



The New Qualified Business Income Deduction Under IRC Section 199A

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Introduction

Public Law 115-97 (the Act) provided a significant benefit to corporate taxpayers. While the highest marginal corporate tax rate was previously 35%, corporations now face only a flat 21% tax. In an attempt to provide parity for non-corporate taxpayers, the Act introduces a new IRC section 199A, which provides a 20% deduction for qualified business income earned by individuals, trusts, and estates. Not all non-corporate taxpayers, however, are eligible to claim this new deduction. This article describes the basics of the new deduction and several of the requirements that must be met in order to claim it.

The Basics

IRC section 199A provides a deduction of 20% of a taxpayer's "qualified business income" from each "qualified trade or business" (QTB) of the taxpayer. Income earned through a sole proprietorship, partnership, or S corporation is eligible for the deduction, which effectively lowers the marginal rate for eligible income. For a top marginal rate taxpayer, the impact is a reduction from 37% to 29.6 % (i.e., $37\% * 80\%$).

As the goal of the deduction was to create parity between doing business in corporate versus non-corporate form, Congress intended to limit the deduction to business income and not compensation. Thus, "qualified business income" is defined to exclude both portfolio income and compensation income that the taxpayer receives from the QTB. The definition of QTB specifically excludes the performance of services as an employee.

For taxpayers who engage in a QTB through a partnership, qualified business income also excludes guaranteed payments for services or IRC section 707(a) payments for services (the latter to be provided in forthcoming regulations). For taxpayers who engage in a QTB through an S corporation, qualified business income does not include reasonable compensation paid by the S

corporation to its shareholders. Qualified business income must also be domestic-sourced, as only effectively connected income is eligible for the deduction.

The overall deduction is limited to 20% of taxable income, excluding net capital gain and the IRC section 199A deduction itself. Once the taxpayer computes "pre-Section 199A taxable income" and determines the amount of the deduction, the deduction is taken to compute taxable income. Favorably, this deduction is available to both taxpayers who itemize and those who take the standard deduction.

Complications for High Earners

For taxpayers with taxable income below a threshold amount of \$157,500 (or \$315,000 for joint filers, both amounts of which are adjusted for inflation), the above-described rules tell the whole story. For higher earners, however, two additional rules apply to limit the benefit of this deduction.

First, high earners have a narrower definition of QTB that prevents a high-earning taxpayer in a "specified service trade or business" from claiming the deduction. A specified service trade or business includes (a) investment and investment management services and (b) services enumerated by cross-reference to IRC section 1202(e)(3)(A): (i) health, (ii) law, (iii) accounting, (iv) actuarial science, (v) performing arts, (vi) consulting, (vii) athletics, (viii) financial services, or (ix) brokerage services. Architecture and engineering services, however—both of which are listed in IRC section 1202(e)(3)—are specifically excluded from the definition and therefore are QTBs. IRC section 199A also incorporated IRC section 1202(e)(3)(A)'s catchall provision, under which a trade or business "where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners" is ineligible for the section 199A deduction.

Second, high earners have to satisfy either the "Wages Test" or the "Wages Plus Property Test" in order to claim the deduction. Under the Wages Test, the IRC section 199A deduction is limited to 50% of the wages paid by the QTB. Under the Wages Plus Property Test, the IRC section 199A deduction is limited to 25% of the wages paid plus 2.5% of the unadjusted basis of all qualified property of the QTB. Under the latter test, "qualified property" is defined as tangible property for which depreciation is allowable under IRC section 167. The taxpayer includes the "unadjusted basis"—i.e., the cost basis prior to depreciation—in the calculation. Generally, only property that is still being depreciated counts for purposes of this test, and the taxpayer is allowed the *greater* of the amounts determined by these two tests. The tests, however, are done on a per-QTB limit.

These two additional rules fully apply to taxpayers with taxable incomes of \$207,500 (\$415,000 for joint filers, both of which are adjusted for inflation) or more. For taxpayers in between the threshold amount and the applicable amount, phase-out rules apply to give a partial benefit but result in a high marginal rate for income trapped in this middle ground.

More Favorable Rules for Certain Types of Income

IRC section 199A also provides a 20% deduction for ordinary REIT dividends and income from publicly traded partnerships. Such income is not subject to the high earner limitations described above, but only to the general limitation of the deduction to 20% of taxable income.

Takeaways

The IRC section 199A deduction is, potentially, a great benefit for certain taxpayers. But not all non-corporate taxpayers will be eligible for the deduction. The rules to determine eligibility are complicated, especially for high-earning taxpayers, and IRC section 199A may now encourage high-earning taxpayers to reevaluate their business models and structure their businesses in certain ways. In particular, because the Wages Test and the Wages Plus Property Test are done on a per QTB limit, they give taxpayers an incentive to place more wage expense and qualified property in an income-generating QTB in order to maximize the deduction. These taxpayers may also have a new incentive to invest in REITs and publicly traded partnerships, as income from such entities is eligible for the deduction without all of the complications that the statute imposes on qualified business income. It will be important to watch for future regulations or other guidance, which will help implement this new deduction but may not limit planning opportunities.



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