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CERTIFIED PUBLIC ACCOUNTANTS | TAX & ADVISORY SERVICES

TAX CUTS AND JOBS ACT OF 2017
SECTION 199A

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This memorandum has been long delayed in an effort to obtain greater clarity from the Internal Revenue Service and its Office of Chief Counsel. Recently, the Internal Revenue Service did issue Proposed Regulations on one significant aspect of the law, Section 199A (which provides a maximum deduction equal to 20% of the net trade or business income of certain individuals and "pass-through entities").

Although great uncertainty remains, we have decided to present our ideas regarding Section 199A and related provisions of the law to facilitate initial planning by those affected. In many cases, significant tax savings can be achieved if the planning is completed and appropriate action is taken by December 31, 2018.

I. SUMMARY OF MAJOR PROVISIONS OF SECTION 199A

1) Benefits Provided by §199A

This section provides a deduction equal to the lesser of 20% of combined Qualified Business Income generated by individuals and pass-through entities or 20% of taxable income (excluding capital gains), with important limitations. Included in combined Qualified Business Income is 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (QPTP) income.

Qualified Business Income (QBI) is defined as net income from certain "trades or businesses". Therefore, the activity must first qualify as a "trade or business" under general tax principles. Specifically excluded are compensation as an employee and any type of investment income. Also, excluded are activities which require little involvement by their owners or employees (e.g. an individual who owns one triple-net-lease property). It should be noted, however, that a rental real estate operation generally does qualify as a "trade or business". Also, there is a special rule which specifically allows a real estate operation renting only to one entity to be considered a "trade or business" if that entity owns, directly or indirectly, 50% or more of the real estate operation.

A taxpayer must combine all Qualified Business Income and Losses for the year before calculating the deduction, and if the result is a net loss, that loss must be carried forward and included in the following year's QBI calculation.

2) Limitations

a) Specified Service Trades or Businesses (SSTBs)

This restricted category includes: attorneys, accountants, health care providers, financial consultants, brokers (except real estate and insurance), artists and athletes, and services that consist of investing, investment management and trading or dealing in securities. Specifically excluded from this restricted category are engineers and architects.

Individuals, trusts and estates which have SSTB income face severe limitations. All benefits of the QBI deduction are phased-out at certain taxable income ranges: for married individuals, between $315,000 and $415,000; for single individuals, trusts and estates, between $157,500 and $207,500. There is absolutely no benefit of a QBI deduction above the upper limits of these phase-out ranges in the case of SSTBs.

b) Other Qualified Trades or Businesses

For all other Qualified Trades or Businesses, the QBI deduction is available at all taxable income levels, subject to limitations based on the same taxable income ranges as described for SSTBs. When taxable income is above the upper limits of these taxable income ranges ($415,000 for married individuals and $207,500 for others), the otherwise allowable QBI deduction can not exceed the greater of (a) 50% of wages related to the activity paid during the taxable year or (b) 25% of wages plus 2.5% of unadjusted basis of assets of the activity immediately after their acquisition (UBIA). When taxable income is within the above described ranges, the limitations are phased-in.

There are special rules for what constitutes wages and UBIA. For example, wages include elective deferrals under retirement plans, etc. UBIA excludes land, limits the inclusion period for assets to the greater of their depreciation recovery period or 10 years, and ignores accelerated write-offs such as under Section 179.

(See Example 1 in Appendix)

3) Aggregation Rules

For purposes of computing the wage and asset limitations of trades or businesses other then SSTBs, a taxpayer can elect to "aggregate" some or all such trades or businesses. (A taxpayer would make this election only if it results in a greater §199A deduction.)

In order to "aggregate", all of the following conditions must be met:

(1) All entities to be aggregated, must have at least 50% common ownership and each component entity must be held for the majority of the taxable year.

(2) Each component entity must itself be a trade or business.

(3) None of the components can be an SSTB.

(4) All entities to be aggregated, must have the same tax year.

(5) At least two of the following factors must be satisfied:

(a) The trades or businesses must provide products or services that are the same or customarily offered together (e.g. a gas station and a car wash).

(b) The trades or businesses must share facilities or share significant centralized business elements (such as personnel, accounting, legal, manufacturing, purchasing, human resources or information technology).

(c) The businesses must be operated in coordination with or in reliance on each other (e.g. supply chain interdependence).

There are several important supplementary provisions with respect to "aggregation":

(1) Once aggregation is elected for a year the taxpayer is bound by the election for all subsequent years.

(2) If the aggregation requirements are met, even minority owners may elect to aggregate.

(3) Individual owners of pass-through entities are not required to aggregate in the same manner as other owners.

(See Example 2 in Appendix)

II. PLANNING FOR PROFESSIONALS

Since most professionals are deemed to be engaged in SSTBs, the benefits of §199A are limited. The main planning opportunities include:

(1) Controlling taxable income.

(2) Excluding non-SSTB income from SSTB business operations.

(3) Minimizing guaranteed payments.

(4) Elevating associates to partner status, where appropriate.

(5) Treating certain professionals as independent contractors rather than employees.

(6) Operating as a C-Corporation.

(1) Controlling Taxable Income

Although it is difficult for many professionals to hold taxable income below the QBI phase-out levels described above, this approach can be very effective in many cases. Some of the more common techniques are:

(a) Controlling receipt of professional fees and payment of expenses so that taxable income can be held under the phase-out ranges, at least for "alternating" years.

(b) Increasing payments to retirement plans (e.g. 401(k) plans, profit sharing plans and defined benefit plans).

(c) Making larger charitable contributions in "alternating" years.

(d) Offsetting capital gains, with capital losses where practical.

(See Example 3 in Appendix)

(2) Excluding Non-SSTB Income

The Proposed Regulations make it very difficult to split elements of an SSTB operation to obtain the §199A deduction for the non-SSTB elements. For example, if the non-SSTB operation is in an entity 50% or more owned directly or indirectly by the owners of the SSTB and 80% or more of its property or services are provided to the SSTB, all the income of both operations will be considered SSTB income. However, there are some potential exceptions to the restrictions of the Proposed Regulations. For example:

(a) If the entity providing the real estate or services which are used in the SSTB is owned by several groups so that no group owns 50% or more of the separate entity, the income of that entity can avoid SSTB treatment. (For example, a building owned 40% by a law firm, 40% by an accounting firm and 20% by a dental practice and used by all three firms for their professional practices, could produce rental income that would not be considered SSTB income.)

(b) An entity which has 50% or more common ownership with a professional firm and sells related products could nevertheless produce income which would qualify for non-SSTB treatment, as long as gross receipts from the related products are more than 5% of the combined gross receipts of both entities. (The result would be the same if the products are sold directly by the professional firm.)

(3) Minimizing Guaranteed Payments

Guaranteed payments do not constitute QBI and therefore should be avoided if at all possible.

(4) Elevating Associates to Partner Status

If appropriate under the circumstances, granting partner status to an associate could qualify the new partner for the QBI deduction. Perhaps the net tax benefits of partner status could be shared with the firm.

(5) Treating Professionals as Independent Contractors

Where appropriate, a professional providing services for a firm could be treated as an independent contractor, thereby providing the professional with QBI, rather than wages which would not qualify as QBI. The professional would have to qualify as an independent contractor under general tax rules, regulations and case law.

(6) Operating As a C-Corporation

In limited situations in which a professional firm is rapidly expanding and in need of retaining substantial capital, it might be advantageous to operate as a C-Corporation for a period of time. Income could be accumulated in the corporation at the low 21% corporate tax rate rather than the likely much higher individual tax rates of its owners. Later, when sufficient capital has been accumulated, S-Corporation status could be elected. The result could be long-term deferral of tax or possibly permanent tax reduction.

III. PLANNING FOR OTHER THAN SPECIFIED SERVICE TRADES OR BUSINESSES

1) Taxable Income Below Lower End of Phase-Out Range

When taxable income is below the threshold of the phase-out range ($315,000 for married individuals and $157,500 for all others), the main planning tool is controlling taxable income. Since QBI can not be greater than taxable income, it might be desirable to increase taxable income for the year, without exceeding the appropriate phase-out amount. (Of course, this would increase the net tax for the current year and reduce the tax in future years in which the taxable income would otherwise be reported, and could reduce the overall tax burden.)

If additional taxable income is desired, the following should be considered:

(a) Accelerating business taxable income or deferring related expenses.

(b) Taking retirement plan distributions.

(c) Converting from a traditional IRA to a Roth IRA.

(d) Reducing charitable contributions for the year.

2) Taxable Income In or Above Phase-Out Range

Assuming all has been done to reduce taxable income to avoid the application of the phase-out, the following should be considered:

(a) Increase wages and/or assets used in the business, where appropriate, to avoid the limitations on QBI when taxable income is in or above the phase-out range.

(b) If the entity is not an S-Corporation, consider forming an S-Corporation to allow wages to be paid to the owners of the business, thereby reducing or avoiding the limitations on QBI.

(See Example 4 in Appendix)

(c) If more than one entity is involved, consider "aggregation" of the entities, especially in the case in which much of the wages are paid by one entity.

(d) In circumstances in which a substantial amount of capital is needed to be retained in the entity, consider operating as a C-Corporation in order to obtain the low 21% corporate tax rate. Later, when sufficient capital has been accumulated, an S-Corporation election can be considered.

(e) Ensuring that the taxable income is as close to QBI as possible, to avoid the taxable income limitation. (Again, this would accelerate taxable income and tax for the current year, with an offsetting reduction in future years, and a reduction in the overall tax burden.)

IV. GENERAL COMMENTS

The above represents a brief outline of the main concepts and opportunities under Section 199A. We want to emphasize that the rules governing its operation are very complex and their interpretation is still quite uncertain. It is also important to note that the Proposed Regulations are not effective until they are finalized and there could be significant modifications in the Final Regulations.

As of this writing, most of the provisions affecting individuals (including Section §199A) are scheduled to sunset in 2025. The U.S. House of Representatives has passed legislation to make many of these provisions permanent, but the ultimate fate of this legislation is uncertain. Moreover, a change in the Administration and control of Congress could result in dramatically different tax legislation sooner than 2025.

We will communicate with you when the §199A Regulations become final, as well as provide memoranda concerning other aspects of the Tax Cuts and Jobs Act of 2017 as greater clarity develops. In the meantime, clients who expect to be in, or close to, the §199A limitations or phase-out ranges discussed above, are urged to have professional income tax projections and planning done prior to December 31st in order to have the opportunity to maximize the §199A deduction for 2018. (Such tax projections and planning could also be useful with respect to other aspects of the Tax Act, such as the potential use of the greatly expanded standard deduction and maximizing the deduction for state and local taxes.)

If you would like further explanation of any of the matters contained in this memorandum or if you would like to explore how Section 199A affects your specific situation, please do not hesitate to contact us.

APPENDIX

Example #1:

Assume in each case below that an individual taxpayer has $1,000,000 of non-SSTB QBI from an unincorporated entity and taxable income of over $1,000,000 without capital gains, putting the taxpayer in the highest Federal Income Tax bracket of 37%. Note that in all cases the maximum potential QBI deduction is $200,000 (QBI of $1,000,000 x 20%) since taxable income exceeds QBI.

A. The source of the QBI paid no wages and has no unadjusted basis in the assets (UBIA) of the activity. As a result, the taxpayer is not entitled to any deduction.

B. The source of the QBI has paid wages of $400,000. As a result, the taxpayer is entitled to the maximum potential deduction of $200,000 ($400,000 x 50%). This deduction results in $74,000 in Federal tax savings ($200,000 x 37%).

C. The source of the QBI has paid wages of $200,000 and has unadjusted basis in assets (UBIA) of the activity of $3,000,000. As a result, the taxpayer is entitled to $125,000 of the maximum potential deduction ($200,000 x 25% plus 2.5% of $3,000,000). This deduction results in a tax savings of approximately $46,000($125,000 x 37%).

D. If the taxpayer in examples A or C has the ability to control what is paid in wages and or make investments in assets that are appropriate for the circumstances, it can result in incremental tax savings.

   For example, in 1-A above, if the taxpayer decided to form an S-Corporation and pay wages of $280,000 to the owners, the QBI would be reduced to $720,000, which would result in a maximum deduction of $140,000 ($720,000 x 20%), and the wage limitation would result in the same $140,000 deduction ($280,000 wages x 50%). This deduction results in tax savings of approximately $52,000 ($140,000 x 37%).

Example #2:

An individual, X, owns a 100% interest in four LLCs, each of which is involved in active real estate operations, each producing $250,000 of net income. X also owns a 100% interest in an S-Corporation which provides the employees and administrative services for the real estate operations. The S-Corporation pays wages of $300,000 and is operated on a break-even basis. X has taxable income of $750,000. It is assumed that there is very little UBIA since the buildings were acquired over 50 years ago. It is also assumed that all conditions for "aggregation" are met, including condition "5" of the "aggregation" requirements (listed in I-3 above) since (a) all entities are in the real estate business and (b) they share significant centralized business elements.

A. If X does not "aggregate", X's QBI deduction is "0" since the real estate operations produce income but have no wages and the S-Corporation has wages but no net income.

B. If X elects to "aggregate", X's QBI deduction would be $150,000. X has QBI of $1,000,000 ($250,000 x 4) resulting in a tentative QBI deduction of $200,000. However, this deduction is limited to 50% of wages paid ($300,000 x 50%= $150,000).

C. If X pays himself additional wages of $100,000 (assuming his total wages are deemed reasonable), his tentative QBI deduction would be $180,000 ($1,000,000- $100,000= $900,000 x 20%). Since total wages are now $400,000, the 50% of wages limitation would not apply and his QBI deduction would be $180,000.

Example #3:

A is a self- employed attorney with net income of $400,000 from the practice. A is married and has taxable income of $500,000 including capital gains of $50,000.

A. If A takes no further action, A's QBI deduction is "0" since A's taxable income is greater than the upper level of the phase-out range ($415,000).

B. A defers the receipt of a $50,000 fee in A's practice, contributes $50,000 to a 401(k) profit sharing plan, contributes $35,000 to a donor advised fund and sells undesirable securities resulting in a $50,000 loss. A's taxable income would be reduced to $315,000 ($500,000 less $50,000 reduced fees, $50,000 401(k) contribution,

$35,000 donor advised fund contribution and $50,000 capital loss). A’s tentative QBI deduction would be $70,000 ($400,000-$50,000 deferred fees= $350,000 x 20%). However, the final deduction would be limited to $63,000 ($315,000 taxable income x 20%).

Example #4:

B operates an automobile repair shop as a single member LLC, which produces a net income of $ 600,000, but pays no wages. B’s taxable income is $700,000.

A. If B takes no further action, B’s QBI deduction will be “0”, since it would be limited to 50% of wages paid.

B. B forms an S-Corporation and pays himself $150,000 in wages. B’s QBI deduction would be $75,000. The net income from B’s repair shop is $450,000($600,000-$150,000 wages) which would produce a maximum deduction of $90,000 ($450,000 x 20%). However, the deduction would be limited to $75,000 ($150,000 wages x 50).

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