WHITE PAPER

The New Section 199A Deduction for Qualified Business Income

BY **KIM D. GARCIA, CPA/PFS,** PRINCIPAL

The Tax Cuts and Jobs Act which became effective on December 22, 2018 created a new Internal Revenue Code Section – 199A. This section permits a deduction of up to 20% of Qualified Business Income for owners of sole proprietorships, LLCs, partnerships and S corporations. The deduction also applies to income from REITs (Real Estate Investment Trusts), publicly traded limited partnerships and certain personally owned real estate investments. This new code section is extremely complicated and many of the nuances will continue to be refined over the coming year. This paper will provide an overview of the definitions and calculations that are involved in determining the amount of the deduction.

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The objective of the deduction is to afford pass-through entities and sole proprietorships similar tax treatment to C corporations which are now subject to a flat 21% corporate tax rate.

The deduction applies at the individual taxpayer level for taxpayers who are sole proprietors, partners, members or shareholders. The deduction applies to ordinary income from trades or businesses. The deduction will not reduce the adjusted gross income of an individual but will be a deduction applied to compute taxable income. The deduction may be used by taxpayers claiming the standard deduction as well as those who itemize deductions.

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Definitions

There are several terms that must be defined before the mechanics of the deduction can be understood:

Qualified Business Income

This term refers to the net amount of income, gain, deduction and loss that are connected with the conduct of a trade or business within the United States. The following items are not considered qualified trade or business income:

- **Short and Long term gains and losses**
- **Dividends**
- **Interest**
- **Annuity payments**
- **Guaranteed payments paid to a partner for services rendered**
- **Reasonable compensation paid to the taxpayer by a trade or business owned by the taxpayer**

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Specified Service Trades or Businesses

The act provides that certain service businesses will not be eligible for the deduction if the individual taxpayer has taxable income in excess of certain thresholds. These service businesses are specifically identified as those involving the performance of services in the following fields:

- **Health**
- **Law**
- **Accounting**
- **Actuarial Science**
- **Performing Arts**
- **Consulting**
- **Athletics**
- **Financial Services**
- **Brokerage Services**
- **Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners**
- **Any trade or business which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests or commodities.**

The Act excludes businesses that involve engineering and architecture from the definition of a specified service trade or business.

W-2 Wages

This includes compensation paid to employees of a trade or business in the form of salary, bonuses and profit sharing plan contributions. Wages do not include payments to independent contractors.

Qualified Property

This is physical property used in a trade or business during the taxable year. It includes real estate, furniture and equipment. For use in the calculation of this deduction, qualified property is accounted for at its original cost before any deduction for depreciation.

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Taxable Income Thresholds

The deduction is reduced or completely eliminated if an individual's taxable income exceeds certain limits as shown below (single taxpayers in parentheses):

TAXABLE INCOME AMOUNT	NON-SERVICE BUSINESS	SPECIFIED SERVICE BUSINESS
Below $315,000 ($157,500)	Full Deduction	Full Deduction
Between $315,000 and $415,000 ($207,500)	Reduced Deduction	Reduced Deduction
Above $415,000 ($207,500)	Deduction Limited by Wage and Property Threshold	No Deduction

Wage and Property Limitation

This limitation applies when an individual's taxable income exceeds $415,000 ($207,500 for single taxpayers). In such cases, the potential deduction for each qualified trade or business will be limited to the lesser of:

1. **20% of the qualified business income or**
2. **The greater of –**
   a. **50% of the W-2 wages of the qualified trade or business or**
   b. **The sum of 25% of the W-2 wages of the qualified trade or business plus 2.5% of the unadjusted basis of the business's qualified property.**

Note that no deduction is allowed for any Specified Service Business where a taxpayer's taxable income exceeds the maximum income threshold. If a taxpayer's income is between the minimum and maximum threshold amount, the wage and property limitation is phased in as shown below under Reduced Deduction.

Qualified Business Income Amount

This is the amount calculated as the maximum allowable deduction for each trade or business taking into account the taxable income thresholds and wage and property limitation defined above.

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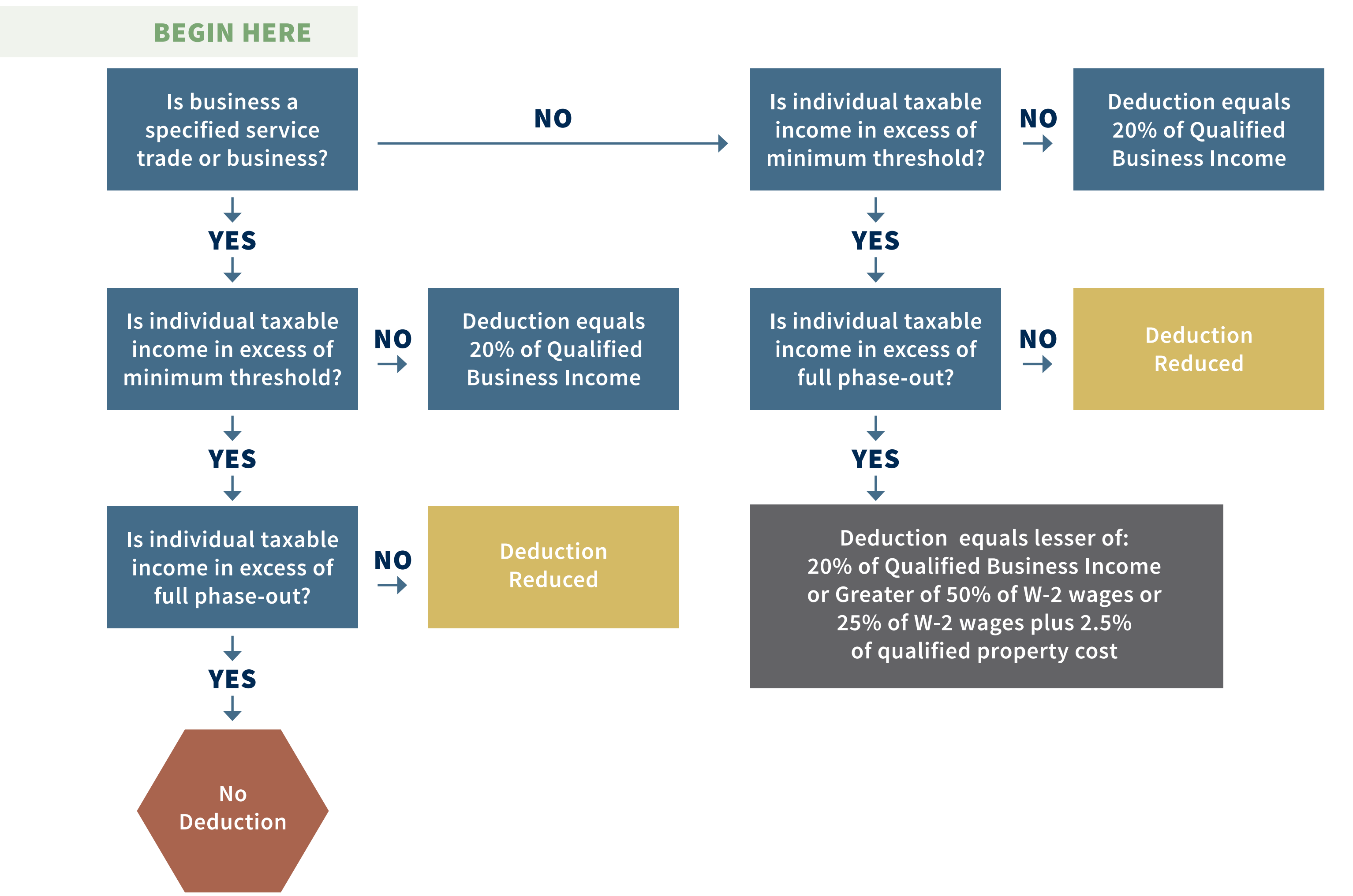
Mechanics of the Calculation of Qualified Business Income Amount

1. **Identify each trade or business to which the deduction may apply including identification of any specified service businesses as defined above.**
2. **The income threshold is applied at the individual taxpayer level and will determine if the deduction will be subject to a reduction.**
3. **The wage and property limitation is applied to each trade or business separately based upon the individual taxpayer's income threshold.**

The following flowchart demonstrates the process of determining the amount of the Qualified Business Income Amount for each trade or business:

Section 199A Calculation



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Reduced Deduction

The reduction of the deduction in cases where a taxpayer's taxable income is between $315,000 and $415,000 ($157,500 and $207,500 for single filers) is calculated as follows:

$$\text{Reduction \%} = \frac{\text{Amount of taxable income in excess of minimum threshold}}{\text{\$100,000 (\$50,000 for single filers)}}$$

Final Deduction Amount

The sum of all of the Qualified Business Income Amounts for each trade or business as illustrated above is compared to the individual taxpayer's taxable income less net capital gain. The final deduction is equal to the lesser of:

Combined Qualified Business Income Amount

OR

20% of Individual Taxable Income in excess of Net Capital Gain

Important Notes And Disclosures

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Examples

These calculations are best understood by viewing several simple examples:

ONE – Income Below Minimum Threshold

Individual Taxable Income of $300,000 (no capital gains)

Qualified Business Income of $50,000

Business has W-2 Wages of $10,000

The Qualified Business Income amount for this business is $10,000. The Wage Limitation does not apply since the taxable income is below the $315,000 threshold.

The amount of the deduction is $10,000 because this amount is less than $60,000 which is 20% of taxable income of the taxpayer.

TWO – Income Below Maximum Threshold

Individual Taxable Income of $375,000 (no capital gains)

Qualified Business Income of $50,000

Business has W-2 Wages of $10,000

The Qualified Business Income Amount for this business is $7,000. The Wage Limitation is $5,000 (50% of $10,000). This amount is phased in because taxable income exceeds the income threshold of $315,000. The phase-in amount is 60% because the excess of taxable income over the threshold is $60,000 (60%= 60,000/100,000). 60% of the wage limitation is $3,000 (($10,000-$5,000) x 60%). $3,000 reduces the original $10,000 business amount to $7,000. The amount of the deduction is $7,000 because this amount is less than $75,000 which is 20% of taxable income of the taxpayer.

THREE – Income Above Maximum Threshold

Individual Taxable Income of $450,000 (no capital gains)

Qualified Business Income of $50,000

Business has W-2 Wages of $10,000

The Qualified Business Income Amount for this business is $5,000. Because taxable income exceeds the maximum threshold of $415,000, the wage limitation applies to fully limit the amount to $5,000. The amount of the deduction is $5,000 because this amount is less than $90,000 which is 20% of taxable income of the taxpayer.

Note that if the business in Example Three was a specified service business, no deduction would be allowed.

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Losses

The act also revised Internal Revenue Code Section 461 to provide that any excess business loss of any taxpayer other than a corporation shall not be allowed, including losses incurred at the shareholder or partner level of pass-through businesses. The term excess business loss means the excess of the aggregate losses which are attributable to trades or businesses, over $500,000 for joint returns and $250,000 for single filers. These excess business losses may be carried over to offset future trade or business income in the following tax year.

Planning Considerations

Below is a list of ways in which business activities may be structured to take advantage of the Section 199A deduction:

- Segregate specified service business activities from non-service activities. If a service business such as a medical practice also provides medical equipment in addition to patient care, it may be possible to move the equipment sales into a separate entity which would not be considered a health service business.
- Increase Tax-Deductible Employer Qualified Plan Contributions. Employer paid pension contributions are not considered wages paid to employees but will serve to reduce the overall income of the business.
- Gift Portion of Flow-Through Entity to Family Members. If a taxpayer's income is above the threshold, the taxpayer's ownership percentage of the entity and resulting flow-through income could be reduced by gifting interests to lower income family members.
- Consider Converting Flow-Through Business into a C Corporation. Section 199A is set to expire at the end of 2025 while the 21% flat corporate tax rate is permanent. It may be worthwhile to examine the potential benefits of converting the business into a C corporation.

As stated at the outset of this paper, this code section is extremely complex and requires careful consideration of each business situation. Contact us if you have questions or would like to discuss planning ideas for maximizing the deduction. This paper is intended to be educational in nature and does not replace the need for analysis of individual circumstances.

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO

300 N Greene Street, Suite 2150
Greensboro, NC 27401
Phone: 336.217.0151

MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302