Alan Gassman and Brandon Ketron: Dymistifying the New Section 199A Deduction for Pass-Through Entities

"New Internal Revenue Code Section 199A will allow individual taxpayers and trusts to receive up to a 20% deduction on what is referred to as "qualified business income". This will result in a great many businesses and professionals being taxed at a rate which is 80% of the otherwise applicable rate if several requirements are met. For example, taxpayers in the highest bracket (37%) that qualify for the full deduction will be taxed at a 29.6% rate on qualified business income (80% of the highest bracket rate of 37% is 29.6%--an additional 3.8% Medicare tax may apply depending upon the level of participation that the taxpayer has in the flow through entity).

Many taxpayers will not be able to take this deduction in 2018 due to improper positioning, or failure to restructure in ways that can make the deduction available. This newsletter will take the reader through the definitions and hurdles that need to be navigated and discuss obstacles and strategies that must be identified and applied, as well as uncertainties in the law that may cause problems for many."

Alan Gassman and **Brandon Ketron** provide members with commentary that helps advisors struggling with the calculations in the new Section 199A deduction.

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articles in publications such as BNA Tax & Accounting, Estate Planning, Trusts and Estates, and for InterActive Legal. His book "Gassman & Markham on Florida & Federal Asset Protection Law" has recently been updated, and will be available to InterActive Legal subscribers at the InterActive Legal table at the Heckerling Institute, along with information on the EstateView Estate Tax Planning Software that he designed with Professor Jerry Hesch. Alan will speak at the InterActive Legal booth on Tuesday, January 23rd at 10:40 a.m. on Illustrating Estate Tax Planning, and will speak on Asset Protection for Business Owners and Their Entities at the 5th Annual Estate Planning Symposium of the Miami Estate Planning Council on Tuesday, February 6th along with Stacy Eastland, Tami Conetta, Lester Law and others. On Tuesday, March 2nd, Alan will be speaking at the Jacksonville Estate Planning Council on Dynamic Planning Strategies for the Successful Client, and will present a six-hour Professional Acceleration Workshop for law students and alumni of Stetson University in St. Petersburg on Friday, April 6th, beginning at 11 a.m. You can contact Alan at agassman@gassmanpa.com for more information with respect to any of these programs.

Here is their commentary:

EXECUTIVE SUMMARY:

New Internal Revenue Code Section 199A will allow individual taxpayers and trusts to receive up to a 20% deduction on what is referred to as "qualified business income". This will result in a great many businesses and professionals being taxed at a rate which is 80% of the otherwise applicable rate if several requirements are met. For example, taxpayers in the highest bracket (37%) that qualify for the full deduction will be taxed at a 29.6% rate on qualified business income (80% of the highest bracket rate of 37% is 29.6%--an additional 3.8% Medicare tax may apply depending upon the level of participation that the taxpayer has in the flow through entity).

Many taxpayers will not be able to take this deduction in 2018 due to improper positioning, or failure to restructure in ways that can make the deduction available. This newsletter will take the reader through the definitions and hurdles that need to be navigated and discuss obstacles and strategies that must be identified and applied, as well as uncertainties in the law that may cause problems for many.

FACTS:

On December 22nd, President Trump signed into law the Tax Cuts and Jobs Act (TCJA) adding a new Code Section 199A, which dramatically impacts the taxation of flow through entities.

This is a complicated code provision that has gray areas that will be worked out over the upcoming months, if not years. Practitioners will need to take extra time in order to familiarize themselves with Code Section 199A and be able to advise clients on how to properly structure their business and wages paid from such businesses to maximize tax savings.

COMMENT:

OVERVIEW

The following definitions and terminology are used in this article, and may be appropriately memorized for long term use in this letter and subsequent use in this new arena.

1. A Flow Through Trade or Business is a "trade or business" activity which occurs under an entity taxed as a partnership, an S corporation, or as disregarded or owned individually by a single person or married couple.[1] The statute does not define "trade or business" or give guidance as to which definition of that term will apply to determine whether a passive activity, such as triple net leasing, may qualify. Many investment arrangements will be restructured to become more active in nature in order to help assure qualification for the deduction. The deduction will also apply to income from Real Estate Investment Trusts ("REIT's") and publically traded limited partnerships.[2]

2. Flow Through Income consists of K-1/reported income, or Schedule C or E income, and is thus measured by the income of the flow through entity or individual from the flow through

activity, and not by the amount of cash distributions received. In order to qualify for the deduction, the income must be effectively connected to the conduct of a trade or business within the United States.[3]

3. Individual Taxpayer means an individual married or single person who has an ownership interest in a flow through entity or has direct flow through income under a Schedule C business or a Schedule E rental activity which may qualify for the 20% deduction. When the Individual Taxpayer is married we are referring to all income of both spouses and assuming that they are filing joint returns for the purposes of this letter.

4. Specified Service Trades or Businesses consists of those eleven (11) categories of businesses or activities which will not qualify for the flow through deduction if the individual taxpayer reporting such income has taxable income exceeding the levels described below. For the most part these primarily consist of service provider professions that are normally paid by W-2 wages for services provided.[4]

5. W-2 Wages means compensation paid to employees as salary, bonuses, and elective profit sharing plan deferrals paid by a flow through entity, and does not include wages earned by an individual taxpayer from sources other than a flow through entity, compensation paid to independent contractors, or income that is subject to self-employment taxes, if not paid and treated as wages paid to an employee.[5] Wages will also not include amounts not timely reported to the Social Security Administration. Since wages cannot be paid by a partnership to a partner because of the guaranteed payment rules, or from a Schedule C proprietor or Schedule E rental activity to the individual taxpayer there will be many businesses and activities moving to S corporations early in 2018.

6. Qualified Property means physical assets, including real estate, furniture and equipment owned by a flow through entity which may be used to meet the wages and 2.5% of the cost of qualified property test described below.[6]

Before diving into a more technical description of the statute, the reader can be best served by reviewing the following steps of analysis that can be used to determine if and how the deduction will be applied.

IMPORTANT NOTE: LISI has developed a tool that: 1) quickly calculates the 199A pass-through deduction, and 2) also helps advisors model the more complex choice of entity question as to whether a particular client is "better off" being a C Corporation or a pass-through entity. For more information or to purchase simply click this link: leimbergservices.com/analyzers

STEP ONE -- IDENTIFY FLOW THROUGH ENTITIES AND FLOW THROUGH INCOME.

Flow through entities, which will qualify under the statute will consist of S corporations, entities taxed as partnerships, Schedule C entities such as sole proprietorships, "disregarded" LLC's owned solely by an individual or married couple, and Schedule E income received from rental activities owned personally or under a disregarded LLC. When Limited Liability Companies (LLC's) and Limited Partnerships (LP's) are involved there will often be confusion because these may be treated as C corporations, S corporations, partnerships, or as "disregarded" and owned by individuals, depending upon circumstances. Entity documents, historical elections, and tax returns must be closely examined in many situations to determine whether flow through treatment will apply.

For example, many LLC Operating Agreements for corporations that have attempted to make S elections have provisions that would require the company to be treated as a C corporation (as opposed to an S corporation) if the language of the Operating Agreement violates what is known as the "second class of stock" rule.

Companies treated as C corporations may elect to be treated as S corporations by making an election 75 days after the date upon which the S corporation election will apply (by March 15, 2018 for a January 1st S election), but entity documents must exist on January 1st which meet the S corporation eligibility rules.[7] Caution should be exercised due to the harsh tax results that may be imposed on S corporations that have made an S election under the unrecognized built in gain rules of Code Section 1374 and the "sting tax" rules of Section 1375. There are ways to navigate around the impact of these rules by advance planning, which may involve accruing expenses in the minutes of a meeting of a C corporation before the effective date of the S election. For example, if the S election is to effective January 1st, then sufficient legitimate expenses would need to be accrued by the preceding December 31st, and actually paid by March 15th, in order to "zero out unrecognized built in gains" under Section 1374.

Advisors should keep in mind, however, that the 21% top tax bracket for C corporations is also very attractive, and may be preferable to the 80% of 37% (29.6%) top bracket for those who wish to reinvest corporate earnings, or take advantage of 1202 companies which may be sold or liquidated in a tax advantaged manner.[8]

STEP TWO -- APPLY INCOME LIMITS AT THE INDIVIDUAL TAXPAYER LEVEL BASED ON THE ACTIVITY INVOLVED.

First, please keep in mind that all income limits in the statute are applicable to the taxpayer who receives the flow through income, and not at the flow through entity level.[9]

Second, keep in mind that going above the limit can cause loss of thousands of dollars of deductions.

We next discuss two very essential and possibly confusing steps in the analysis, which both involve income calculations of the individual taxpayer, but apply in separate circumstance:

As a preview, Step Three applies where the flow through entity's income is from one of the 11 categories of Specified Service Trades or Businesses and the individual taxpayer is above the income amounts.

Step Four applies where the individual taxpayer is above the income amounts and there is not a sufficient amount of wages paid by the flow through entity, and/or the value of qualified property to permit the deduction.

Please keep in mind that: (1) the deduction will be based upon up to 20% of the flow through entity income, (2) the wage test under Step Four will be based on all wages paid by the flow through entity to all of its employees, including the taxpayer, and (3) the income limits will apply to the sum of the flow through entity income that is passed to the individual taxpayer and the individual taxpayer's other income (4) Wages and Qualified Property calculations will apply at the flow through entity level, and may not be aggregated or "mixed" where an individual taxpayer has ownership interest in multiple entities.

STEP THREE -- IDENTIFY ACTIVITIES THAT CANNOT QUALIFY IF THE INDIVIDUAL TAXPAYER'S 2018 INCOME EXCEEDS $415,000/$207,500, OR WHERE DEDUCTION IS REDUCED IF TAXPAYER'S 2018 INCOME EXCEEDS $315,000/$157,500.

A great many taxpayers and advisors were shocked to learn that only individual taxpayers receiving less than $415,000 for taxpayers married filing jointly or $207,500 for single filers will be eligible to take the deduction as to flow through activity income that consists of any one or more of the following categories of businesses or professions[1011]:

1. Health
2. Law
3. Accounting
4. Actuarial science
5. Performing arts
6. Consulting
7. Athletics
8. Financial services
9. Brokerage services
10. Any trade or business where the principal asset is the reputation or skill of one or more employees
11. 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.

This limitation for the above categories of businesses or professions is phased in ratably beginning at $315,000 of taxable income for taxpayers married filing jointly, and at $157,500 for single filers, as is further discussed below.[12]

STEP FOUR -- NAVIGATE THE WAGES AND QUALIFIED PROPERTY TEST THAT APPLIES WHERE THE INDIVIDUAL TAXPAYER HAS TOTAL TAXABLE INCOME ABOVE $315,000 FOR MARRIED AND $157,501 FOR SINGLE FILERS – THE DEDUCTION CANNOT EXCEED A SPECIFIED PERCENTAGE OF THE GREATER OF (1) THE SALARIES PAID BY THE ACTIVITY OR (2) THE SUM OF A PORTION OF SALARIES PAID PLUS A PERCENTAGE OF THE VALUE OF "QUALIFIED PROPERTY" USED IN THE ACTIVITY.

The deduction for individual taxpayers will generally be based upon 20% of the flow through income for taxpayers at or below the $315,000 for married and $157,500 for single taxpayers, while taxpayers whose personal income exceeds these levels may have their deduction limited based upon the wages and qualified property test described above.[13]

The above distinction will cause much confusion, and should be carefully understood and remembered. This applies with reference to the income level of the individual taxpayer receiving the deduction, and not the flow through entity, and can significantly limit the deduction of those individuals who are above the $315,000 or $157,500 income amounts.

FOR INDIVIDUAL TAXPAYERS BELOW $315,000/$157,500:

If the individual taxpayer has income from a business or activity below $315,000 for married taxpayers filing jointly or $157,500 for single filers then the deduction will be calculated by taking the lesser of (1) the individual taxpayer's qualified business income multiplied by 20%, which is referred to in the statute as the Combined Qualified Business Income Amount, or (2) 20% of the individual taxpayers' taxable income less net capital gains.[14] This calculation may be altered slightly if the taxpayer has (1) dividends received from a cooperative housing organization, which are known as "Qualified Cooperative Dividends", or (2) certain amounts of net capital gains, as described below.[15] [16]

For example, if A and B are a married couple filing jointly and have taxable income of $300,000, consisting of $200,000 of qualified business income from their 10% ownership of an LLC taxed as a partnership, then A and B would receive a deduction of $60,000 ($200,000 * 20%) regardless of the LLC's wage and qualified property situation.

By second example, if A and B have taxable income of $300,000 consisting of $150,000 of qualified business income from their LLC,$200,000 of capital gains, and $50,000 of itemized deductions, then A and B would receive a Section 199A deduction of $20,000 ($300,000- 200,000 * 20%), because 20% of taxable income less net capital gains is less than 20% of A and B's qualified business income, or the Combined Qualified Business Income Amount ($150,000 * 20% = $30,000).

For readers who want to roll their sleeves up to completely understand the formula that applies to individual taxpayers having less than $315,000 of taxable income if married or $157,000 for single filers, the deduction is technically calculated by taking the lesser of:

(1) the "Combined Qualified Business Income Amount" (the 20% deduction described above)

OR

(2) 20% of the excess of

A. the taxpayer's taxable income for the taxable year

less

B. any net capital gains, <u>plus qualified cooperative dividends, plus the lesser of</u>

1. <u>20% of qualified cooperative dividends</u>

2. <u>taxable income reduced by any net capital gain</u>

Unless you or your client will receive a qualified cooperative dividend the underlined technical language of the statute above can be ignored, and the deduction will be the lesser of (1) 20% of qualified business income or (2) 20% of taxable income less any net capital gain, which is the test that will be used for the remainder of this article.

Under no circumstances can the amount of the deduction exceed the excess of the taxpayer's taxable income over net capital gains.[17]

LIMITATION FOR SPECIFIED SERVICE TRADES OR BUSINESSES

As indicated above**,** Code Section 199A limits the ability of specified service trades or businesses to make use of the deduction for qualified business income.[18]

A specified service trade or business is defined by Subsection 1202(e)(3)(A) to be "any trade or business involving 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."[19]

It is noteworthy that engineering and architecture firms are named under Section 1202(e)(3)(A) but are specifically exempted under the statute and thus not considered to be Specified Service Businesses under Code Section 199A.[20]

Specified Service Businesses also include trade or businesses which involve the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[21] Very little guidance is given on the above definitions, so many taxpayers may fall into a gray area, or may divide their businesses into separate companies to isolate and possibly maximize the type of income that qualifies for the deduction. Examples of gray area businesses will include payroll services, certain types of insurance agencies, IT companies and management companies.

If the flow through entity is engaged in one of the above referenced businesses and the taxpayer has taxable income that exceeds $415,000 for taxpayers married filing jointly or $207,500 for single filers then the deduction under Code Section 199A is not available.[22] If the taxpayer's taxable income is less than the above amounts then the taxpayer will be able to deduct the lesser of (1) 20% of the taxpayer's qualified business income or (2) 20% of taxable income less any net capital gain.[23]

If the taxpayer's taxable income exceeds $315,000 for taxpayer's married filing jointly or $157,500 for single filers then the deduction will be phased out by the amount the taxpayer's taxable income exceeds the above amounts divided by $100,000 for taxpayer's married filing jointly or $50,000 for single filers.[24]

For example, if a married doctor receives $200,000 of flow through income from his medical practice and has taxable income of $365,000 then the deduction will be limited to $20,000, which is calculated as follows:

$$\frac{\$365{,}000 - \$315{,}000}{\$100{,}000} = 50\%$$

$$50\% * (\$200{,}000 * 20\%) = \$20{,}000$$

In addition, since the doctor's income exceeds the income limit his deduction may be further limited by the wages and qualified property test, which is also phased in at $315,000 for taxpayer married filing jointly. This test is discussed in more detail below.

LIMITATION FOR HIGH INCOME INDIVIDUAL TAXPAYERS:

Individual taxpayers who have taxable income before the Section 199A deduction exceeding $415,000 for married taxpayers filing jointly or $207,500 for single filers face a limit on what they can deduct on their individual returns, which takes into account the wages paid and qualified property used by the flow through entity based upon the <u>lesser</u> of (1) or (2) below:

(1) 20% of the taxpayer's qualified business income with respect to the qualified trade or business

(2) The greater of:

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

OR

B. the sum of (i) 25% of the W-2 wages with respect to the qualified trade or business plus (ii) 2.5% of the “original cost” (technically the unadjusted basis immediately after the acquisition) of all “qualified property” used in the business or investment activity.[25]

W-2 wages are defined as wages paid by the flow through entity with respect to the employment of employees during the calendar year ending during such taxable year.[26] Wages include those amounts that are paid to all employees of the flow through entity, including but not limited to the individual taxpayer/owner.[27]

For example, if the taxpayer has $1,000,000 of qualified business income received from a flow through entity, the flow through entity does not pay any W-2 wages, and has no qualified trade or business assets then there will be no deduction.

If the same individual taxpayer, however, takes a salary from the flow through trade or business of $333,000, so that the qualified trade or business income is $667,000, then 20% of $667,000 is $133,400, and 50% of $333,000 in wages is $166,500, so the deduction will be the lesser of the two numbers, which is $133,400.

By further example, if A and B have qualified trade or business property with an unadjusted basis of $5,000,000, no W-2 wages, and qualified business income of $1,000,000, $5,000,000 multiplied by 2.5% is $125,000 and $1,000,000 multiplied by 20% is $200,000, so a deduction of $125,000 may be taken, in addition to having depreciation deductions for the qualified property.

Taxpayers who will be above the threshold amount will want to analyze what the most efficient ratio of wages to non-wage income will be under this formula, which will be 28.57% of the flow through income if the 50% of W-2 wages limitation applies, or will vary at lower than 28.57% when the 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property limitation applies.[28]

As the result of this, married taxpayers who have more than $415,000 of taxable income, or $207,500 for single filers, will have no Section 199A deduction from a flow through entity that does not pay wages to employees (from any source or from that income) and has no qualified property.

Many businesses may use independent contractors or outside service agencies and will need to switch to using employees and paying wages to allow their high earner owners to have the benefit of the 20% of net income deduction. This may adversely impact pension planning for the other employees, health care plan rules and costs, and many other aspects of an applicable business.

The qualified property test will allow taxpayers owning passive activity endeavors such as real estate and equipment leasing to have the benefit of the deduction. The rules define qualified property as tangible (physical) property of a character subject to the allowance for depreciation under Section 167 which is (1) held by, and available for use in the qualified trade or business at the close of the taxable year, (2) used at any point during the taxable year for the production of qualified business income, and (3) the depreciable period for the property has not ended before the close of the taxable year.[29] In laymen's terms this means furniture, equipment, buildings, and other physical non inventory property that has not yet outlived its depreciable life.

It is noteworthy that "depreciable period" is defined as the time period ending upon the later of (1) ten years after the date the property is first placed into service or (2) the depreciable period that would apply to the property under Section 168 even if such property was acquired prior to its enactment in 1981.[30] This means that property with a depreciable life under Section 168 of less than ten years can still be counted until the ten-year period expires. For example, vehicles, computers, equipment and other property that may have been fully expensed with bonus depreciation or a Section 179 deduction can still be counted for at least 10 years after acquisition. Real estate and improvements thereto, whether acquired prior to 1981 or thereafter, will be counted based upon the depreciable life as calculated under Section 168, which is 27.5 years for residential real property or 39 years for commercial buildings such as include warehouses, manufacturing, offices, shopping centers, supermarkets, retail, restaurants, hotels, motels, casinos, entertainment, auto dealerships, self-storage, hospitality and hospitals. As a result, the depreciable period for purposes of calculating the Section 199A may not be equal to the property's depreciable life for the purposes of calculating the deprecation deduction for tax and book purposes.

The statute authorizes the Secretary of the Treasury to issue Treasury Regulations to prescribed rules for the purposes of determining the depreciable period of assets acquired under 1031 exchanges or involuntary conversions.[31] It is therefore unknown whether the asset will be considered to have been acquired when the exchanged property was originally acquired, although it is quite likely the acquisition date will be when the original "relinquished" asset was purchased.

Taxpayers with qualified trades or businesses that have significant qualified property will therefore be able to take lower salaries or even no salary, which would otherwise be subject to employment taxes and taxed at the taxpayer's individual income bracket. Once the property exceeds its depreciable life it will no longer be included, so taxpayers relying on this subsection will need to pay close attention to the length of time property has been in service in order to continue taking advantage of the Section 199A deduction.

A more detailed example to illustrate how to calculate the deduction for a taxpayer with income exceeding the $415,000 or $207,500 limit is as follows:

A and B a married couple filing jointly have the following items of income:

Taxable Income -	$1,000,000
Qualified Business Income -	$800,000
W-2 Wages -	$200,000

Net Capital Gain - $50,000

Qualified Property Basis - $100,000

The first calculation is to determine the Combined Qualified Business Income Amount. In this example, the Combined Qualified Business Income Amount will be $100,000 or 50% of the taxpayer's W-2 wages as calculated below:

The Combined Qualified Business Income Amount is equal to the lesser of:

1. $160,000 (20% of the taxpayer's qualified business income)

$800,000 * 20% = $160,000

OR

2. **$100,000**

The greater of:

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

$200,000 * 50% = **$100,000**

OR

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

$200,000 * 25% = $50,000

$50,000 + ($100,000 * 2.5%) = $52,500

The taxpayer's deduction would be equal to the lesser of (1) the Combined Qualified Business Income Amount ($100,000) or (2) 20% of taxable income less any net capital gain (20% * (1,000,000 - $50,000) = $190,000. Therefore, in this example, the taxpayer's deduction under Section 199A would be equal to $100,000.

If the taxpayer's taxable income for taxpayer's married filing jointly is between $315,000 and $415,000 or between $157,500 and $207,500 for single filers then a phase in to the wages and qualified property test described above in calculating the Combined Qualified Business Income Amount applies.[32]

If the greater of (1) 50% of W-2 wages with respect to the qualified trade or business or (2) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after the acquisition of all qualified property (the "limitation amount") is more than 20% of the taxpayer's qualified business income then the phase out will not apply. and the taxpayer's Combined Qualified Business Income Amount will simply be equal to 20% of the taxpayer's qualified business income.

If the limitation amount is less than 20% of the taxpayer's qualified business income then the phase out applies. The taxpayer's Combined Qualified Business Income Amount will then be reduced by the amount that the taxpayer's taxable income exceeds $315,000 divided by $100,000 for taxpayers married filing jointly or by the amount the taxpayer's income exceeds $157,500 divided by $50,000 for single filers multiplied by the difference in 20% of the taxpayer's qualified business income and the limitation amount.

For example, if B, a single taxpayer, has taxable income of $167,500 with qualified business income of $100,000 and W-2 wages of $50,000 then the phase out will not apply because the limitation amount of 50% of B's W-2 wages (25,000) exceeds 20% of B's qualified taxable income ($20,000).

If B has qualified business income of $120,000 and W-2 wages of $40,000 then the phase out will apply because 20% of B's taxable income ($24,000) is greater than the limitation amount $20,000). Therefore B's Combined Qualified Business Income Amount will be reduced by $800 which is calculated as follows:

$$\frac{167{,}500 - 157{,}500}{\$50{,}000} \text{ (Amount taxable income exceeds the threshold amount)}$$

= 20% (Applicable percentage)

20% * $4,000 (Difference between limitation amount and 20% of qualified business income)

= $800

B's Combined Qualified Business Income Amount is equal to $23,200, and B's deduction would be the lesser of (1) $23,200 or (2) 20% of taxable income less any net capital gain ($24,000). Therefore, B's deduction would be equal to $23,200.

RELATED RULES

A complete list and explanation of all aspects and considerations for these new rules are beyond the scope of this newsletter, but the following items are noteworthy for planning purposes:

1. The deduction will not reduce self-employment taxes resulting from the flow through income.[33] For example, an individual taxpayer who earns $80,000 a year on his Schedule C tax return business will pay employment taxes on the entire $80,000, although he may pay income taxes on only $64,000 of such income.

2. A taxable loss from a flow through activity in 2018 or thereafter may result in a reduced deduction for future years.[34] For example, if a Schedule C business had a $50,00 taxable loss in 2018 and $150,000 in income in 2019 then there may only be a $20,000 deduction under Section 199A for 2019.

3. The original Senate version of the bill did not include a provision allowing a Section 199A deduction for entities held by a trust or an estate. Thankfully, this was added in committee. Therefore, the Section 199A deduction will be available even if the qualified business is held through a trust or an estate.[35] If the trust is a grantor trust then the grantor will calculate his deduction as described above. If the trust is a complex trust the deduction will be calculated at the trust level to the extent of income retained by the trust, and at the beneficiary level for each beneficiary who has received a distribution. The rules for the allocation to the trust or beneficiary can be found under Treas. Reg. § 1.199-5.

4. The deduction is only available to the extent that the income from the flow through activity is effectively connected with the conduct of a trade or business within the United States.[36]

Planning Considerations:

Increase Pension Contributions to Reduce Taxable Income

Where a taxpayer is over the income limit, salary could be reduced and mandatory pension contributions increased, and no part of the pension contribution will be included in income, so that the deduction can apply. Many taxpayers in small businesses that have 401(k) plans will install cross tested defined benefit or cash value plans that will enable the higher paid employees to put $200,000 or more a year into pension plans to enable them to be under the income limitation amounts. Elective profit sharing contributions count as wages under the statute, but conventional employer contributions do not.

Move Income Into a C Corporation or pay deductible expenses to other entities.

As another example of planning possibilities, what if a physician spouse with an S corporation medical practice decides to work less in a traditional medical practice where she was earning $415,000 a year and forms a C corporation to provide weight loss services after hours in the medical clinic building, based upon a reasonable investment in advertising, equipment and personnel. Because the physician spouse spends less time in the traditional practice S corporation income goes down by $50,000 a year. The C corporation pays the physician salary of $30,000 and has income at the corporate level of $20,000 taxed at the 37% bracket, which applies to professional companies under the new tax act (as it did before). While this causes $20,000 of income to be taxed at the 37% bracket, the couple may receive deductible medical insurance under a nondiscriminatory medical expense plan, disability insurance and certain other tax advantaged benefits from the C corporation, while saving $5,402 in taxes because of the 20% deduction (14,600 deduction * 37% tax bracket = $5,402 tax savings.

This can be even more beneficial if the stock of the C-Corporation qualifies as "qualified small business stock" which allows a taxpayer to exclude up to 100% of the gain on the sale of a "Qualified Small Business" under Section 1202.[37] Planners must now juggle what activities will qualify for the Section 199A deduction, and what activities may qualify for Section 1202 treatment. It is noteworthy that Section 1202 treatment will not be available for the following trades or businesses:[38]

1) Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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.

2) Any banking, insurance, financing, leasing, investing, or similar business.

3) Any farming business (including the business of raising and harvesting trees).

4) Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A.

5) Any business of operating a hotel, motel, restaurant, or similar business.

It must also be remembered that a Section 1202 company cannot accumulate cash and marketable securities beyond what is needed for reasonable operating capital.[39] Clients have to invest the profits in business related assets, and may not be considered a leasing company

Alternatively, many professional practices may contract with family members who own other entities to take over management and responsibilities that the professional was handling to reduce work load for the professional and allow for the payment of deductible expenses by the flow through entity to family members who may need the work and the money, and who may be in lower tax brackets.

Buy A New Piece of Equipment to Generate a Section 179 Deduction.

A single doctor earning $210,000 a year based upon $70,000 in salary and $140,000 in K-1 income would not be eligible for the deduction because his income exceeds the $207,500 threshold. The single doctor could replace equipment in his office that cost $60,000 and immediately expense such equipment using the new bonus depreciation rules or Section 179 deduction. The doctor's taxable income would then be equal to $150,000 consisting of $70,000 of salary and $80,000 in K-1 income, and the doctor would be eligible for the Section 199A deduction. The doctor could then take a $16,000 Section 199A deduction that would save $5,920 in taxes in addition to the tax savings realized by writing off the property purchased.

Consider Gifting or Selling Part of a Flow Through Entity to a Complex Trust for Children and Grandchildren.

If a taxpayer's taxable income exceeds the threshold amount, a portion of the income could be shifted to a separate taxpayer by using a complex trust.

For example, John, a married individual, receives $300,000 of flow through income from his wholly owned LLC that is a specified service trade or business. John also receives a salary of $125,000, therefore John's taxable income ($425,000) exceeds the threshold limitation and he is not eligible for the Section 199A deduction.

John could gift or sell 50% of the LLC to a complex trust for his wife and/or children. John would still receive his $125,000 salary, but now John's flow through income would only be $150,000. The remaining $150,000 of flow through income would be allocated to the complex trust assuming that the income was not distributed out to the beneficiaries. As a result, John now has taxable income of $275,000 ($125,000 salary + $150,000 flow through income) and can take a Section 199A deduction of $30,000.

Although the trust's income will be taxed at the highest bracket due to the compressed rate tables, it can also take a $30,000 Section 199A deduction on its $150,000 of flow through income. This results in the income being taxed at an effective tax rate of 29.6%, which is less than the 35% tax bracket John was in prior to the transfer of the LLC to the complex trust.

If the income is distributed to the beneficiaries of the trust, the income will be taxed at their individual tax brackets and they will also have the ability to take a Section 199A deduction. If John's wife is also a beneficiary of the trust distributions should be limited so that John and his wife's taxable income will not exceed the income limitation amount.

Gifts or sales may be to children, complex trusts, electing small business trusts, qualified subchapter S trusts, charities, charitable remainder trusts and other entities. Future writings of the authors will provide details on the advantages and disadvantages of gifting or selling ownership interests to one or more of the above specified entities.

A complex trust can also direct income to charities to have the equivalent of a charitable deduction under Section 642(c) without the itemized deduction and percentage of Adjusted Gross Income limitations applying.

Separate Specified Service Trades or Businesses from Non-Specified Service Trades Or Businesses.

If a taxpayer's taxable income exceeds the threshold amount, the taxpayer will want to consider separating service activities that will not be eligible for the deduction and activities that will be eligible for the deduction regardless of the taxpayer's taxable income into separate entities.

For example, it may be possible for a professional athlete or entertainer to convey its intellectual property rights that are separate and apart from the individual identity of the celebrity or applicable individual to a separate entity and to pay arm's-length royalties and marketing expenses to that entity, which may qualify as a flow through income eligible for the deduction.

Conclusion

Section 199A provides an outstanding opportunity for taxpayers to position themselves to pay less taxes while contributing to the economy. The many requirements and mathematical models required to qualify and quantify the deduction will require significant and immediate restructuring for a good many taxpayers. The statute contains many areas where further guidance will be necessary, and hopefully the Treasury Department will provide guidance in the near future on the key issues. In the meantime, advisors and their clients can take steps to maximize tax advantages while also remaining flexible to facilitate fine-tuning as the rules become more clear.

Most importantly, stay posted on future developments as the experts advance planning opportunities for clients in the normal progression of development when new laws are passed and human ingenuity is applied. Advisors may want to consider using a software which 1) quickly calculates the 199A pass-through deduction, and 2) also helps advisors model the more complex choice of entity question as to whether a particular client is "better off" being a C Corporation or a pass-through entity. For more information or to purchase simply click this link: leimbergservices.com/analyzers

The fun never stops!

Alan Gassman

Brandon Ketron

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CITATIONS:

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[1] *See* IRC § 199A(c)

[2] IRC § 199A(b)(1)(B)

[3] IRC § 199A(c)(3)(A)(i)

[4] *See* IRC §199A(d)

[5] IRC § 199A(b)(4)

[6] *See* IRC § 199A(b)(6)

[7] IRC §1362

[8] See Gassman Ketron, *1202 Things to Consider When Setting Up a Related Business Servicing Company,* Leimberg Business Entities Email Newsletter – Archive Message #152.

[9] IRC § 199A(b)(3(B)(i)(I)

[10] For taxpayer's married filing separately the threshold amount is $157,000.

[11] IRC §199A(d)(2) and (3)

[12] IRC §199A(d)(3)

[13] IRC §199A(b)(2) and (3)

[14] IRC §199A(a)

[15] *Id.*

[16] A qualified cooperative dividend is a dividend received from a cooperative that a taxpayer is a member of and is based upon the quantity or value of business done with the cooperative.

[17] IRC §199A(a) flush language

[18] IRC §199A(d)(2) and (3)

[19] IRC §199A(d)(2)(A)

[20] *Id.*

[21] IRC §199A(2)(A); IRC §1202(e)(3)(A)

[22] IRC §199A(d)(3)(A)

[23] *Id*.

[24] IRC §199A(d)(3)(B)

[25] IRC §199A(d)(2) and (3)

[26] IRC §199A(d)(4)

[27] *Id.*

[28] Reilly, *How Much Owner Salary Should S Corp Pay to Maximize Qualified Income Deduction*

[29] IRC §199A(d)(6)

[30] IRC §199A(d)(6)(B)

[31] IRC §199A(h)(2)

[32] IRC §199(b)(3)(B)

[33] IRC §199A(f)(3)

[34] IRC §199A(c)(3)

[35] IRC §199A(f)(1)(B)

[36] IRC §199A(c)(3)(A)(i)

[37] See note 8 above.

[38] IRC §1202(e)(3)

[39] IRC §1202(e)(6)