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TAX CUTS AND JOBS ACT OF 2017
TAX SIMPLIFICATION-
SECTION 199A – REALLY??

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One of the hallmarks of the Tax Cuts and Jobs Act (TCJA) was the reduction of the top corporate tax rate to 21% of corporate taxable income. This new top corporate rate should allow large U.S. corporations to better compete internationally against foreign corporations domiciled in developed industrial countries with similar tax rates.

However, what about most entities in this country? These entities do not pay income tax but rather their income is passed thru to their owners and taxed at their individual tax rate which can be as high as 37%. This is not fair. How can these smaller entities compete when their tax rate may be 37% when any C corporation top tax rate is only 21%? It would make sense for all these pass-thru entities, S corporations or partnerships, to take advantage of this low corporate tax rate and become C corporations. Congress did not want this mass migration to C corporations so it enacted Section 199A for all pass-thru entities that have their taxable income taxed at the owner's individual tax rate rather at the 21% corporate tax rate.

What is Section 199A? Simply put, if a pass thru entity had $100,000 of taxable income, the owner would only have to report $80,000 of taxable income on their individual return. That's right, the owner can exclude 20% of its business taxable income (called qualified business income or QBI) from a pass-thru entity on their individual return. This means that if a married couple have ordinary taxable income between $165,000 and $315,000, their tax rate on this income is 24% but their effective tax rate on their qualified business income will be only 19.20% (80% x 24%). That should stop a mass conversion from an S corporation or partnership to a C corporation!!

However, it is never that easy. Congress decided to limit the 20% deduction to the lesser of taxable income on the return, net of qualified dividends and capital gains, or 20% of QBI. OK, this is somewhat understandable. Qualified dividends and long-term capital gains qualify for a top income tax rate of 20% so if an individual was already benefitting from this type of income, it made sense to limit the 20% deduction to only ordinary income which could be taxed as high as 37% if the ordinary income was less than the QBI.

But then it gets crazy!! What happens if a married taxpayer has taxable income before this deduction that exceeds $315,000 but is less than $415,000 or any other individual taxpayer (single, married filing separately or head of household) has taxable income before this deduction between $157,500 or $207,500? Holy smokes hang on and buckle your seat belt!! Taxpayers that have taxable income within these ranges face another limitation. This limitation phases-in the entity's wages and depreciable assets into the 199A 20% deduction calculation. This phase-in can severely limit the deduction for an entity that has limited or no wages or depreciable assets.

Should the married taxpayer's taxable income exceed $415,000 or any other taxpayer's taxable income exceed $207,500 this new limitation is fully phased-in. The owner must determine the greater of their proportionate share of 50% of the pass thru entity's wages or 25% of the entity's wages plus 2.5% of the entity's depreciable assets original cost basis. The original cost basis would include all depreciable assets with a depreciable life greater than 10 years that would normally be eligible for depreciation in the current tax year and all other assets with a depreciable life of less than 10 years that would be depreciated for the tenth time or less on the entity's current tax return. For purposes of this calculation, it does not matter if a taxpayer had previously elected Section 179 or utilized bonus depreciation for an asset. The asset's original cost basis is included in the 2.5% calculation if the asset is currently being depreciated or, for 2018 returns, was first depreciated in the 2009 tax year or later.

Again, if the owner's individual taxable income exceeds the limits ($415,000 for marrieds or $207,500 for everyone else) determine the greater number of 50% of the wages or 25% of the wages and 2.50% of the original cost of qualifying assets. Then compare this number to 20% of taxable income reduced for qualified dividends and capital gains and 20% of the QBI (qualified business income). The 20% deduction allowed would be the lowest of the three numbers. That was simple wasn't it?

Are we done yet? NO, you are not done!! One must ask if the qualifying pass thru entity is a specified service trade or business (SSBT). Should the business be an SSBT and the taxable income exceeds the $415,000 or $207,500 taxable income limit, the 20% 199A deduction is **$0!!.**

What is an SSBT? The IRS final regulations define a SSBT as any trade of business that performs services in the field of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, dealing in securities, partnership interests or commodities or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners and employees. The final regulations further define what is generally meant by the performance of services in these fields. The final regulations further exempt engineering or architectural firms from being classified as a SSBT. As you can clearly see, this is tax simplification at its best.

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