A Practical Roadmap Through Section 199A

By Jason B. Freeman, JD, CPA | Column Editor

Perhaps no other provision of the Tax Cuts and Jobs Act of 2017 has given rise to more speculation, debate and consternation than new Section 199A. The complex maze that is Section 199A introduces a set of rules and formulas that determine when a taxpayer qualifies to deduct 20 percent of certain income from pass-through trades or businesses.

The provision, which was designed to bring parity to such income, has widespread application – and many unresolved issues. It is widely anticipated that the IRS will issue guidance in the near future. If and when that guidance is issued, this column will provide a second installment on this topic, diving deeper into the gray areas. For now, however, what follows is a practical roadmap without detours.

The General Rule

Section 199A generally provides individuals, trusts and estates with a deduction equal to 20 percent of the taxpayer's Combined Qualified Business Income (Combined QBI). The phrase Combined QBI is generally defined as the aggregate of the "deductible amount" (described below) for each "qualified trade or business" that flows to the taxpayer. Read the prior sentence carefully, because it contains an important point: Combined QBI is determined on a "trade or business"-by-"trade or business" basis. Unfortunately, what constitutes a distinct trade or business for Section 199A purposes is not entirely clear from the statute.

Qualified Trades or Businesses and Specified Service Trades or Businesses

As a general rule, the phrase "qualified trade or business" does not include a "specified service trade or business" or the trade or business of performing services as an employee. Thus, again as a general rule, income from a specified service trade or business is not eligible for the 20 percent deduction under Section 199A.

A specified service trade or business is any trade or business that involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, 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 employees. A specified service trade or business also includes any trade or business that involves the performance of services that consist of investing and investment management, trading or dealing in securities (as defined in section 475(c)(2)), partnership interests or commodities (as defined in section 475(e)(2)).

While income from a specified service trade or business is generally not eligible for the 20 percent deduction, there is an exception for taxpayers with taxable income below certain threshold amounts. The threshold amount is $157,500 (and $315,000 for taxpayers filing married filing joint).

As a result, taxpayers with taxable income below this threshold are not prohibited from taking the 20 percent deduction for income derived from activities that would otherwise be classified as a specified service trade or business. For taxpayers with taxable income over the applicable threshold amount, but less than $207,500 (or $415,000 for taxpayers filing married filing joint), the specified service trade or business exclusion is "phased in," allowing a partial benefit. Once a taxpayer's taxable income exceeds these amounts, the specified service trade or business rule effectively prohibits any Section 199A deduction for income that is attributable to the specified service trade or business.

Qualified Business Income

The definition of "qualified business income" is central to the Section 199A deduction analysis. QBI is statutorily defined to include the net amount of "qualified items of income, gain, deduction and loss with respect to any qualified trade or business of the taxpayer." This amount includes all such items (income, gain, deduction and loss) to the extent they are "effectively connected" with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the year.

It specifically excludes, however, qualified investment income, including dividends, capital gain or loss, investment interest, commodities gains or losses, foreign currency gains or losses, and certain annuity amounts; REIT dividends, qualified cooperative dividends and qualified publicly traded partnership income; reasonable compensation paid to the taxpayer for services for the trade or business; Section 707(c) guaranteed payments paid to the taxpayer for services performed for the trade or business; or Section 707(a) payments to the taxpayer for services performed for the trade or business.

The Deductible Amount

After determining the separate and distinct qualifying trades and businesses and their QBI, the next step in the Section 199A analysis is to determine the "deductible amount," if any, that flows from such trades or businesses to the taxpayer in order to compute the taxpayer's Combined QBI. The "deductible amount" for each "qualified trade or business" is generally equal to the QBI with respect to the qualified trade or business, although such amount is limited to the greater of (i) 50 percent of W-2 wages with respect to the qualified trade or business (the W-2 Wage Limitation) or (ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property (the Alternative Limitation). In other words, the deductible amount for each trade or business cannot exceed the greater of these two possible limitations.

By way of example, if a qualified trade or business has (i) QBI of $100, (ii) W-2 wages of $150 and (iii) qualified property with an unadjusted basis of $200, then the "deductible amount" with respect to that trade or business would be $75. The deductible amount is calculated as the lesser of QBI ($100) or the limitation amount, which is equal to the greater of two amounts: (i) the W-2 Wage Limitation, which is 50 percent of $150 and thus equals $75 in the example and (ii) the Alternative Limitation, which here is $42.50 (25 percent of W-2 wages, which is $37.5, plus 2.5 percent of the unadjusted basis of qualified property, which is $5). The greater of the two possible limitations ($75 or $37.5) is, therefore, $75; and the lesser of QBI ($100) and the applicable limitation ($75) is $75, leaving a "deductible amount" of – you guessed it – $75.

The Limitations

For purposes of the W-2 Wage Limitation, W-2 wages are defined as total wages paid by the qualified trade or business that are subject to withholding, elective deferrals and deferred compensation with respect to employment of employees. W-2 wages do not include any amount that is not properly allocable to QBI, nor do they include any amount that is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date for such a return.

The term "qualified property" is defined as tangible property with respect to any qualified trade or business of a character that is subject to depreciation allowance under section 167 and that meets three tests: (i) it is held by, and available for use in, the qualified trade or business at the close of the tax year, (ii) it is used at any point during the tax year in the production of QBI and (iii) the depreciable period for the property has not ended before the close of the tax year. Notably, for these purposes, the property's "depreciable period" is defined as ending the later of the date that is 10 years from the date it was first placed in service by the taxpayer or the last day of the last full year in the applicable recovery period that would apply to the property under section 168.

Limitations on the Limitations

The limitations don't always apply. Specifically, the W-2 Wage Limitation and the Alternative Limitation do not apply – that is, they do not limit the "deductible amount" – whenever the taxpayer's taxable income is below a threshold amount. That threshold amount is $157,500 (and doubled to $315,000 for taxpayers filing married filing joint). Thus, taxpayers with taxable income below the applicable threshold amount are simply not subject to these limitations.

For taxpayers with taxable income exceeding these threshold amounts, the limitations are "phased in." Thus, the limitations are partially "phased in" over the next $50,000 of taxable income (or $100,000 for married individuals filing jointly) that exceeds the applicable threshold amount; they apply in full, however, for taxpayers with taxable income over the sum of the threshold amount and the phase-in amount (i.e., over $207,500 or $415,000 for married individuals filing jointly).

The Provisions are Complex

Section 199A introduced a Byzantine set of rules and formulas that determine when a taxpayer qualifies to deduct 20 percent of certain income derived from pass-through trades or businesses. Its provisions, which were designed to bring parity to pass-through trade or business income, leave many open questions and have been the subject to much debate. The foregoing article provides an overview.

As for the many subtle and unanswered questions, expect to see guidance from the IRS in the near future addressing a number of those provisions. At that time, we intend to take up the task of further fleshing out those provisions in this column. ■

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