20% multiplied by the QBI of the business**. The lesser of the wage or property limit and 20% of QBI shall be the QBI deduction with respect to the qualified trade or business.

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[11] I.R.C. §199A(b)(6).
[12] I.R.C. §199A(b)(2)(B)(ii).

c. *If taxable income is between the amounts identified in items a. and b. above.* The taxpayer should be able to deduct a portion of 20% of QBI with respect to each qualified trade or business. Although the calculation of the deductible portion is not entirely clear for specified service businesses, the statute provides the following formulas.

i. *Non-Specified Service Business QBI Deduction: Phase-in of the W-2 Wage or Property Limit.* If the Wage or Property Limit is less than 20% of QBI, then the QBI Deduction is equal to 20% of the qualified trade or business's QBI minus a Reduction Amount, which serves to phase-in the W-2 Wage or Property Limit. The QBI deduction is calculated as follows:

$$\boxed{\text{QBI Deduction}} \quad \boxed{\text{20\% of QBI}} \; - \; \underbrace{\boxed{\text{Excess Amount}} \times \boxed{\text{Ratio}}}_{\textbf{Reduction Amount}}$$

$$\boxed{\text{Excess Amount}} = \boxed{\text{20\% of QBI}} - \boxed{\text{Wage or Property Limit}}$$

$$\boxed{\text{Ratio}} = \frac{\left[\boxed{\text{Taxable Income}} - \boxed{\begin{array}{c}\text{applicable Threshold Amount}\\ \text{(\$315K or \$157,500)}\end{array}}\right]}{\boxed{\text{\$100K (MFJ) or \$50K (single)}}}$$

ii. *Specified Service Business QBI Deduction: Phase-out of the QBI Deduction.* For Specified Service Businesses that fall between the two thresholds, Section 199A requires that each of the amounts that go into the calculation of the pass-through tax deduction (i.e., income, wages, and property) be reduced before calculating the QBI deduction.[13] This serves to phase-out the deduction for specified service businesses. What is not clear is whether in addition to the phase-out of the deduction, the phase-in of the W-2 Wage or Property Limit also applies.

The first step in calculating the phase-out is to determine the ratio, which is the same calculation used in the phase-in of the wage or property limit.

[13] I.R.C. §199A(d)(3)(A)(ii).

$$\text{Ratio} = \frac{\left[\text{Taxable Income} - \text{applicable Threshold Amount } (\$315\text{K or } \$157{,}500)\right]}{\$100\text{K (MFJ) or } \$50\text{K (single)}}$$

The second step is to subtract the Ratio from 100% to arrive at the "Applicable Percentage."

Each element of the QBI Deduction for the Specified Service Business must be multiplied by the Applicable Percentage. The recalculated amounts are then used to calculate the QBI Deduction for the service business.

If 20% of QBI is less than the wage or property limit, then the calculation stops there.

However, if the wage or property limit is less than 20% of QBI, the question is whether the service business is then able to phase-in the wage or property limit also.

The below example illustrates the issue.

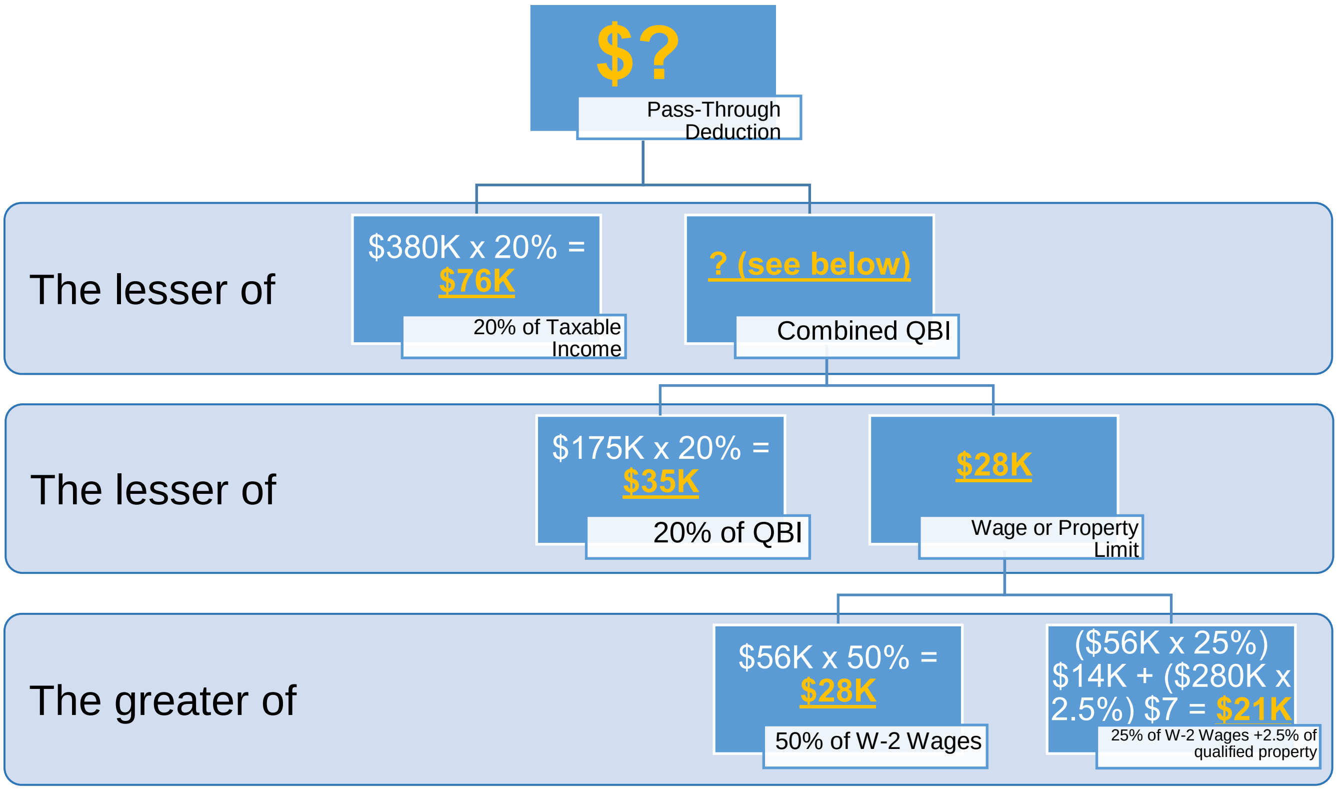
Taxpayer = Married Filing Joint
Taxable Income = $380K
QBI = $500K
W-2 Wages = $160K
Qualified Property Cost = $800K

Calculate Ratio
- ($380K - $315K)/$100K = 65%

Determine Applicable Percentage
- 100% - 65% = 35%

Calculate Reduced Factors
- 35% x
  - $500K = **$175K**
  - $160K = **$56K**
  - $800K = **$280K**

Now that we have the recalculated factors, the QBI deduction can be calculated.



If the analysis ended here, then the pass-through tax deduction would be equal to $28,000. However, because the taxpayer's taxable income falls between the two income thresholds, then it is possible that the phase-in of the wage or property limit could apply to increase the available deduction.

In the example above, the phase-in of the wage or property limit would be applied as follows:

- Excess Amount = $35K (20% of QBI) – $28K (wage or property limit) = $7K
- Ratio = 65%
- Reduction Amount = 65% x $7K = $4,550
- QBI Deduction = $35K – $4,550 = $30,450

Therefore, if the wage or property limit isn't phased-in, the pass-through deduction would be equal to $28,000 and if the phase-in applies, then the pass-through deduction would be equal to $30,450.

Guidance required

The IRS is charged specifically with providing guidance on the following items under Section 199A:

- Acquisitions and dispositions of businesses and short tax years.[14]

- How W-2 wages and the cost of property will be allocated to partners and shareholders.[15]
- Whether to require or restrict the allocation of items and wages and any appropriate reporting requirements.[16]
- How the pass-through tax deduction will apply to tiered entities.[17]
- Preventing the manipulation of the depreciable period of qualified property using transactions between related parties, and rules for determining the unadjusted basis for property acquired in a like-kind exchange or involuntary conversions.[18]

In addition to the guidance identified in the statute, there are many questions with respect to how Section 199A will be interpreted and applied that need to be answered. The following are among the issues on which guidance is needed.

- *What's a qualified trade or business?* The statute defines a qualified trade or business as any trade or business other than a specified service business or the trade or business of performing services as an employee.[19] It isn't clear when an activity will rise to the level of a trade or business. It also isn't clear whether activities conducted in an entity can be separated into separate trades or businesses, or whether activities that are engaged in in separate entities would be aggregated into a single trade or business.

  For example, a taxpayer is a partner in three partnerships. Partnership 1 is a medical practice. Partnership 2 owns a building that it rents to Partnership 1 to be used as a surgical center. Partnership 3 owns the medical equipment that it leases to Partnership 1 to be used in the surgical center. Are these 3 separate businesses or would they be treated as a single business?

- *What's a specified service business?* Based on the definition in the statute, there are certain types of businesses that will definitely be considered service businesses (i.e., law firms and accounting firms). However, the statute also includes a broad reference to any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.[20] This catch-all could encompass many businesses that do not fit into the identified categories.

[14] I.R.C. §199A(b)(5).
[15] I.R.C. §199A(f)(1)(A)(iii).
[16] I.R.C. §199A(f)(4)(A).
[17] I.R.C. §199A(f)(4)(B).
[18] I.R.C. §199A(h).
[19] I.R.C. §199A(d)(1).
[20] I.R.C. §199A(d)(2) and §1202(e)(3)(A).

Planning Opportunities

- *Manage taxable income*. Taxable income plays a large role in applying Section 199A, both in eligibility for the deduction and limitations on the amount deductible. For service businesses or businesses with few employees or property, it could be critical for taxable income to be below the threshold amounts to be able to benefit from the deduction. For other business owners, it may be more important to have taxable income high so that the overall limit of 20% of taxable income doesn't apply to reduce the deductible amount.

  Taxable income is defined as gross income less permissible deductions, including itemized deductions if the standard deduction isn't taken. As a result, individuals have a few levers that they can work with to influence taxable income.

Gross Income	defer income
	qualified plan contributions
	depreciation elections
Permissible Deductions	self-employed health insurance
	HSAs
	self-employed SEP, SIMPLE, and qualified plans
Standard v. Itemized Deductions	charitable contributions
	medical expenses
	mortgage interest

Note that reductions to gross income that alter QBI will affect the calculation of the deduction.

- *Align QBI with payroll and property.* The amount of QBI eligible for the deduction is limited by wages or property on a per business basis. As a result, if a taxpayer has multiple businesses, wages or property should be sufficient on a per business basis so that the wage or property limit doesn't impact the ability of the taxpayer to deduct the maximum amount of QBI.

- *Convert to an S corporation to pay business owner wages.* If a sole proprietor's taxable income is greater than the threshold amounts, then the amount of W-2 wages paid by the proprietorship could limit the amount of income eligible for the deduction. Because a sole proprietor does not get paid wages from the business, the amount of cash the owner takes out does not get included in the total wages for purposes of the limit. If the sole proprietorship is instead classified as an S corporation, any wages paid to the owner will reduce the amount of QBI eligible for the deduction, but it will also increase the W-2 wage and property limit.

Penalties

Along with the pass-through tax deduction, the New Tax Law included a special penalty provision for taxpayers who take the deduction. Generally, the 20% penalty on a substantial underpayment of tax only applies if the amount of the income tax owed exceeds what was reported to the IRS by the greater of 10% of the tax or $5,000.[21] However, if a taxpayer claims the pass-through tax

[21] I.R.C. §6662(d)(A).

deduction, a substantial underpayment of tax could exist if the tax assessed by the IRS exceeds the tax reported by the taxpayer by 5%.[22]

Conclusion

The pass-through tax deduction should result in lower taxes on business income for most pass-through business owners. However, there are many questions that need to be asked to determine how it applies to each taxpayer and each business in which the taxpayer is an owner. Further, there are certain situations that have special treatment, such as publicly traded partnership income and qualified REIT dividends. In addition, the complexity of Section 199A, along with the uncertainty as to the meaning of some of the key terms leaves taxpayers and their advisors trying to navigate the uncertainty on their own.

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[22] I.R.C. §6662(d)(C).

