Business Tax Act Considerations

Section 199a Pass-through entity business deduction

The IRS released proposed regulations under section 199A in August 2018. It is also important to keep in mind that, while the IRS proposed regulations can be relied upon, these regulations are still proposed, meaning, they can and most likely will be revised before being finalized. Taxpayers should exercise caution before making changes to their business structure designed solely to take advantage of the QBI deduction.

Section 199A deduction:

Section 199A is complex and still has some areas of uncertainty. Section 199A allows taxpayers other than C corporations — i.e., individuals, estates and trusts — a deduction of up to 20 percent of their qualified business income (QBI) from qualified pass through entities. The deduction is in effect for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026. There are many various limitations of section 199a, to the extent if one qualifies for the deduction and to the extent of the actual deduction.

In general, qualified business income (QBI) with respect to each qualified trade or business is eligible for the 20% deduction. The new section 199A regulations does not define the term "trade or business," rather, they fall back on the definition of a "section 162 trade or business." Therefore, each business has to be analyzed based on facts and circumstances.

For taxpayers above the limitation phase-in range ($207,500 for single filers, $415,000 for joint filers), with income from specified service trades or businesses (SSTB) are not eligible for the section 199A deduction. Specified services include health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading and dealing. Specified service income also includes fees, compensation or other income received by an individual for endorsing products or services, licensing fees for the use of their name, image, voice, personal trademarks, etc., or appearance fees.

Qualifying (SSTB) income must come from U.S. sources and excludes various investment-related items such as capital gains and losses, section 1231 gains, dividends and nonbusiness interest income. Reasonable compensation paid to the taxpayer, as well as guaranteed payments for services rendered to a partnership, also are excluded from QBI.

The section 199A deduction is a deduction from individual taxable income.

Managing your section 199A deduction:

One might be able to increase your section 199A deduction if one is able to keep their *taxable income under the section 199A threshold*. For taxpayers with taxable income at or below the threshold amount — the 2018 thresholds are $157,500 for single filers, $315,000 for joint filers — the W-2 wage limitation, wage/basis limitation and SSTB limitation do not apply. For these taxpayers, the QBI component of the section 199A deduction is 20 percent of their QBI. If your projected taxable income is above the threshold and you are in a position to defer income, accelerate deductions and/or make additional retirement plan contributions, you may be able to claim the full 20 percent deduction and spare yourself the complexity of the limitation calculations.

The aggregation rules allow taxpayers to combine their trades or businesses, if they meet certain requirements, and treat them as a single trade or business for purposes of the section 199A calculation. This can result in a potential larger deduction than if the calculations were done separately for each business and have the potential to overcome the wage limitations under section 199a

S Corporation stockholder / employee compensation paid is not QBI and is not eligible for the section 199A deduction but is a component in the wage limitation computation. Adjusting Corporation stockholder / employee compensation could have a potential to increase one's section 199A deduction. Though it is important to keep in mind the IRS reasonable compensation rules.

Making a priority allocation of income versus a guaranteed payment, could also potentially increase one's section 199a income. Guaranteed payments to partners are not QBI and are not eligible for the section 199A deduction, nor are they factored into the wage limitation computation. The partnership agreement will have to be amended, and the new allocation must have substantial economic effect. This may involve renegotiating the economic arrangement among partners.

Converting from a Schedule C or Partnership to a S Corporation could increase your section 199A deduction in some situations.

Real estate rentals might or might not qualify for section 199A deduction. As with other businesses under section 199A your rental activity must qualify as a business of trade. The new regulations allow property rented to a commonly controlled trade or business to be treated as a trade or business for section 199A purposes, even if the rental does not rise to the level of a trade or business on its own. However, there is no such accommodation for standalone rentals. Nor is there a safe harbor, similar to the safe harbor under the net investment income tax rules, which treats rental income of real estate professionals as trade or business income based on a 500-hour participation test. The IRS still needs to give guidance to the extent real estate rentals might be able to take advantage of section 199A.

QBI must be effectively connected with a U.S. trade or business in order to be eligible for the section 199A deduction. For businesses with both U.S. and foreign operations, it is critical (for many reasons) to ensure the right amount of income is being reported in the right jurisdiction

Qualified real estate investment trust dividends and qualified publicly traded partnership income are not subject to the W-2 wage limitation, the basis limitation or the SSTB limitation. Income from these investments is eligible for a straight 20 percent deduction; the only limit on this component of the section 199A deduction is the overall limit based on the excess of taxable income over net capital gains.

While the new regulations answer many questions, they do not (and cannot) address every possible fact pattern. Section 199A is a new and untested code section — expect the IRS to be on the lookout for abusive situations. Any planning ideas should be implemented only after careful case by case analysis; the new section 199A deduction is just one piece of the overall tax-planning puzzle.

Market-based sourcing rules and single sales factor and expansion of the Nexus net

The use of market-based sourcing of receipts from services and intangible assets to apportion income continues to gain state attention. Currently, many states have adopted market-based sourcing rules. If you sell tangible or intangible products and or provide services to states in multiple states, you could have an income tax filing and income tax liability in such multiple states. (Even if you do not have physical presence in such other states)

The current Wayfair sales tax case is having a significant impact related to income and franchise tax nexus concerns. More and more states believe they have the authority to assert some type of economic nexus, i.e., they can require multistate businesses to file an income or franchise tax return when physical presence is absent, but some type of economic connection exists (for example, sales to in-state customers). Additionally, nexus policy in several states are based on factor presence, meaning that if a taxpayer's activity in the state exceeds sales, property or payroll thresholds, the taxpayer is deemed to have nexus in the state. We highly recommend that you review your exposure and potential sales tax liability due to the Wayfair sales tax case.

If you have any questions, please feel free to reach out to our office.

2019 is going to be a great year!

** The information provided here is of a general nature and is not intended to be all encompassing nor address the specific circumstances of any individual or entity. In specific circumstances, the services of a professional should be sought. Tax information, if any, contained in this communication was not intended or written to be used by any person for the purpose of avoiding penalties, nor should such information be construed as an opinion upon which any person may rely. The intended recipients of this communication and any attachments are not subject to any limitation on the disclosure of the tax treatment or tax structure of any transaction or matter that is the subject of this communication and any attachments.*