<u>Deduction for Qualified Business Income</u>
Last year's sweeping tax overhaul, the Tax Cuts and Jobs Act of 2017 (TCJA), introduced a new tax break for owners of many businesses called the deduction for qualified business income. It's also known as code Section 199A deduction. If you qualify for it, you will receive a 20% deduction on your qualified business income.

<u>Qualified Business Income</u> - Qualified business income means the net income from a qualified trade or business. However, qualified business income does not include certain investment-related income, including:

1. Short and long-term capital gain and losses;
2. Dividend income, income equivalent to a dividend, or payment in lieu of a dividend;
3. Any interest income other than interest income properly allocable to a trade or business;
4. Net gain from foreign currency transactions and commodities transactions;
5. Income from notional principal contracts, other than items attributable to notional principal contracts entered into as hedging transactions;
6. Any amount received from an annuity that is not received in connection with the trade or business; and
7. Any deduction or loss properly allocable to any of these bulleted items described above.

<u>Qualified Trade or Business</u> – Qualified trade or business means <u>any</u> trade or business **<u>other than</u>**:

1. Employee
2. A Specified Service Trade or Business

Employee - As an employee you can never qualify for this deduction no matter what.

Specified Service Trade or Business – A specified service trade or business is defined as any trade or business involving the performance of services in the following fields:

1. Health.
2. Law.
3. Accounting.
4. Actuarial science.
5. Performing arts.
6. Consulting.
7. Athletics.
8. Financial services.
9. Brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities,
10. 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. Catch all rule.

Engineering & Architecture Services - Are specifically excluded from the definition of a specified service trade or business. Therefore, they qualify.

Some of the categories and fields listed above are fairly clear in their meaning. Others - such as "consulting" and "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" - are vague, and will be difficult to apply until the IRS provides guidance.

While doctors, accountants, and attorneys will clearly fall victim to the specified fields found in this definition, many businesses will not fit so neatly into one of the disqualified categories. For example, while an actor is in the field of performing arts, is a director? A makeup artist? A producer?

The catch all definition is a bit concerning that a disqualified business includes any trade or business of which the principal asset is the reputation or skill of one or more of its employees or owners. The most obvious problem posed by the catch-all is that it threatens any taxpayer who is not engaged in one of the businesses specifically listed as a disqualified field. Consider the case of a "personal trainer to the stars": Using the definition of "a specified service business" in the law the argument can be made that the trainer is not in the fields of health or athletics. Application of the catch-all, however, would likely yield a different result. What is the principal asset of a celebrity? personal trainer if not the reputation and expertise of that trainer?

To further illustrate the complications caused by the catch-all, compare two restaurants - the first a prominent chain, the second a stand-alone bistro with a world-renowned, five-star chef. Neither restaurant is in a listed disqualified service nor so the initial presumption is that both eateries generate qualified business income eligible for the deduction. Now, consider the application of the catch-all. The principal asset of the chain restaurant is clearly not the skill of its employees or owners; after all, if the chef at one of the locations leaves the restaurant, he or she will be replaced and life will go on. As a result, the chain restaurant should not fall victim to the catch-all. The bistro, however, may not be so fortunate. In this scenario, it is much more likely that the business's principal asset is the skill and reputation of the five-star chef who prepares its food. Put in simple terms, if that chef leaves the bistro, the business probably shutters its doors, adding further evidence that it is the expertise of the chef that drives the business. Thus, based on the current structure of the law it would not be unreasonable to conclude that the second restaurant is a specified service business. But why should the owners of the two restaurants be treated differently when they both provide the same mix of food and services to customers?

As one can see, until further guidance is issued that narrows the scope of the catch-all, it threatens to ensnare far more taxpayers than the specifically delineated disqualified fields.

Real Estate Activities – An emerging consensus among practitioners and expert commentators is that most rental real estate activities other than those involving triple net (NNN) rentals will qualify as trades or businesses, because such rental activities typically involve the regular provision of substantial services to tenants. Also, the fact that last-minute changes were made to the bill to make the deduction more readily available to rental property owners is seen an indication that Congress intended that rental income would be eligible for the deduction.

Limitations – There are three limitations that come into play at different income levels. They are:

1. **Specified Service Trade or Business Limitation** – if you are a specific service trade or business, married and your taxable income is $315,001 to $415,000 or single $157,501 to $207,500, your deduction will be limited. Above these thresholds it will be completely denied and you will not qualify for the deduction. The limitation is based on the amount that you are over the $100,000 allowed for married and $50,000 for single.

2. **Wage Limitation** – The W-2 wage limitation on the deduction for qualified business income is based on either W-2 wages paid by the trade or business, or W-2 wages paid plus tangible assets owned by the trade or business. It is the greater of:

    a. 50% of the W-2 wages paid with respect to the qualified trade or business, or

    b. The sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted tax basis, immediately after acquisition, of all qualified property.

3. **Taxable Income Limitation** – The qualified business income deduction can never be more than 20% of your taxable income.

Wages – Only W-2 wages paid and reported to the Social Security Administrator qualify. Thus wages paid by an S Corporation to its sole shareholder/employee qualify. However, guaranteed payments paid by a partnership (LLC, GP, LP or LLP) to its member(s) do not. Therefore, in some cases an S Corporation will qualify for the deduction while partnerships that have no employees will not.

Furthermore, IRS is very specific that a partnership cannot pay/issue a W-2 to its members. Only to its non-member employees.

Who Can Claim the Deduction – Shareholders of S Corporations, members/partners of Limited Liability Company (LLC), partners of a general partnership (GP), partners of a limited partnership (LP), members/partners of a limited liability partnership (LLP), independent contractors and sole proprietorships. Going forward the Code refers to these businesses as a

"Pass-Through Business".

Trusts and estates qualify for the tax break as well.

<u>Different Rules Apply at Different Levels of Taxable Income</u> – Therefore, we have created three categories of income to address each rule that is applicable to that category. They are:

> **Category 1** – Married with taxable income of less than $315,000 or single less than $157,500.
>
> **Category 2** - Married with taxable income of $315,001 to $415,000 or single $157,501 to $207,500.
>
> **Category 3** - Married with taxable income over $415,001 or single over $207,501.

<u>Category 1 – Married with taxable income of less than $315,000 or single less than $157,500</u>
If you fall under this category, everyone who is a Pass-Through Business, regardless of what trade or business you are in, will qualify for the deduction. However, the taxable income limitation applies.

For simplicity in all examples below, we will assume either the taxpayer is married or single, has no dependents, mortgage interest or property taxes to deduct.

Example 1A: Assume that the taxpayers are married. One spouse receives $50,000 of W-2 income and the other $250,000 from any trade or business. Their qualified business income deduction is $50,000 ($250,000 x 20%). Therefore, they will pay federal income tax on $250,000 ($300,000 - $50,000) not $300,000. Their federal income tax liability is approximately $42,900.

Example 1B: Assume that the taxpayers are married. One spouse receives $50,000 of W-2 income and the other $250,000. They do not qualify for the qualified business income deduction because both are employees. Their federal income tax liability is approximately $55,300.

As employees the taxpayers will pay approximately $12,400 more in federal tax.

Example 1C: Assume that the taxpayers are married. One spouse does not work. The other spouse has $300,000 of income from any trade or business. Their qualified business income deduction should be $60,000 ($300,000 x 20%). However, their taxable income is $276,000 ($300,000 minus the standard deduction of $24,000). Based on the taxable income limitation their qualified business income deduction is the lesser of:

a. 20% of the qualified business income, $60,000 ($300,000 x 20%) or

b. 50% of wages paid – Not applicable since they are below the threshold of $315,000 or
c. 20% of their taxable income, $55,200 ($276,000 x 20%).

Their qualified business income deduction is $55,200. Their federal income tax liability is approximately $41,600.

Example 1D: Taxpayer is single and an employee, but not an owner, of a qualified business. Taxpayer receives a salary of $100,000 in 2018. Taxpayer does not qualify for the deduction because he or she is only the employee of the qualified business and not an owner.

If you are an employee, it may be tax advantageous for you to consider becoming a Pass-Through Business such as an S Corporation.

Category 2 - Married with taxable income of $315,001 to $415,000 or single $157,501 to $207,500

If you fall under this category you can still claim the qualified business income deduction but you are subject to the specified service trade or business, wage and taxable income limitations. Therefore, your deduction can either be limited or denied.

Example 2A: Single taxpayer has taxable income of $187,500, of which $150,000 is from a specified service trade or business. Assume that the specified service trade or business has paid sufficient W-2 wages to its employees. He or she is over the threshold allowed by $30,000 ($187,500 - $157,500). The maximum amount allowed that a single taxpayer can be over is $50,000. Therefore, he or she is 60% ($30,000 / $50,000) over the maximum amount allowed. Thus, he or she is only allowed 40% (100% - 60%) of the maximum amount of the qualified business income. The qualified business income is $150,000 x 20% = $30,000. However, he or she only claim 40% of it. Therefore, the deduction for the qualified business income is $12,000 ($30,000 x 40%).

Example 2B: Single taxpayer has taxable income of $187,500, of which $150,000 is from a specified service trade or business. Assume that the specified service trade or business has paid $40,000 in W-2 wages to its employees. He or she is over the threshold allowed by $30,000 ($187,500 - $157,500). The maximum amount allowed that a single taxpayer can be over is $50,000. Therefore, he or she is 60% ($30,000 / $50,000) over the maximum amount allowed. Thus, he or she is only allowed 40% (100% - 60%) of the maximum amount of the qualified business income. But, he or she has only paid $40,000 in wages. Thus, the maximum qualified business income that the taxpayer qualifies for is the lesser of:

a. 20% of the qualified business income, $30,000 ($150,000 x 20%) or

b. 50% of wages paid, $20,000 ($40,000 x 50%).

However, the taxpayer can only claim 40% of the lesser amount since he or she was over the threshold. Therefore, the deduction for the qualified business income is $8,000 ($20,000 x 40%).

Example 2C: Single taxpayer has taxable income of $217,500, of which $150,000 is from a specified service trade or business. Since its taxable income is more than the maximum threshold allowed, $207,500, the taxpayer does not qualify for the qualified business deduction.

Example 2D: Single taxpayer has taxable income of $187,500, of which all of it is from a qualified trade or business and it paid $60,000 in W-2 wages to its employees. The qualified business income deduction is the lesser of:

a. 20% of the qualified business income, $37,500 ($187,500 x 20%) or
b. 50% of wages paid, $30,000 ($60,000 x 50%).

Therefore, the deduction for the qualified business income is $30,000, the lesser of the two figures above.

Category 3 - Married with taxable income over $415,001 or single over $207,501

If you fall under this category the only way that you will qualify for the deduction is if you have a qualified trade or business. You will not qualify for the deduction if your only source of income is from a specified service trade or business. The wage and taxable income limitations apply.

Example 3A: Robert is single and the sole shareholder/employee of ABC, Inc., an S corporation that is a qualified trade or business. ABC has net income in 2018 of $250,000 after deducting Robert's salary of $150,000. Assume that the $150,000 salary paid to Robert is the only W-2 wages paid. Robert’s tentative qualified business income deduction is $50,000 ($250,000 x 20%). However, he has to calculate the wage limitation to determine if its less. The wage limitation is $75,000 ($150,000 x 50%). Therefore, Robert can deduct the $50,000 because the wage limitation is bigger.

Example 3B: Taxpayers owns residential or commercial rental properties through an LLC. His or her share of the rental income earned by the LLC is $800,000. The LLC pays no W-2 wages, but taxpayer’s share of the unadjusted basis of the building is $5 million. Taxpayer’s tentative qualified business income deduction is $160,000 ($800,000 x 20%). However, taxpayer has to calculate the wage limitation to see if its less. Taxpayer has the option of choosing the greater of the following for the wage limitation calculation:

a. 50% of W-2 wages= $0; or
b. 25% of W-2 wages, $0, plus 2.5% of qualified property = $125,000 ($5M x 2.5%).

Therefore the taxpayer’s qualified business income deduction is $125,000.

Example 3C: Taxpayer is a sole proprietor. During 2018, the business generates $400,000 of qualified business income, pays $120,000 of W-2 wages, and has $1.5M of qualified property. Taxpayer flies jointly with his or her spouse and their combined taxable income for the year, including the qualified business income, is $600,000. Taxpayers’ tentative deduction is $80,000 ($400,000 x 20%). However, taxpayers’ have to calculate the wage limitation to determine if its less. Taxpayers have the option of choosing the greater of the following for the wage limitation calculation:

a. 50% of W-2 wages = $60,000 ($120,000 x 50%)
b. 25% of W-2 wages, $30,000 ($120,000 x 25%) plus 2.5% of unadjusted basis of qualified property $37,500 ($1.5M x 2.5%) = $67,500 ($30,000 + $37,500).

Therefore, taxpayers’ qualified business income deduction is $67,500.

<u>Reasonable Compensation</u> - S corporations have long had an incentive to classify payments made to shareholder-employees as dividends rather than wages, because wages are subject to employment taxes such as social security and Medicare dividends are not. The IRS, however, can re-characterize "dividends" that are paid lieu of reasonable compensation for services performed for the S corporation to wages. So, "reasonable compensation" of an S corporation shareholder refers to any amounts paid by the S corporation to the shareholder, up to the amount that would constitute reasonable compensation.

Example 4A: Assume taxpayers A & B own identical businesses. Neither business has any employees or quailed property. Each business generates $500,000 of qualified business income before any wages are paid. A operates his business as a sole proprietor; B an S corporation.

Because A's business has no employees and because, as a sole proprietor, A cannot pay himself a wage, A has a W-2 wage limitation and its zero. Thus, A does not get a deduction.

B as the shareholder of his S Corporation, must comply with the reasonable-compensation requirement. As a result, assume B pays himself $80,000 in 2018. B's is the lesser of:

a. 20% of the qualified business income, $84,000 (20% x $420,000) or
b. 50% of wages $40,000 ($80,000 x 50%).

B’s qualified business income deduction is $40,000 because B paid him or herself $80,000 of W-2 wages and was able to qualify for the deduction. If B was a member/partner of a LLC and received an $80,000 in guaranteed payments, he or she would not have qualified for the deduction because guaranteed payments do not count as wages.

Example 4B: Assume the same facts as in the previous example, except the income earned in each business is $150,000, not $500,000. Assume further that both A and B have taxable income below the $315,000/$157,500 thresholds.

A, the sole proprietor, is entitled to a deduction of $30,000 (20% of $150,000). B, the sole shareholder of the S corporation, remains required to pay himself reasonable compensation. Assume he is paid W-2 wages of $70,000. This reduces the qualified business income B receives from the S corporation to $80,000 ($150,000 - $70,000) and in turn reduces B's deduction to $16,000 ($80,000 x 20%). Thus, when income is below the threshold, the reasonable-compensation requirement works against the shareholder in the S corporation, reducing both his qualified business income and deduction. A, the sole proprietor, has no such requirement and thus preserves the full amount of his qualified business income, giving him a deduction of $30,000, when his S corporation shareholder counterpart receives a deduction of only $16,000.

Netting of Qualified Business Income and Loss – The deduction must be determined separately for each qualified trade or business. After calculating the qualified business income deduction for each trade or business, the taxpayer totals the amounts. If there is an overall loss, no deduction is allowed for that year and the loss is carried over to next year.

Example 5A: In 2018 taxpayer is allocated qualified business income of $20,000 from qualified business 1 and a qualified business loss of $50,000 from qualified business 2. Taxpayer is not permitted a deduction in 2018 and has a carryover qualified business loss of $30,000 to 2019.

Unadjusted Tax Basis - Only the unadjusted basis of qualified property is counted toward the limitation. Qualified property is tangible property subject to depreciation. As a result, the basis of raw land and inventory, for example, would not be taken into account.

The basis of property used to determine the limitation is unadjusted basis determined *before the close of the tax year.* The depreciable period begins on the date the property is placed in service and ends on the later of:

- 10 years after the date placed in service; or
- The last day of the last full year in the applicable recovery period that would apply to the property under Sec. 168

Example 6A: On April12, 2010, Partnership AB*,* a calendar-year partnership, places in service a piece of machinery purchased for $50,000 that has a five-year life. The partners may take into account their allocable share of the $50,000 unadjusted basis of the property in 2018, despite the fact that the asset was fully depreciated before the year began. This is because the depreciable period runs for the longer of:

• 10 full years from April12, 2010 (to April12, 2020); or
• The last day of the last full year in the recovery period, which for a five-year asset placed in service during 2010 would have been 2014.

The partners will also take into account the $50,000 unadjusted basis of the property in 2019. The basis will not be taken into account in 2020, however, because the depreciable period ends on April12, 2020, before the end of the 2020 tax year. Alternatively, assume the machinery was placed in service on June 1, 2008. The partners of Partnership *AB* would not take the $50,000 unadjusted basis into account in 2018 because the depreciable period ended on June 1, 2018, before the close of the 2018 tax year.

How to Avoid Specified Service Trade or Business Status – We are constantly being asked by clients that are a specified service trade or business, what they can do to qualify for the deduction?

Option 1 - One strategy that has been discussed is to infuse a qualified business into a disqualified business - for example, a law firm might acquire commercial real estate that it rents to tenants, or a famous actor might launch a clothing line – in the hopes that it "muddies the waters" enough to convert the entire enterprise into a qualified business. This strategy faces two significant hurdles. First, because the law requires that the deduction be determined on a business-by-business basis, the IRS may force a taxpayer to distinguish among multiple lines of business within the same entity, denying a deduction attributable to any disqualified business line. But even if the businesses could be commingled, the law treats as a disqualified specified service business any business involving the performance of services in the fields of health, law, etc. Thus, the language suggests that even a small amount of services provided in a disqualified field could taint an entire business. Thus, in the examples above involving the law firm/real estate company or actor/clothing line scenarios, because each business would continue to provide some element of personal services in a disqualified field, those services could taint the entire business, potentially preventing the rental income or the income from the clothing line from being treated as qualified business income.

Option 2 - Perhaps a more prudent alternative to maximizing the deduction involves the opposite approach: Having a disqualified business "spin off" the activities of a potentially qualifying business into a separate entity.

Example 7A: Assume Doctor A currently owns a medical/dental S Corporation, S Corporation 1. He or she is the sole shareholder/owner. It has a net income of $500,000 after it pays Doctor A wages of $200,000 and $300,000 to other employees. Doctor A is married.

If Doctor A does nothing, he/she will not qualify for the deduction because being a doctor or dentist a specified service trade or business and his or her taxable income is over $415,000.

Doctor A's federal tax liability will be approximately $189,500.

Example 7B: Same facts as Example 7A.

Doctor A creates two new S Corporations. S Corporation 2 which will do the billing for S Corporation 1. S Corporation 2 which will provide professional services such as administration, purchasing, billing paying and hiring non-licensed professionals for S Corporation 1. These types of organizations are know by many names such as Professional Service Organizations (PSO), Professional Employer Organizations (PEO), Management or Medical Service Organizations (MSO), Dental Service Organization (DSO) and etc.

To make the math simple, assume the only expenses S Corporations 2 and 3 have are the employees that used work for S Corporation 1 to the billing, $50,000, and the non-licensed employees, $100,000. Thus, S Corporation's 1 salaries and wages expense will decrease by $150,000 ($50,000 + $100,000) because going forward they will be paid by S Corporations 2 and 3.

S Corporation 1 pays fair market fees to S Corporation 2 of $100,000 and $200,000 to S Corporation 3 for the services that they provide it.

S Corporation 1 now has a net income of $350,000 ($500,000 - $100,000 - $200,000 + $150,000).

Assume S Corporation 2 pays $50,000 in wages so its net income is $50,000 ($100,000 - $50,000) and S Corporation 3 pays $100,000 in wages so its net income is $100,000 ($200,000 - $100,000).

Doctor A's federal tax liability will be approximately $178,400.

By "spinning-off" the activities of his or her medical/dental practice into three separate entities that two qualify as a qualified trade or business, Doctor A was able to reduce his or her federal tax liability by approximately $11,100.

The above structure is not limited to medical or health professionals. Law firms can do the same. Real estate management companies can “spin off” the janitorial and repair divisions into separate entities. Financial planners can hire their spouses to provide them with administrative services and etc.

The “spin off” division would take the position that because its new business not in the field of health, it is not a specified service trade or business. The IRS could craft regulations which provide that administrative and support services provided to a specified service trade or business are treated as the provision of services in that same specified service trade or business. If this were the case, rendering administrative and support services to a doctor group would be treated as services provided in the field of health, converting that business from a qualified to a disqualified or specified service trade or business.

Furthermore, you need to take into account the cost, management & etc. associated with opening new entities.

Option 3 - Perhaps a safer alternative is for a specified service trade or business - for example, a doctor - forms a new LLC that purchases the building it currently leasing, which then rents the building to the medical practice at the highest justifiable rate. It is unlikely future regulations would deny such a structure, provided the rent were fairly valued, because, in this example, it is property, rather than services, that is being provided to a specified service trade or business.

Example 7C: Same facts as Example 7B.

However, Doctor A purchases the building he or she practices out of for $5M. Assume the rent that was paid to the old landlord, $60,000 per year, is now paid to Doctor A’s LLC. Assume the LLC has no other income, expenses or employees.

The LLC qualifies for the deduction it even though it has no employees. The tentative deduction is 20% of the qualified business income, $12,000 ($60,000 x 20%). Or the lesser of:

a. 50% of the W-2 wages paid, which is zero or,
b. The sum of 25% of the W-2 wages, zero, plus 2.5% of the unadjusted tax basis which is $125,000 ($5M x 2.5%).

Thus the deduction is $12,000.

<u>Advantages & Disadvantages S Corporation versus Sole Proprietorships</u> – The following are the advantages of conducting your business through an S Corporation versus a sole proprietorship:

1. **Payroll Tax Savings** – S Corporations pay payroll taxes on the wages paid to its shareholder/employee(s). Sole proprietorships pay payroll taxes on the net income of

the business. Payroll tax is made up of:

a. Social Security or FICA – 12.4% on the first $128,400 of wages and
b. Medicare – 2.9% and there is no limit.
c. Hospital Insurance (HI) - 0.9% of wages over $250,000 for married and $200,000 for single.

Example 8A: Taxpayer is single and the sole shareholder/employee of his or her S Corporation. Its net income is $330,000 before wages. The S Corporation pays the taxpayer wages of $80,000. Taxpayer will pay the following payroll taxes:

$9,920 in Social Security or FICA – 12.4% x 80,000
$2,320 in Medicare – 2.9% x $80,000
$0 in Hospital Insurance

Total payroll tax paid by the taxpayer is $12,240.

Example 8B: Same facts as above except that the taxpayer is a sole proprietorship. Thus, its net income is $330,000. Taxpayer will pay the following payroll taxes:

$15,923 in Social Security or FICA – 12.4% x $128,400
$9,571 in Medicare – 2.9% x $330,000
$943 in Hospital Insurance - .9% x ($330,000 – $200,000 - $15,922 - $9,570)

Total payroll tax paid by the taxpayer is $26,437. By being an S Corporation and receiving a reasonable compensation the taxpayer saved $14,197 ($26,437 - $12,240) in payroll taxes.

In Example 4B, A the sole proprietorship received a bigger deduction than B the sole shareholder/employee of the S Corporation. However, you have to take into account the additional payroll tax cost to accurately calculate if there is a tax savings as a sole proprietorship.

2. **Liability Protection** – Generally S Corporations provide liability protection to their shareholders. A sole proprietor is liable for his or her business. This is a legal issue and it should be discussed with an attorney.

3. **Audit Protection** – S Corporations have the least chance of being audited by IRS. Sole proprietors have a higher chance.

The following are the disadvantages of conducting your business through an S Corporation versus a sole proprietorship:

1. **Incorporation Fee** – There is a one-time fee to incorporate with the Secretary of State.

2. **Annual Minimum Franchise Tax** – State a California charges the greater of $800 or 1.5% of the S Corporation's net income as a franchise tax. Thus, at minimum you will pay $800 a year in franchise tax.

3. **Quarterly & Annual Federal and State Payroll Tax Returns** – You have to file quarterly and annual federal and state payroll tax returns.

4. **Annual S Corporation Income Tax Returns** – You have to file annual federal and California S Corporation income tax returns. Furthermore, you need to keep separate books and records for the corporation. Therefore, you should have some kind of a bookkeeping system implemented.

We are able to provide you with any and all of the services listed above. We can incorporate your business, provide bookkeeping services, prepare the required quarterly and annual payroll tax returns and prepare your annual S Corporation income tax returns.

Gain on the Sale of Depreciable Asset Used in a Trade or Business, Section 1231 Gain – The law is silent on the treatment of the gain when you sell an asset that you have used in your trade or business for more than one year. This is called a Section 1231 gain.

Is the gain qualified business income? Since Section 1231 asset is specifically excluded from the definition of a capital asset it seems like until guidance from the IRS provides otherwise, it is reasonable to include the gains and losses in qualified business income.

Like-Kind Exchanges - Regulations will provide rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

Tiered Entities - Future regulations will provide guidance on how to determine the deduction in the case of tiered entities.

Commonly Controlled Entities - At present, the law does not allow for an allocation of the W-2 wages paid by the management company to each of the operating companies. As a result, assuming the shareholders of the operating companies have taxable income exceeding the threshold amounts, they would be precluded from claiming a deduction, courtesy of the W-2 limitations. Similar problems arise in the case of employees leased through a professional employer organization (PEO) or employee leasing firm.

Increased Exposure to Underpayment Penalty - Generally, for taxpayers other than C corporations, the understatement is substantial if its amount for the tax year exceeds the greater of:

• 10% of the tax required to be shown on the return for the tax year; or

• $5,000

Under the new law, substantial understatement penalty is applied when:

• 5% of the tax required to be shown on the return for the tax year; or
• $5,000

This lower threshold is particularly harsh, given the lack of guidance surrounding key aspects of this new law and the resulting challenges taxpayers and their advisers face in implementing the provision. Importantly, the changes do not require the substantial understatement to be attributable to the qualified business income deduction. Thus, any taxpayer who claims the deduction will be subject to the lower threshold, even if the understatement on the return is unrelated to the qualified business income deduction.

Conclusion - While the purpose of the deduction is clear, its statutory construction and legislative text is anything but clear. The provision is rife with limitations, exceptions to limitations, phase-ins and phase-out's, and critical but poorly defined terms of art. As a result, the new law has created ample controversy since its enactment, with many tax advisers anticipating that until further guidance is issued, the uncertainty surrounding the provision will lead to countless disputes between taxpayers and the IRS. Adding concern is that, despite the ambiguity inherent in the law, Congress saw fit to lower the threshold at which any taxpayer claiming the deduction can be subject to a substantial understatement penalty.

Right now is a great time for tax planning and creating an analysis specific to your business to determine if you qualify for the deduction. If you do not qualify for the deduction we can advise you on other options that may be available to you. Please do not hesitate to call us.

The information within this email is an accumulation from many sources; especially, Parker Tax Pro Library and The Tax Adviser April 2018 issue.

Very truly yours,
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