Navigating New Tax Deductions for Private Companies: Section 199A

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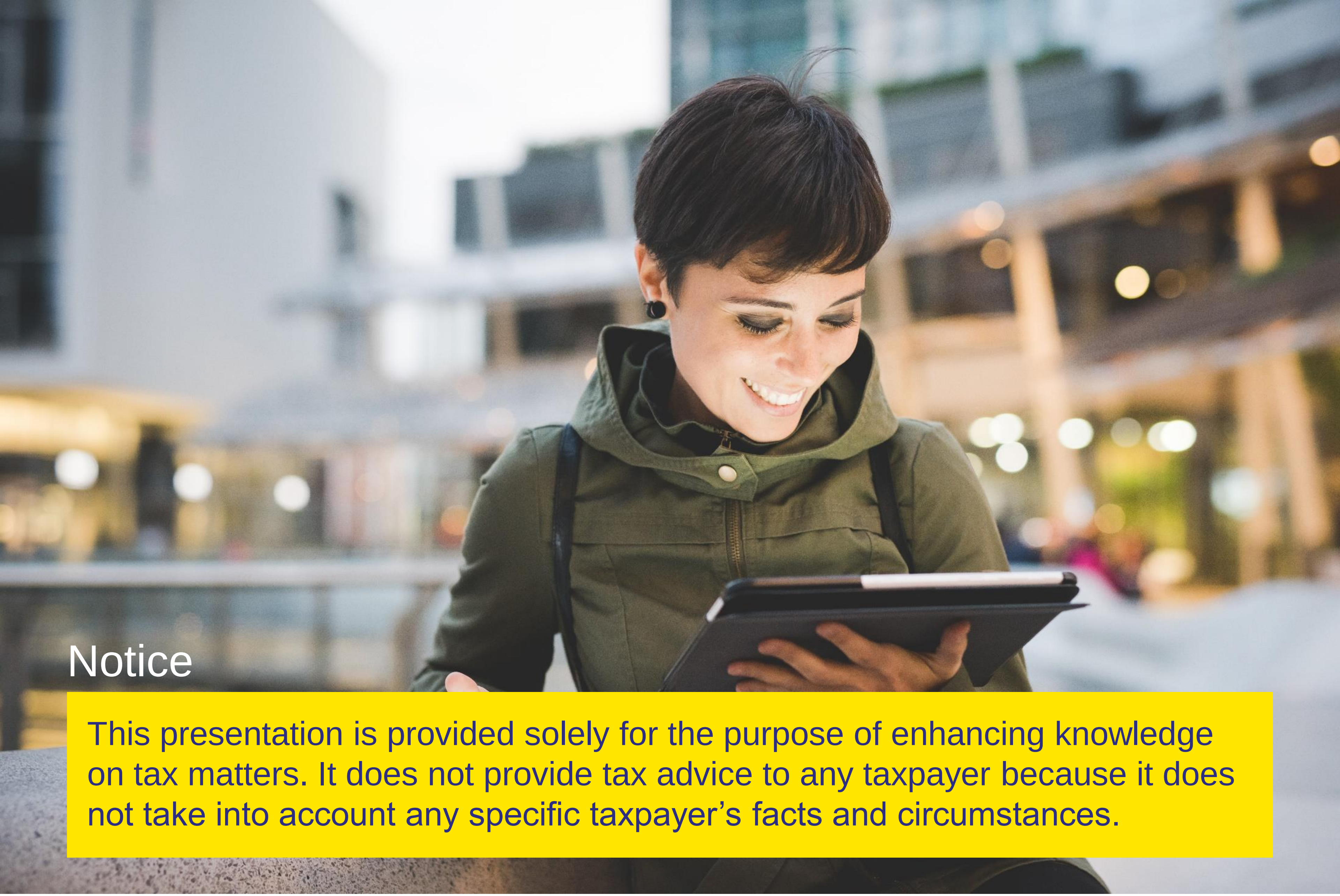

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Today's speakers: EY tax partners

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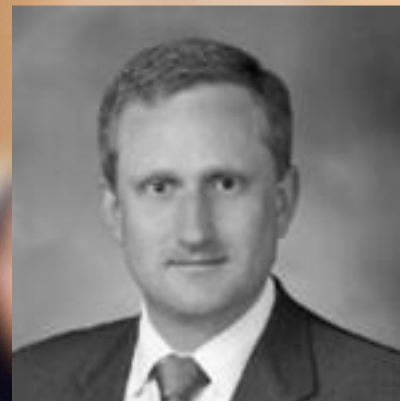

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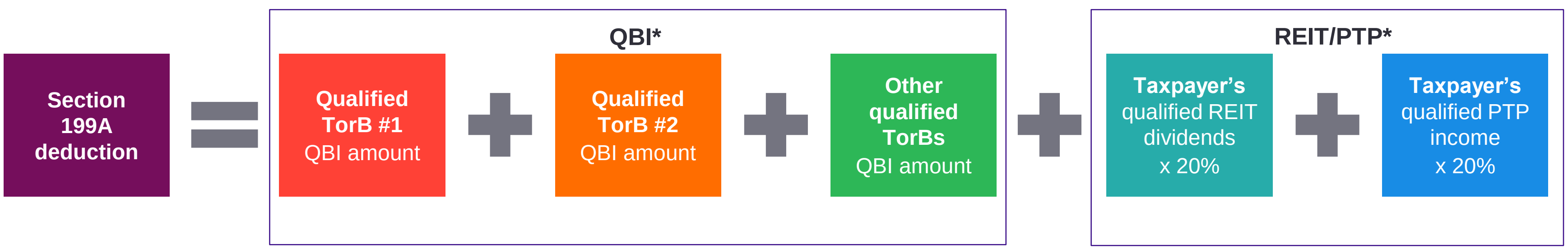
Overview of Section 199A

- Section 199A, the deduction for qualified business income (QBI), is available for taxable years beginning after December 31, 2017 and before January 1, 2026
  - Proposed regulations were issued August 8, 2018 (2018 Proposed Regulations)
  - Guidance released on January 19, 2019 consists of:
    - Final regulations (Final Regulations)
    - Proposed regulations (2019 Proposed Regulations)
    - Notice 2019-07
    - Revenue Procedure 2019-11

Overview: deduction calculation

- The deduction is equal to the QBI amount for each of the taxpayer's qualified trades or businesses, plus 20% of a taxpayer's (1) qualified real estate investment trust (REIT) dividends, and (2) qualified publicly traded partnership (PTP) income.
- The deduction cannot exceed 20% of taxable income (reduced by net capital gain and qualified dividend income) of the taxpayer for the taxable year.



*If the QBI or REIT/PTP amount is an overall loss, it is treated as zero for the deduction calculation and is carried forward to the next year.

TorB = Trade or business

Overview: potential benefit

- The Section 199A deduction is a permanent tax benefit that reduces a taxpayer's federal effective tax rate (ETR).
- The potential benefit is a reduction in ETR of up to 7.4 percentage points.

Section 199A effective tax rate impact			
	With Section 199A	**Without Section 199A**	
Taxable income before Section 199A	$ 1,000,000	$ 1,000,000	
Section 199A deduction limited to 20% of taxable income	$ (200,000)	$ –	
Taxable income after Section 199	$ 800,000	$ 1,000,000	
Federal tax at 37%	$ 296,000	$ 370,000	**Difference**
Effective tax rate	29.6%	37.0%	**7.4%**

What is QBI?

QBI

- QBI is a taxpayer's qualified items of income, gain, deduction and loss for the taxable year that are effectively connected with the conduct of a trade or business within the United States (including Puerto Rico)
  - Generally includes income earned through partnerships, S corporations and sole proprietorships that are engaged in a trade or business within the United States
- QBI is determined for each of the taxpayer's qualified trades or businesses
- A net QBI loss is treated as a loss from a qualified trade or business in the succeeding taxable year

Qualified income items + Qualified gain items − Qualified deduction items − Qualified loss items = Qualified business income (QBI)

QBI exclusions

- QBI does not include
  - Qualified REIT dividends*
  - Qualified PTP income*
  - Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,
  - Any guaranteed payment described in Section 707(c) paid to a partner for services rendered with respect to the trade or business
  - Any payment described in Section 707(a) to a partner not acting in its capacity as a partner for services rendered with respect to the trade or business to the extent provided in regulations
  - Certain investment income, including but not limited to capital gain/loss; dividends; interest; and gain/loss relating to certain commodities, foreign currency, and notional principal contracts transactions
    - See Section 199A(c)(3)(B) for the full list of items excluded from QBI

*Although not included in the definition of "QBI," these items are factored into the 199A deduction

QBI, qualified REIT dividends, qualified PTP income

- The Final Regulations make several notable changes regarding items included or excluded from QBI, including:
  - Section 1231 gains or losses
  - Previously disallowed losses or deductions
  - Excess business loss arising under Section 461(l)
  - Other deductions attributable to a trade or business
- The 2019 Proposed Regulations provide additional rules on the treatment of previously disallowed losses or deductions

QBI, qualified REIT dividends, qualified PTP income

- The Final Regulations generally follow the 2018 Proposed Regulations regarding qualified PTP income and clarify that the specified service trade or business (SSTB) limitations apply to qualified PTP income received by an individual above the income threshold
- The Final Regulations modify the definition of a qualified REIT dividend to exclude: (1) a dividend held for a period of time that is less than the prescribed period under Treas. Reg. Section 1.199A-3(c)(2)(A); and (2) a dividend, to the extent that the shareholder is required to make certain related-party payments
- The 2019 Proposed Regulations add provisions that would allow a regulated investment company (RIC) shareholder to be treated as if the shareholder directly earned its share of any qualified REIT dividends earned by the RIC

Qualified trade or business

- A qualified trade or business is any trade or business other than a specified service trade or business (as defined under Section 1202(e)(3)(A) without regard to engineering and architecture)
- A “trade or business” is a trade or business under section 162 other than the trade or business of performing services as an employee
  - Special rule for rental or licensing of tangible or intangible property to a commonly controlled trade or business
  - Notice 2019-07 proposes a revenue procedure that provides a safe harbor for rental real estate

Specified service trade or business

- A specified service trade or business includes any trade or business involving services in the fields of:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Investing and investment management, trading, or dealing in securities, partnership interests, or commodities

- A specified service trade or business also includes any trade or business where the principal asset is the reputation or skill of one or more employees or owners

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SSTB: anti-abuse provisions

- The Final Regulations retain the 2018 Proposed Regulations' SSTB de minimis rule, but add two examples illustrating the rule
  - Gross receipts less than $25m: less than 10% SSTB gross receipts
  - Gross receipts $25m or more: less than 5% SSTB gross receipts
- The Final Regulations modify the 2018 Proposed Regulations' SSTB anti-abuse rules
  - The Final Regulations remove the 80% threshold rule relating to services or property provided to an SSTB
  - The Final Regulations remove the rule relating to a trade or business being treated as incidental to an SSTB
- The Final Regulations modify the 2018 Proposed Regulations' rule regarding the presumption that former employees are still employees

Exception to specified service trade or business

- The specified service trade or business provisions do not apply to taxpayers with taxable income below certain amounts
  - $315,000 (2018) and $321,400 (2019) for married taxpayers filing a joint return
  - $157,500 (2018) and $160,725 (2019) for all other eligible taxpayers
- The exception phases out for taxpayers with taxable income between
  - $315,000 and $415,000 (2018) and $321,400 to $421,400 (married filing jointly);
  - Otherwise between $157,500 and $207,500 (2018) and $160,725 to $210,725
- The exception does not apply to taxpayers with income greater than:
  - $415,000 (2018) and $421,400 (2019) for married taxpayers filing a joint return
  - $207,500 (2018) and $210,725 (2019) for all other eligible taxpayers
- These threshold amounts are indexed for inflation annually

Section 199A deduction limitations

Overview of the limitations

- For taxpayers with taxable income above the phase-in range:
  - QBI for each trade or business is limited by the greater of:
    - 50% of the trade or business's W-2 wages attributable to QBI; or
    - 25% of the trade or business's W-2 wages attributable to QBI plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of the trade or business's qualified property for each qualified trade or business
  - QBI does not include income from a specified service trade or business (SSTB)
- QBI is limited to income that is effectively connected with the conduct of a US trade or business

W-2/UBIA thresholds

- The applicable thresholds are the same as for the SSTB exception:
- Taxable income below the threshold is not subject to the W-2/UBIA limitation
  - $315,000 (2018) and $321,400 (2019) for married taxpayers filing a joint return
  - $157,500 (2018) and $160,725 (2019) for all other eligible taxpayers
- For taxable income within the phase-out range, only the "applicable percentage" of what is otherwise QBI is taken into account
  - $315,000 and $415,000 (2018) and $321,400 to $421,400 (married filing jointly);
  - Otherwise between $157,500 and $207,500 (2018) and $160,725 to $210,725
- For taxable income above the phase-out limit, the W-2/UBIA are fully effective
  - $415,000 (2018) and $421,400 (2019) for married taxpayers filing a joint return
  - $207,500 (2018) and $210,725 (2019) for all other eligible taxpayers
- These threshold amounts are indexed for inflation annually

W-2 wages

- W-2 wages include:
  - Those wages paid with respect to employment of employees for the calendar year ending during the taxpayer's taxable year
    - Includes wages paid by the qualified business to its employees
    - Includes elective deferrals including 401(k) plans, 403(b) plans, pension plans, and simple retirement plans
    - Excludes any amount which is not properly included in a return filed with the SSA on or before the 60th day after the due date (including extensions) for such return
  - Only includes wages attributable to a qualified trade or business

W-2 wages

- The Final Regulations generally follow the 2018 Proposed Regulations regarding W-2 wages, including:
  - Wages paid by a person other than a common law employer
  - Acquisitions and dispositions
  - Short tax years
  - W-2 wage allocation
- Revenue Procedure 2019-11 is substantially the same as the proposed revenue procedure provided in Notice 2018-64

UBIA of qualified property

- Qualified property under Section 199A(b)(6)(A) is tangible property of a character subject to depreciation under Section 167 that:
  - Is held by, and available for use in, the qualified trade or business at the close of the tax year;
  - Is used for the production of qualified business income at any point during the taxable year; and
  - Whose depreciable period has not ended prior to the end of the taxable year
- Unadjusted basis, not current tax basis, is used in calculation
- Generally, the unadjusted basis of qualified property is its acquisition cost regardless of whether the qualified property is actually being depreciated

UBIA of qualified property

- The Final Regulations make several significant additions and changes to the rules regarding the UBIA of qualified property, including:
  - Computation of UBIA of qualified property held by a partnership or S corporation
  - Section 743(b) basis adjustments
  - Non-recognition transactions
  - Section 1031 and Section 1033 transactions
  - Property acquired from a decedent
  - An anti-abuse provision to discourage transactions with a principal purpose of increasing UBIA of qualified property

Section 199A aggregation and other rules

Aggregation

- Aggregation allows taxpayers to treat multiple trades or businesses as a single trade or business for purposes of applying the wage and qualified property limitations
- To aggregate multiple trades or businesses:
  - Each trade or business must independently qualify as a trade or business;
  - There must be majority ownership by same person or group of persons;
  - No trade or business may be a SSTB; and
  - Trades or businesses must be integrated
- The Final Regulations modify the 2018 Proposed Regulations to allow individuals and relevant pass-through entities (RPEs) to aggregate trades or businesses

Relevant Passthrough Entity (RPE)

- Regulations provide special computational and reporting rules for RPEs, PTPs, and trusts and estates
  - Trusts and estates are treated as RPEs to the extent that they allocate QBI and other items to beneficiaries
- For purposes of threshold amount, trusts and estates determine taxable income after taking into account the trust's or estate's income distribution deduction
  - The S and non-S portion of an ESBT are treated as a single trust for this purpose
- Anti-abuse rule applicable to the creation of a single trust with the principal purpose of avoiding, or using more than one, threshold amount
- The 2019 Proposed Regulations also add rules relating to charitable remainder trusts

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