Updated 199A and Qualified Business Income (QBI) Insight for the Construction Industry | September 20, 2018

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- More than 5,400 employees
- Offices coast to coast
- We serve over 5,000 privately held construction contractors

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Speaker Introductions

Mark Bellows

Principal, Sacramento, CA

Mark has more than 28 years of experience, including his first 15 years at PricewaterhouseCoopers in both San Diego and Sacramento. Mark has served clients in numerous industries including real estate, construction, manufacturing and distribution, agriculture, retail, service, investment, and nonprofit. Mark primarily serves clients in the manufacturing and distribution, retail (B2b and B2C), real estate (commercial and residential development, investment, and buying and selling), and construction industries (general contractors and subcontractors).

Focusing on tax, Mark has assisted clients with their needs on many levels including consulting, strategic planning, and other complex issues. He has worked on many different types of transactions, including entity choice and formation, structuring, succession planning and mergers and acquisitions.

Learning Objectives

At the end of this session, you will be able to:

- Recognize the Section 199A provision for Qualified Business Income
- Recognize activities included in Qualified Business Income
- Identify opportunities for increasing the Section 199A deduction

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Agenda

1. Basics
2. Qualified Trade or Business
3. Wage and Qualified Property Limitation
4. Qualified Business Income
5. Aggregation
6. Calculation Specifics & Examples
7. Other
8. Planning

Basics

Basics of IRC §199A

- 20% deduction on qualified business income (QBI)
- Individuals & some estates and trusts
- Businesses other than C corporations
- QBI does not include specified service trade business (SSTB) income
  - Exception based on threshold income plus phase-out range
- QBI does not include wage income
- Can also get 20% deduction on Real Estate Investment Trust (REIT) dividends and qualified Publicly Traded Partnership (PTP) income

Basics of IRC §199A (cont.)

- Separate trades or businesses
  - Exception based upon threshold income plus phase-out range
- Wage and asset limits applied to each business
  - Exception based upon threshold income plus phase-out range
- Deduction claimed after calculating AGI
- Deduction can't exceed 20% of ordinary income
- Participation not relevant

Qualified Trade or Business

Qualified Trade or Business

- Trade or Business (T or B) other than an SSTB
  - Exception for income threshold
- T or B other than performance of services as employee
  - Watch reclassification to Independent Contractor or equity position in partnership or S corporation
- Use definition of T or B from IRC §162
- Rental Real Estate: No specific guidance in Prop. Regs., so follow case law and IRS guidance under IRC §162
  - Except: Self-rentals treated as T or B if rental and other T or B are commonly controlled

Specified Service Trade or Business

- Any T or B involving performance of services in one or more of the following fields:
  - Health;
  - Law;
  - Accounting;
  - Actuarial Science;
  - Performing Arts;
  - Consulting (provision of professional advice and counsel);
    - ◊ However, not SSTB if embedded in or ancillary to sale of goods or performance of services on behalf of T or B that would otherwise not be an SSTB, and no separate payment for consulting
  - Athletics;

Specified Service Trade or Business (cont.)

- Any T or B involving performance of services in one or more of the following fields (cont.):
  - Financial services;
  - Brokerage services;
  - Investing and investing management;
  - Trading;
  - Dealing in securities, partnership interests, or commodities; or
  - Any T or B where principal asset of such T or B is reputation or skill of one or more of its employees or owners.
    - ◊ "Reputation or skill" defined narrowly in Prop. Regs.
    - ◊ Examples include endorsing products, licensing image, appearance fees

Specified Service Trade or Business (cont.)

- De minimis test:
  - Gross Receipts (GR) $25M or less: T or B not considered SSTB if <10% of GR in SSTB
  - GR > $25M, test is 5%
  - Example 1: ABC company, a fire sprinkler contractor, has $20 million in gross receipts in 2018. Of that $20 million, $1 million is from trading Bitcoin.
    - ◊ The fire sprinkler income is considered QBI.
    - ◊ Normally, the trading of Bitcoin would be considered an SSTB; however, since ABC's total GR are <$25M and GR from that line of business are less than 10% of total GR, the income from trading of Bitcoin will be considered QBI.

Specified Service Trade or Business (cont.)

- "Crack and Pack" strategy won't work
  - Crack and Pack: Separate business into two or more separate businesses, with SSTB isolated into one, and non-SSTB into one or more.
- SSTB includes any T or B with 50% or more common ownership (direct or indirect) that provides 80% or more of its property or services to an SSTB.

Specified Service Trade or Business (cont.)

- Example 2: Cracked Consulting provides consulting services to clients, owns its office space, and employs its own administrative staff. They are considering separating into three businesses: Business 1 provides consulting services, Business 2 owns building and rents entirely to Business 1, and Business 3 employs administrative staff and provides employees only to Business 1. All three businesses are owned by same people.
  - Since 50% common ownership and 80% or more services (of Businesses 2 and 3) provided to SSTB (Business 1), all three businesses will be treated as one SSTB.

Wage and Qualified Property Limitation

Wage and Property Limitation Specifics

- If taxable income exceeds threshold amount, IRC §199A deduction may be limited based on the following:
  - Type of T or B engaged in;
  - Amount of W-2 wages paid with respect to the T or B (W-2 wages); and/or
  - Unadjusted Basis Immediately after Acquisition (UBIA) of qualified property held for use in the T or B
- These limitations do not apply to REIT dividend or qualified PTP income.

Wage Specifics

- W-2 wages must be for employment by taxpayer
  - Can include third-party payors, as long as W-2 wages paid to common law employees or officers
  - Third-party payor cannot then include wages in their own 199A calculation
- W-2 wage applies separately for each T or B
- Must allocate W-2 wages among commonly controlled T or B
  - Wage expense must be taken into account in computing QBI for those T or B

Wage Specifics (cont.)

- Notice 2018-64 provides guidance for calculating W-2 wages for IRC §199A: Three methods for calculating wages, substantially similar to methods provided in Rev. Proc. 2006-47
  - Unmodified Box 1 method;
  - Modified Box 1 method; and
  - Tracking wages method.

Qualified Property

- Tangible property;
- Subject to depreciation;
- Held by and available for use in T or B at close of tax year;
- Used in production of QBI; and
- Depreciable period has not ended before close of tax year.
- Depreciable period: period beginning on date property first placed in service by taxpayer and ending on later of (1) date 10 years after that date, or (2) last day of full year in applicable recovery period under IRC §168(c), regardless of IRC §168(g)

Qualified Property (cont.)

- UBIA = Unadjusted Basis Immediately after Acquisition
- “Immediately after Acquisition” means as of date property placed in service; “qualified property” must be used in production of QBI.
- Property is NOT qualified property if acquired within 60 days of end of tax year and disposed of within 120 days without having been used in T or B for at least 45 days before disposition

Qualified Property (cont.)

- Basis adjustments under IRC §§734(b) or 743(b) are NOT treated as separate qualified property
- Nonrecognition transactions have specific rules
  - IRC §§1031, 1033, 721, 351, 168(i)

Qualified Business Income

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Qualified Business Income

- Netting of all items with respect to any qualified T or B
  - Income, gains, deductions, and losses appearing on various forms and schedules of tax returns
- Does not include:
  - Wage income, including S corporation shareholder wages
    - ◊ Reasonable compensation considerations (i.e. paid or not)
  - Guaranteed payments
  - Interest (other than from T or B), dividends
  - Capital gain or loss
  - REIT dividends or qualified PTP income
    - ◊ Separately calculated for 199A

Qualified Business Income (cont.)

- Includes:
  - IRC §751 gain;
  - IRC §481 adjustments;
  - Previously disallowed losses incurred in 2018 or later (IRC §§465, 469, 704(d), 1366(d))
  - Net operating losses as a result of IRC §461(l) (excess business loss rules)

Aggregation

Aggregation

- Permitted but not required
- IRC §469 grouping rules NOT adopted
- Can aggregate T or B if satisfy requirements:
  - Each T or B must itself be a T or B;
  - Same person or group of persons must own majority interest, for majority of year, in each T or B to be aggregated;
    - ◊ Family attribution allowed (siblings not included)
  - Same tax year;
  - None of T or B can be SSTB;

Aggregation (cont.)

- Can aggregate T or B if satisfy requirements (cont.):
  - T or B must meet at least 2 of 3 factors:
    - ◊ T or B provide products and services that are the same or are customarily provided together;
    - ◊ T or B share facilities or significant centralized business elements; and
    - ◊ T or B operated in coordination with, or reliance on, other T or B in aggregated group
- Can aggregate T or B operated directly and T or B operated through relevant passthrough entities (RPEs)
  - Individual owners of same RPEs NOT required to aggregate in same manner

Aggregation (cont.)

- First, compute QBI, W-2 wages and UBIA of qualified property for each T or B, including from RPE, then apply W-2 wage and UBIA limitations to aggregated group
- Must consistently report aggregated group each year
  - May add newly created or newly acquired
  - Must disaggregate if T or B no longer qualifies

Calculation Specifics & Examples

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Computing the Deduction

- If multiple T or B, calculate QBI deduction from each and net the amounts
  - If net QBI is less than zero, that amount is treated as loss from qualified T or B in succeeding year
- If combined REIT dividends and qualified PTP income is less than zero, does NOT reduce other QBI
  - That amount is treated as loss from REIT dividends and qualified PTP income in succeeding year

Computing the Deduction (cont.)

- Different rules for taxpayers below income threshold and those above income threshold
  - Taxable income before 199A deduction
  - $157,500 Single / $315,000 MFJ
  - Indexed for inflation
- Phase-out range for those above income threshold
  - $50,000 Single / $100,000 MFJ
- Determine tentative taxable income first before sorting out details

Computing the Deduction (cont.)

- Deduction is equal to lesser of:
  - 20% of the QBI PLUS 20% of combined REIT dividends and qualified PTP income, or
  - 20% of excess of taxable income over net capital gain
    - Capital gain includes qualified dividends and unrecaptured IRC §1250 gain

Computing the Deduction (cont.)

- Above the income threshold, special QBI Rules:
  - SSTB:
    - ◊ If taxable income within phase-out range, only applicable percentage of SSTB info taken into account
    - ◊ If taxable income exceeds phase-out range, none of SSTB info taken into account
  - Follow aggregation rules if aggregation chosen
  - "20% of QBI" for each T or B is lesser of:
    - ◊ 20% of QBI for that T or B, or
    - ◊ Greater of 50% of W-2 wages for that T or B, or the sum of 25% of W-2 wages for that T or B plus 2.5% of the UBIA of qualified property for that T or B
  - QBI if taxable income within phase-out range:
    - ◊ If the wage and UBIA of qualified limitation is less than the QBI limitation, QBI is modified

Computing the Deduction Examples

- Example 3: Alan is single and owns and operates a computer repair shop as a sole proprietorship. The business generated $100,000 in net taxable income from operations in 2018. Alan has no capital gains or losses. After allowable deductions not relating to the business, Alan's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss.
  - Alan's IRC §199A deduction for 2018 is equal to $16,200, the lesser of 20 percent of his QBI from the business ($100,000 x 20% = $20,000) and 20 percent of his total taxable income for the tax year ($81,000 x 20% = $16,200).

Computing the Deduction Examples

- Example 4: Assume the same facts as in Example 3 except that Alan also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, Alan's taxable income for 2018 is $74,000. Alan's taxable income minus net capital gain is $67,000 ($74,000 - $7,000).
  - Alan's IRC §199A deduction is equal to $13,400, the lesser of 20 percent of his QBI from the business ($100,000 x 20% = $20,000) and 20 percent of his total taxable income minus net capital gain for the tax year ($67,000 x 20% = $13,400).

Computing the Deduction Examples (cont.)

- Example 5: Bob and Carol are married and file a joint tax return. Bob earned $500,000 in wages as an employee of an unrelated company in 2018. Carol owns 100 percent of the shares of X, an S corporation that provides landscaping services. X generated $100,000 in net income from operations in 2018. X paid Carol $150,000 in wages in 2018. Bob and Carol have no capital gains or losses. After allowable deductions not related to X, Bob and Carol's total taxable income for 2018 is $270,000. Bob's and Carol's wages are not considered to be income from a T or B for purposes of the IRC §199A deduction.

Computing the Deduction Examples (cont.)

- Example 5 (cont.):
  - Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to Carol are considered to be a qualified item of deduction for purposes of determining X's QBI. The IRC §199A deduction with respect to X's QBI is then determined by Carol, X's sole shareholder, and is claimed on the joint return filed by Bob and Carol.
  - Bob and Carol's IRC §199A deduction is equal to $20,000, the lesser of 20 percent of Carol's QBI from the business ($100,000 x 20% = $20,000) and 20% of Bob and Carol's total taxable income for the tax year ($270,000 x 20% = $54,000).

Computing the Deduction Examples (cont.)

- Example 6: Assume the same facts as in Example 5 except that Bob also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500.
  - Bob and Carol's IRC §199A deduction is equal to $20,300, the lesser of (i) 20% of Carol's QBI from the business ($100,000 x 20% = $20,000) plus 20% of Bob's combined qualified REIT dividends and qualified PTP income ($1500 x 20% = $300) and (ii) 20% of Bob and Carol's total taxable income for the tax year ($271,500 x 20% = $54,300).

Other

Other Rules

- Trusts and estates may have a QBI deduction
  - Follow the same rules as under pre-2018 IRC §199
  - Apportion wages and investment in qualified property between fiduciary and beneficiary
- No separate computation required for AMT
- QBI deduction does not reduce SE taxable income
- QBI deduction does not reduce NII
- Deduction allowed to non-itemizers

Other Rules

- Subject to 20% accuracy-related penalty at 5% understatement, not 10%
- Temporary provision, not available for years beginning after December 31, 2025

Planning

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Taxable Income Target

- Staying below threshold
  - Effective marginal tax rate

Reorganizing Businesses

- Splitting apart SSTB to isolate non-SSTB income (limited to businesses not providing services to each other)
- Place SSTB into C corporation
- Combining businesses (if aggregation doesn't apply and insufficient wages or UBIA of qualified property)
- Migrate S activities to Schedule C or partnership

Compensation

- Restructure partnership compensation
- Review S corporation compensation

Evaluate C Corporation

- Elect S corporation on C corporation
- Incorporate as a C corporation
  - Potential Section 1202 qualification for exclusion of gain
- Evaluate existing C corporations
- Split up existing C corporation and elect S on one of the resulting corporations
- Drop down of assets to lower tier entity
- Consider whether Congress will increase the C corporation tax rate

Evaluate Entity Structure

- Is a C corporation an appropriate entity?
  - Income needs of the business versus the owners
  - Reasonable compensation levels
  - Growth or expansion plans of the business favor C corporation
  - Length of time to liquidate or sell favor C corporation
  - Lack of appreciating assets in entity favor C corporation

Questions?

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Questions?

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- Entity Choice – S Corp vs. C Corp– Tuesday, October 30 at 11 am cst

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