Northwestern Mutual®

Section 199A Pass-Through Tax Deduction

After the final regulations

Overview of the QBI deduction

For tax years starting in 2018 (but ending after 2025), pass-through business owners can deduct up to 20% of their income earned from a sole proprietorship, partnership, or S corporation.

Income eligible for the deduction (qualified business income or QBI) generally includes net income from a US active trade or business.

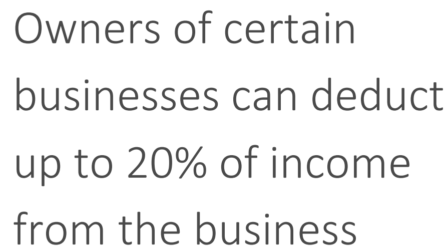
There are limits to this deduction for income from businesses categorized as “specified service trades or businesses” (SSTBs). In addition, for non-SSTBs, the amount of income eligible for deduction may be limited based on the wages paid and property owned by the business.

Finally, the amount of the deduction that appears on the taxpayer’s personal tax return is subject to an overall limit of 20% of the taxpayer’s taxable income.

Opportunity to reduce tax of business owners

The 2017 Tax Act provided many benefits to businesses, most significantly, the reduction of the corporate income tax rate to a flat 21%.

The income of businesses operated as sole proprietorships, partnerships, and S corporations (i.e., pass-through businesses) isn’t subject to the corporate tax. Instead, the income of the business passes through to the owners of the business and is taxed on their personal income tax returns at ordinary income tax rates. As a result, pass-through business income does not benefit from the 21% tax rate change.



To address the tax rate differences, the 2017 Tax Act added Section 199A, a special deduction for the owners of pass-through businesses that is measured by the income generated by the business.

Section 199A is one of the more complex new provisions added by the 2017 Tax Act. The deduction that appears on the business owner’s return is arrived at by adding up the deductible amount of qualified business income (QBI) of each pass-through business that the taxpayer has an ownership interest in. The deduction is increased by 20% of certain income from REITs and publicly traded partnerships.

The final deduction, however, is subject to an additional limitation. The total deduction that appears on the owner's tax return is limited to 20% of the owner's taxable income.

The basis for the deduction starts by determining the deductible QBI amount of each pass-through business and builds from there. The ***deductible QBI amount of each business*** could range from 0% to 20% depending on certain factors.

Significant complexity for higher income taxpayers

The application and calculation of the deduction differs for each taxpayer, and may be relatively straightforward for many taxpayers. Higher income taxpayers who are engaged in different types of business activities will have additional considerations that will need to be addressed, especially if they include both service and non-service business activities.

While non-service business income is eligible for the deduction regardless of the taxpayer's income, income from service businesses is not eligible for any deduction if the taxpayer's income is above a certain amount. Which activities constitute each business and whether activities are combined or separate become a key element to the determination of the deduction.

Framework of the QBI deduction

Varying levels of complexity go into calculating the deduction, depending primarily on the taxable income of the taxpayer.

Easy	Hard	Harder
taxable income under the "threshold amount"	**taxable income that is more than:** • **$100K above the threshold amount (for married filing joint taxpayers) or** • **$50K above the threshold (for single taxpayers)**	**taxable income between "easy" and "hard"**
☑ deduct a flat 20% of QBI from all qualified businesses up to 20% of the taxpayer's taxable income	☑ determine whether each business is an SSTB ☑ if not an SSTB, determine how much employees are paid and how much property it owns	☑ comply with the "hard" rules ☑ calculate a formula for phasing in and phasing out certain limitations

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI

Northwestern Mutual®

For taxpayers who do not fall in the "Easy" category, there are two levels to the calculation of the deduction:

- **Business level** – the income eligible for a deduction is determined at the business level. For each qualified trade or business (QTB) owned by a taxpayer, the taxpayer will have to determine the following:
  - Is the business a specified service trade or business (SSTB)?
  - How much did the business pay its W-2 employees during the year?
  - What is the acquisition cost of certain qualified property that it owns?
  - What income of the business qualifies for the deduction?
- **Taxpayer level** – the deduction is taken on the taxpayer's personal tax return
  - What is the taxpayer's taxable income for purposes of determining how the deduction will be calculated at the business level?
  - What is 20% of the taxpayer's taxable income for purposes of the overall limitation on the deduction?

Elements of the QBI deduction

Taxpayer	deduction is taken on the business owner's personal income tax return
QTB	a business owned by the taxpayer that generates QBI
Taxable income	the taxpayer's gross income, less any permissible deductions (including itemized or standard deduction), less net capital gain - determined before any reduction for the QBI deduction
Combined QBI deduction	the total deduction that appears on the tax return – the sum of the QBI deduction for each QTB plus 20% of qualified REIT dividends, and qualified publicly traded partnership income

Who is entitled to the deduction?

Any taxpayer other than a corporation. That includes individuals, trusts, estates and partnerships. The deduction will appear on the personal income tax return of individual taxpayers. For trusts, estates and partnerships, the IRS regulations contain guidance on how the deduction is reflected and how it passes through to individuals.

What income qualifies for the deduction?

The deduction is based on the "qualified business income" of a "qualified trade or business." In general, QBI is net income effectively connected with a US trade or business, excluding capital gains, dividends, and other types of non-business income.

Note that compensation paid by the business to the owner is not included in QBI that is eligible for the deduction. It is, however, included in the W-2 wages paid by the business.

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI

How is the deduction calculated?

The taxpayer determines the eligible deduction with respect to each qualified trade or business owned by the taxpayer. The aggregate deductible amounts from all qualified trades or businesses is the amount of the deduction that appears on the taxpayer's tax return, provided that it doesn't exceed 20% of the taxpayer's taxable income.

Determine eligible QBI deduction for each business

Calculation of the **eligible QBI deduction for each QTB** is dependent on the ***taxable income*** of the taxpayer.

Type of Business (done on a per business basis)	Taxable Income is less than the Threshold Amount	Taxable Income between identified amounts (the Phase-in Range)	Taxable Income is above: Threshold Amount plus \$100K if MFJ OR \$50K if single
Specified Service Trade or Business	20% of QBI	Phase-out of deduction	\$0
Non-Service Business	20% of QBI	Phase-in of wage or property limitation	**Lesser of:** • 20% of QBI OR Greater of: • 50% of W-2 Wages • 25% of W-2 Wages plus 2.5% of UBIA[1]
The combined passthrough tax deduction cannot exceed 20% of the taxpayer's Taxable Income			

Threshold Amount		
Filing Status	2018	2019
Single and head of household	\$157,500	\$160,700
Married filing joint	\$315,000	\$321,450
Married filing separate	\$157,500	\$160,725

In addition to a deduction for QBI, the combined passthrough tax deduction is increased by 20% of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.

[1] Treas. Reg. §1.199A-1(b)(15) ("unadjusted basis immediately after acquisition (UBIA) of qualified property").

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI

Northwestern Mutual®

Qualified trade or business (QTB)

Before getting into whether income or a trade or business is qualified, it must first be determined which activities ARE a trade or business. Trade or business is not defined in either the statute or the legislative history. The regulations determined that whether activities constitute a trade or business is ascertained by reference to Code Section 162, which permits a deduction for ordinary or necessary business expenses. This is a facts and circumstances test that requires (1) that the taxpayer to intend to make a profit; and (2) that the activities be considerable, regular and continuous.

The IRS acknowledges that multiple QTBs may be engaged in by a single entity. As with the determination of whether a trade or business exists, this is a facts and circumstances analysis. In the explanation accompanying the final regulations, the IRS stated that multiple trades or businesses will generally only exist if the entity would be able to use different methods of accounting for each trade or business under Treas. Reg. Section 1.446-1(d). Section 1.446-1(d) requires that a complete and separable set of books and records be kept for each trade or business.

Service businesses

Defined SSTB activities

Whether a QTB is an SSTB is a key element to the operation of the deduction. Depending on a taxpayer's taxable income, the QBI from an SSTB may not be eligible for any deduction solely because it is an SSTB.

The statute defines an SSTB as a business that performs services in the fields of 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.[2]

The regulations address each of the business types listed in the statute. Of particular interest is the taxpayer-friendly interpretation of when a trade or business has as its principal asset the reputation or skill of 1 or more of its owners or employees. Under the regulations, a trade or business only falls into this category if the individual or entity:

(1) receives fees, compensation, or other income for endorsing products or services;

(2) licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or

(3) receives fees, compensation, or other income for appearing at an event or on radio, television or another media format.[3]

---

[2] I.R.C. §§199A(d)(2) and 1202(e)(3)(A).
[3] Treas. Reg. §1.199A-5(b)(2)(xiv).

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI

The IRS also identifies certain activities that specifically will or will not give rise to an SSTB.

Qualified Trade or Business		SSTB	
Ancillary consulting services	Health clubs & spas	Accounting services	Investment banking
Architectural services	Insurance brokerage	Actuarial services	Investment management
Banking – taking deposits or making loans	Maintaining and operating equipment or facilities used in performing arts or athletic events	Consulting services	Legal services
Broadcasting or disseminating video or audio of athletic events or performing arts	Payment processing & billing services	Dealing in securities, commodities, or partnership interests	Reputation or skill based services
Direct management of real property	Real estate agents or brokerage	Financial services	Selling tickets to art or athletic events
Engineering services	Research, testing, and manufacture and/or sales of pharmaceuticals or medical devices	Health care	Stock brokerage

De Minimis Rule

The IRS included a de minimis rule in the regulations that would permit a business to conduct a certain amount of service business activities without tainting the deduction for the non-service business income.

Under the de minimis rule, a trade or business is NOT an SSTB if:

1. The gross receipts of the trade or business are LESS than $25 million AND less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a specified service activity.

   OR

2. The gross receipts of the trade or business are MORE than $25 million AND less than 5 percent of the gross receipts of the trade or business are attributable to the performance of services in a specified service activity.

In effect, the IRS provided a more favorable interpretation for small business to provide services to its customers and still be eligible for the deduction.

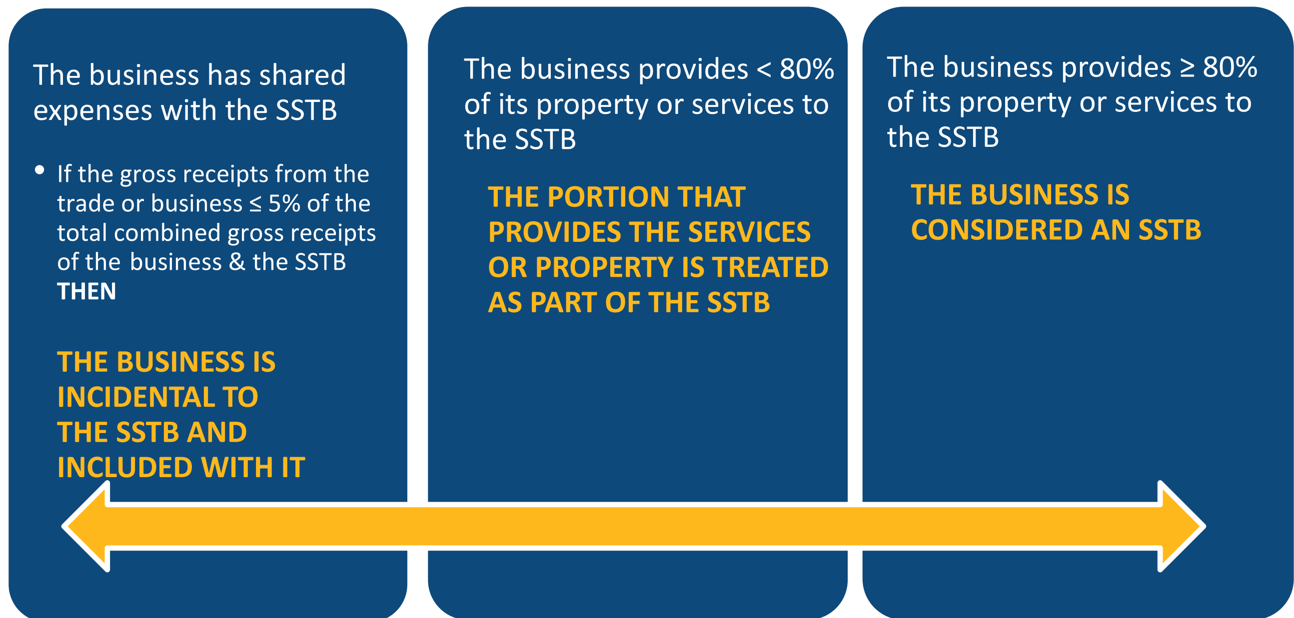
However, if gross receipts from service activities exceed the de minimis percentages, the IRS will treat the entire business as an SSTB. In effect, the percentage constitutes a “cliff” that will result in SSTB treatment.

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI

Related Businesses

To prevent potential abuse, the regulations also contain rules that result in a trade or business being treated as an SSTB that would otherwise not satisfy the definition based on the types of business activities it engages in.

If there is more than 50% common ownership of a trade or business and an SSTB, the business or a portion of the business will be considered an SSTB.



Note: A business that is included as an SSTB under this rule is considered an SSTB for all owners, not just the ones with common ownership.

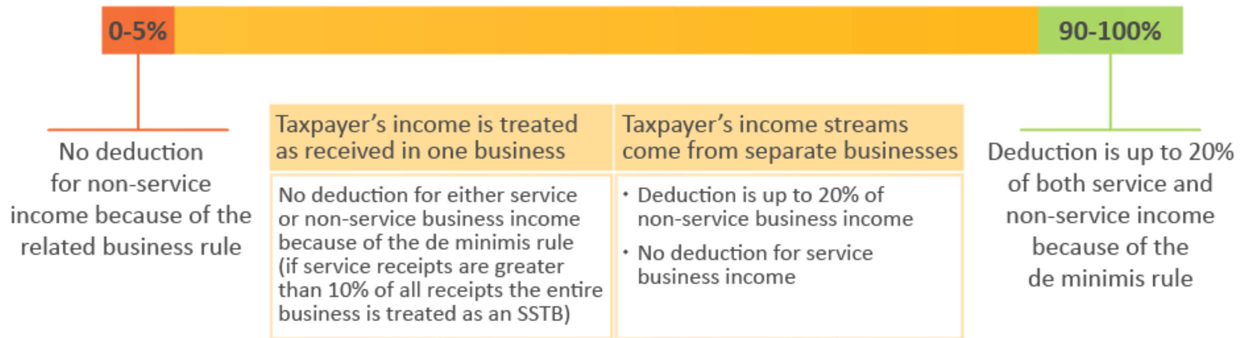
Impact of service and non-service business income in the same entity

Whether activities constitute a single business could be critical to the application of the deduction, particularly if a taxpayer's taxable income is above the "Threshold Amount." If a taxpayer is over the Threshold Amount, the types of activities conducted by the business could impact whether income from the activities is eligible for a deduction at all.

Trying to navigate the application of the de minimis rules and the related business rules can be complicated. The following illustrates how it can apply in situations where there is common ownership among service and non-service businesses that share expenses and the gross receipts from the business are less than $25M.

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI

Northwestern Mutual®



Aggregation of businesses

The IRS permits individuals, estates and trusts to aggregate trades or business for purposes of calculating QBI if:

1. The same person or group of persons, directly or indirectly own 50% or more of each trade or business to be aggregated;
2. The common ownership exists for the majority of the applicable taxable year and they have the same taxable years;
3. None of the businesses are SSTB's; **and**
4. At least 2 of the following 3 factors are present:
    a. Products and services provided are the same or customarily provided together;
    b. Shared facilities or shared significant centralized business elements;
    c. Operated in coordination with, or reliance on, one or more of the businesses in the aggregated group.

Two important notes about the aggregation of businesses. First, the individual, trust, or estate makes this determination. It cannot be aggregated at an entity level. Second, the aggregation rule is an option, not a mandate. Business owners will have to determine when it is advantageous to aggregate. An example where this could be helpful is a business owner who separated the operating business from its real estate. Typically, the real estate business will have no wages and thereby limit the deduction if evaluated on its own. The aggregation rule might provide a larger deduction for that business owner than if they were evaluated separately.

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI

Northwestern Mutual®

Conclusion

For many business owners, the 199A pass-through tax deduction will be relatively straightforward. If taxable income is below the threshold amount, then the taxpayer should be able to deduct 20% of the qualified income generated by all pass-through businesses, subject to the overall 20% of taxable income limitation.

Once a taxpayer's taxable income exceeds the threshold amount, however, the calculation of the deduction becomes much more complex, particularly if any income is generated from service activities. Even if none of the income is from a service activity, each business will need to determine wages paid and property owned. Accordingly, business owners who fall into this category should reach out to their tax advisors to determine how the deduction will apply to them and whether there is any opportunity for planning to maximize the deduction.

Advanced Planning, March 2019

This publication is not intended as legal or tax advice. This information is intended solely for the information and education of Northwestern Mutual financial representatives, their customers, and the legal and tax advisors with whom they work. It must not be used as a basis for legal or tax advice, and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Northwestern Mutual and its Financial Representatives do not give legal or tax advice. Taxpayers should seek advice regarding their particular circumstances from an independent tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.

Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company (NM), Milwaukee, WI (life and disability insurance, annuities, and life insurance with long term care benefits) and its subsidiaries.

 © 2019 The Northwestern Mutual Life Insurance Company, Milwaukee, WI