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New Section 199A Deduction for Pass-Through Entities and Its Impact on Qualified Retirement Plans

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The author discusses the new statute (and related proposed regulations), emphasizing its impact on retirement plan deductions for different types of entities at different income levels, and addresses where advanced planning is needed to help clients make the right choices.

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Public Law 115-97, unofficially known as the Tax Cuts and Jobs Act, added Section 199A to the Internal Revenue Code of 1986 (the Code; IRC). Section 199A was subsequently amended by the Consolidated Appropriations Act of 2018 [PL 115-141]. *In general*, effective for tax years beginning after December 31, 2017, this new code section permits the owner of a pass-through entity to take a deduction for

20 percent of such entity's "qualified business income" (QBI) earned from a "qualified trade or business" (QTB).

The New Deduction

The statue provides that the new deduction is equal to the lesser of (1) the taxpayer's "qualified combined business income amount" or (2) 20 percent of the excess of taxable income over the taxpayer's net capital gain.

As will be the case more than once going forward, we will make some assumptions and strip away layers to get to our point, which is to determine the new law's impact on our clients' qualified retirement plans.

Point (2) above is essentially saying that the deduction will only be allowed against amounts taxed as ordinary income—and not amounts taxed at capital gains rates.

So, what is the "qualified combined business income amount"? Well, of course, it is a combination of several items, some of which we introduce only so we can say that we are going to ignore them—or, at least, assume they do not exist for our purposes.

Code Section 199A(b) defines "qualified combined business income amount" as the sum of two amounts, one of which is the lesser of two amounts, including one that is the greater of two amounts. Really. Beginning with the item we will ignore, the *second* of the two amounts summed is 20 percent of qualified REIT dividends and qualified publicly traded partnership income. The first of the summed items is where we will spend the rest of our time.

With the above stripping, and ignoring the limitation based on capital gain income, we are left with a deduction, separately with respect to each QTB, equal to the lesser of (A) or (B), defined below:

(A) 20 percent of the taxpayer's "Qualified Business Income" with respect to the QTB, or
(B) The greater of:
   (i) 50 percent of W-2 wages with respect to the QTB, or
   (ii) 25 percent of W-2 wages with respect to the QTB plus 2.5 percent of the unadjusted basis of qualified property of the QTB.

(We will see below that the limiting (B) part of the above applies only once certain "threshold" amounts of taxable income are reached.)

So first, we must define what is meant by "Qualified Business Income" (QBI). QBI is defined in Code Section 199A(c) as the ordinary income from a QTB carried on in the United States, net of ordinary deductions. QBI does not include items of investment income passed through, enumerated in Code Section 199A(c)(3)(B).

Further, Code Section 199A(c)(4) precludes the following from QBI:

(A) reasonable compensation paid to the taxpayer by a qualified trade or business for services rendered with respect to the trade or business (i.e., compensation paid to S corporation shareholders per Proposed Reg, §1.199A-3(b)(2)(ii)(H));
(B) guaranteed payments (under IRC §707(c)) paid to a partner for services rendered with respect to the trade or business in his or her capacity as a partner [Proposed Reg. §1.199A-3(b)(2)(ii)(I)]; or
(C) payments to a partner (*not* in his capacity as a partner) for services rendered with respect to the trade or business pursuant to IRC §707(a). [Proposed Reg. §1.199A-3(b)(2)(ii)(J)]

For purposes of the wage-based limits above, only wages count—not guaranteed payments to partners, not management fees (unless paid via payroll), not amounts paid to independent contractors. And wages only count to the extent reported on a Form W-2 filed within 60 days of its due date with the Social Security Administration. This will prevent taxpayers such as S corporation shareholders from deciding well into the following year to reclassify distributions as wages in order to increase the Section 199A deduction. Proposed Treasury Regulations Section 1.199A-2(d)(2)(iii) provides that amended Forms W-2 filed after the 60-day period will be recognized only if they *reduce* the amount of wages reported.

It should be noted for this purpose that W-2 wages means the amounts described in paragraphs (3) and (8) of Code Section 6051(a). Code Section 6051(a)(3) describes wages subject to withholding, and Code Section 6051(a)(8) describes elective deferrals under Code Sections 402(g), 403(b), 408(p) (SIMPLE), 457, and 402(h) (SARSEPs). [IRC § 199A(b)(4)]

Recall from above that the wage-based limit is the greater of two amounts (i.e., 50 percent of wages or 25 percent of wages plus 2.5 percent of the unadjusted basis of all qualified property). For the most part, in the case of entities that will be taking retirement plan deductions, the 50-percent limit will apply (if either of the limits indeed will apply). The

25-percent/2.5-percent limit is more likely to be greater for companies that have few or no employees but significant property (e.g., entities that own significant amounts of real estate but outsource most of the management).

However, for those of you who must know, for purposes of the "unadjusted basis" of all "qualified property," qualified property is defined as tangible property, subject to depreciation, held by the business at the end of the year and used in the production of QBI. Such basis is included only if the "depreciable period" of the property has not ended prior to the last day of the year for which the deduction is being taken. The depreciable period starts on the date the property is placed in service and ends on the *later of* ten years after such date or the last day of the last year in the asset's "regular" depreciable life. [IRC § 199A(b)(6)]

From here, we will ignore the 25-percent/ 2.5-percent limit and assume that the 50-percent limit is greater.

Pursuant to Code Section 199A(b)(3), the wage-based limits actually apply only if the taxpayer's *taxable income* (before the Code Section 199A deduction) exceeds the "threshold amount" ($315,000 if married filing jointly, $157,500 for others, indexed post-2018). [IRC § 199A(e)(2))] We will call taxable income before the Section 199A deduction "tentative taxable income" (TTI). If TTI is over the threshold amount, the limit is phased in based on the threshold amount plus $100,000 if the taxpayer's filing status is married filing jointly (MFJ) or $50,000 for all other taxpayers. (Note that the $100,000/$50,000 amounts are *not* indexed.)

So, if TTI is under the threshold amount, the Section 199A deduction is simply 20 percent of QBI. Assuming a filing status of MFJ, in the case of a taxpayer with TTI of $415,000 or more, the Section 199A deduction is simply the lesser of 20 percent of QBI or the wage-based limit. For MFJ filers between $315,000 and $415,000 of TTI, the Section 199A deduction is phased out, as we will describe in detail below.

In the case of S corporations with multiple shareholders and partnerships, only the taxpayer's "allocable share" of QBI, W-2 wages, and tangible property is taken into account. In the case of an S corporation shareholder, this is simply the shareholder's ownership percent multiplied by such amounts. For a partnership, the wage amount is the partner's allocable share of the deduction for wages paid and his or her share of basis is based on the allocable share of depreciation expense. (Unlike S corporations, partnerships can allocate various expenses to partners in proportions different from the ownership percentages, based on the terms of the partnership agreement.) [IRC § 199A(f)(1)(A)]

Example. Assume an S corporation has QBI of $1 million and wages paid to employees of $600,000. Assume a 25-percent shareholder in such S corporation has TTI of $370,000 (filing status MFJ). What is the taxpayer's §199A deduction?

First, we determine the partner's allocable share of each of the items:

Allocable share of QBI = 25 percent X $1 million = $250,000
Allocable share of wages = 25 percent X $600,000 = $150,000
20 percent of QBI = $50,000
50 percent of wages = $75,000

Because 20 percent of QBI is greater than 50 percent of wages, the wage-based limit is not applicable, and the deduction is $50,000, irrespective of TTI.

But what if wages paid by the S corporation were only $300,000?

Allocable share of QBI = 25 percent X $1 million = $250,000
Allocable share of wages = 25 percent X $320,000 = $75,000
20 percent of QBI = $50,000
50 percent of wages = $37,500

The $12,500 difference between those two percentage calculations is referred to as the "excess amount," and it is this amount that is phased out. At $370,000, taxable income is $55,000 over the threshold amount of $315,000. As indicated above, in the case of MFJ filers, full phase-out happens at $100,000 over the threshold. So, the phase-out percentage is $55,000 / $100,000 or 55 percent, such that $6,875 (55 percent of $12,500) of the excess amount is lost and the Section 199A deduction is reduced to $43,125 ($50,000 – $6,875).

What if all facts were the same except the taxpayer's taxable income was under the $315,000 threshold?

The deduction would be $50,000, as the wage-based limit would not apply.

What if all facts were the same except taxable income was $415,000 (or more)?

The amount over threshold would be $100,000 and taxpayer would lose 100 percent of the excess amount, limiting the deduction to $37,500 (50 percent of the allocable share of wages paid by the business).

An additional limitation is provided in the case of a "specified service trade or business" (SSTB), as defined by new Code Section 199A(d)(2). SSTBs begin to lose the Section 199A deduction *altogether* at phase-in amounts and totally lose the deduction if the QBI exceeds the threshold of $315,000 by $100,000 or more if the taxpayer files MFJ ($50,000 over the $157,500 for others). So, if TTI for an SSTB is under the threshold amount, the wage-based limit is not applicable (same as for other taxpayers), but if TTI exceeds the sum of the threshold plus the phase-out amount, the QBI deduction is zero.

The law defines a "specified service trade or business" as:

> 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 1 or more of its employees, or
> 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. [IRC § 199A(d)(2); Prop. Treas. Reg. § 1.199A-1(b)(10)]

Proposed regulations provided some clarification as to what is and what is not an SSTB. First, Proposed Treasury Regulation Section 1.199A-5(c)(3) requires certain trades or businesses that are "incidental to" an SSTB to be considered part of the SSTB. If a non-SSTB has 50 percent or more common ownership with an SSTB, including related parties (within the meaning of Section 267(b) or 707(b)), and has shared expenses with the SSTB, then such non-SSTB is treated as part of the SSTB if the gross receipts of the non-SSTB represent no more than 5 percent of the total combined gross receipts of the non-SSTB and the SSTB in a taxable year. The regulations provide an example of a dermatology practice (clearly an SSTB) selling skin care products using the same space and employees as the medical practice. The sale of such products is considered part of the SSTB where receipts from the sale of such products are less than 5 percent of total revenue.

Further, Proposed Treasury Regulations Section 1.199A-5(c)(2) deals with services or property provided to an SSTB by a related party (as described above). An SSTB includes any trade or business that provides 80 percent or more of its property or services to an SSTB, if there is 50 percent or more common ownership. If a trade or business provides less than 80 percent of its property or services to a commonly owned SSTB, that portion is treated as a part of the SSTB.

An example in the proposed regulations involves a law firm partnership that owns its own office building. The firm is divided into three partnerships (all owned by the original law partners). P1 performs legal services to clients. P2 owns the building and rents the entire building to P1. P3 employs the administrative staff and provides administrative services to P1 in exchange for fees. Because there is 50 percent or more common ownership of each of the three partnerships, and because P2 and P3 provide substantially all of their property and services to P1, the three partnerships are treated as one SSTB.

Proposed Treasury Regulation Section 1.199A-5(b)(2)(x) also clarified that "brokerage services" do not include insurance or real estate agents or brokers.

Finally, prior to the issuance of the proposed regulations, there was concern as to how broadly the Internal Revenue Service (IRS) would apply the phrase "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." The IRS was in a kind mood here, limiting such language to:

- fees for endorsing products or services;
- fees for the use of a person's name, voice, image, or likeness; and
- appearance fees.

[Prop. Treas. Reg. § 1.199A-5(b)(2)(xiv)]

In the case of a specified service, we subject both the QBI *and* the W-2 wages (as well as unadjusted basis of qualified property) to the threshold reduction. So, let's go back to our example and assume our taxpayer was a shareholder in an accounting firm. Recall these facts:

Allocable share of QBI = 25 percent X $1 million = $250,000

Allocable share of wages = 25 percent X $300,000 = $75,000
20 percent of QBI = $50,000
50 percent of wages = $37,500
TTI (MFJ) $370,000
The TTI is $55,000 over the $315,000 threshold, so the phase-out percentage equals 55 percent ($55,000/$100,000).

Subjecting both the QBI *and* the W2 wages to the threshold reduction, we get the following:

Reduced allocable share of QBI = $250,000 X (1 - .55) = $112,500
Reduced allocable share of wages = $75,000 X (1 - .55) = $33,750
20 percent of QBI = $112,500 X .2 = $22,500
50 percent of wages - $33,750 X .5 = $16,875
Excess amount = $22,500 - $16,875 = $5,625
Phase-out of excess amount = $5,625 X .55 = 3,094
§ 199A deduction = $22,500 – 3,094 = $19,406

This happens to be the same as $43,125 X .45 (the limit if the entity was not an SSTB, multiplied by 1 minus the phase-out percentage).

What if taxable income is over $415,000? The phase-out percentage would be 100 percent, so:

Reduced allocable share of QBI = $250,000 X (1 - 1) = $0
Reduced allocable share of wages = $75,000 X (1 -1) = $0
So, there is no QBI deduction.

Entity Choice and Qualified Plan Deductions

Let's look at the impact of this new Code section on entity choice and qualified plan deductions using several examples.

Example 1. Assume Sharon, a CPA, owns 100 percent of an S corporation, Sharon's CPA Firm, PC (PC). PC has income of $300,000 before the payment of any compensation to Sharon. As an S corporation shareholder, Sharon must receive reasonable compensation, which we will assume is $175,000. This leaves pass-through income of $125,000. Assuming Sharon's TTI is under the threshold, her Section 199A deduction is $25,000 (20 percent of $125,000).

What if Sharon operated as a sole proprietorship? Ignoring for now the deduction for 50 percent of self-employment tax, Sharon's deduction would be $60,000 (20 percent of $300,000). Why? Because sole proprietors do not take compensation.

Therefore, it appears that taxpayers under the threshold are better off as sole proprietors than as S corporation shareholders.

Example 2. Assume Jim, a real-estate agent (and, therefore, not an SSTB), operates as a sole proprietorship. Jim has no employees and no qualified property. Jim's business income is $1 million, and his TTI is well above any thresholds such that any phase-outs are 100 percent.

Recall the general rule that the deduction is the lesser of 20 percent of QBI or 50 percent of wages paid. As Jim is fully phased out, his QBI deduction is limited to 50 percent of wages paid. Because there are no wages paid, Jim's Section 199A deduction is $0.

What if Jim operates as a S corporation?

As an S corporation shareholder, Jim would take wages. Ignoring for a moment whether the compensation is reasonable, the "sweet-spot" is 2/7ths of prewage income. That is, if compensation were $285,714 (2/7 X 1,000,000), the remaining pass-through would be $714,286 ($1,000,000-$285,714). At this level, 50 percent of wages and 20 percent of QBI would both be $142,857, and this would be the Section 199A deduction amount.

What if it were determined that $400,000 was a reasonable level of compensation? This would leave pass-through (QBI) of $600,000. The Section 199A deduction would be $120,000 (the lesser of 50 percent of $400,000 or 20 percent of $600,000).

And what if $150,000 were contributed into a cash balance plan for Jim?

Let's pause here and discuss reasonable compensation for a moment. When measuring reasonable compensation, contributions to retirement plans are taken into account. [*See* Treas. Reg. § 1.404(a)-1(b); *Plastic Engineering & Manufacturing Co.*, 78 T.C. 1187 June 30, (1982), *Bianchi v. Commissioner*, 66 T.C. 324 (1976), and *LaMastro v. Commissioner*, 72 T.C. 377 (1979)]

If $150,000 were put into a plan for Jim, and $400,000 is indeed a reasonable level of compensation, then Jim would need to take only $250,000 of current compensation to have "reasonable compensation." As 20 percent of QBI would still be less than 50 percent of wages, the Section 199A deduction would remain at $120,000.

In Jim's case, Section 199A really has no impact on the retirement plan deduction. That is, each dollar put in the retirement plan reduces his taxable income by a dollar.

In certain situations, a dollar contributed to a retirement plan can result in a reduction of taxable income by more than a dollar.

Example 3. Consider Jane, the sole shareholder in a law firm taxed as an S corporation, Jane Law Firm PC (PC). Jane is married and files a joint tax return (Jane's spouse is a homemaker). Jane receives $250,000 in wages from PC and, in addition, has pass-through income (QBI) of $200,000. Taking into account her other items of income and deduction, Jane's TTI is $415,000. As PC is an SSTB, and Jane's TTI is at full phase-out level ($100,000 over the $315,000 threshold amount), Jane has no Section 199A deduction. As a result, her taxable income is $415,000.

What if Jane contributes $100,000 of the $200,000 pass-through to a cash balance plan? Jane's QBI from PC is now $100,000. Additionally, Jane's TTI is now $315,000. At this level, Jane is no longer over the threshold, so there is no phase-out. Jane is, therefore, entitled to a Section 199A deduction of 20 percent of QBI or $20,000. Her taxable income is now $295,000.

The net result is a $100,000 pension contribution that reduces taxable income by $120,000!

Take it a step further. If reasonable compensation is $250,000 and PC is making a pension contribution of $100,000 on her behalf, Jane's current compensation could be reduced to $150,000. This increases QBI back to $200,000 (after the pension contribution), such that the Section 199A deduction is now $40,000 and taxable income is $275,000.

The net result is that a $100,000 pension contribution, combined with a reduction of current compensation of the same amount, reduces taxable income by $140,000!

Example 4. Beth is an insurance agent operating as a sole proprietorship. Beth has no employees, is married, and files a joint tax return with her spouse. Beth's TTI is $400,000, including $300,000 in QBI from her sole proprietorship. At $400,000 of TTI, Beth is 85 percent phased out. Beth's Section 199A deduction is $9,000, determined as follows:

20 percent of QBI = $60,000
50 percent of wages = $0
Excess amount = $60,000
§ 199A deduction = $60,000 – ($60,000 * 85) = $9,000

So, Beth's taxable income is $391,000.

What if Beth contributes $85,000 to a cash balance plan?

Beth's TTI is now $315,000 ($400,000 – $85,000), and her QBI is now $215,000 ($300,000 - $85,000). As her TTI no longer exceeds the threshold amount, there is no phase-out. Her Section 199A deduction is 20 percent of QBI or $43,000. Beth's taxable income is now $272,000 ($315,000 – $43,000).

The net result is a $85,000 pension contribution that reduces taxable income by $119,000!

Example 5. Finally, let's look at the dark side.

Here we'll discuss Jeff, age 50. Jeff is a lawyer who works for a not-for-profit (NFP). Jeff makes $60,000 in wages from the NFP. Jeff also practices as a self-employed lawyer, and his net income for 2018 is $150,000, which he reports on Schedule C. Jeff would like to maximize his deduction to a solo 401(k) (assume the NFP has no plan to which Jeff makes elective deferrals). We'll also presume Jeff's TTI is under the threshold, so no phase-outs apply.

To arrive at the maximum amount Jeff can deduct, we must first determine his compensation. For a self-employed person, compensation is equal to "earned income." Code Section 401(c)(2) defines such amount as "net earnings from self-employment" less the deduction for half of self-employment tax, less the deduction for employer contributions made to a retirement plan on behalf of the self-employed person.

So we first compute Jeff's self-employment (SE) tax as follows:

(A) Total SE income	$ 150,000
(B) Multiply (A) by .9235	138,525
(C) Lesser of (B) or taxable wage base	128,400
(D) W-2 wages subject to full FICA	60,000
(E) SE income subject to 12.4 percent SE tax (C)-(D)	68,400
(F) (E) *12.4 percent	8,482
(G) Medicare portion on full amount (B) * 2.9 percent	4,017
(H) Total SE tax (F)+(G)	12,499
(I) Deduction for SE tax 50 percent of (H)	$ 6,250

Jeff's maximum deductible contribution to his solo 401(k) plan is, therefore, $53,250 as follows:

(1) Net earnings from self-employment	$ 150,000
(2) Deduction for SE tax	6,250
(3) Pre-pension earned income	143,750
(4) Maximum profit sharing contribution (20 percent of pre-contribution net)	28,750
(5) Add 401(k) deferral	24,500
(6) Total deductible amount ((4) + (5))	$ 53,250

Proof of maximum profit sharing:

Net earnings from self-employment	$ 150,000
Deduction for SE tax	(6,250)
Profit Sharing	(28,750)
Compensation	115,000
25 percent of compensation	28,750

How is this all impacted by Section 199A?

Before the 401(k) contribution, Jeff's QBI is $143,750 (presuming the half of SE tax reduces QBI), such that his Section 199A deduction is $28,750 (20 percent of $143,750). With the $53,250 to the plan, QBI is reduced to $90,500 ($143,750-$53,250), 20 percent of which is $18,100.

The net impact of the $53,250 contribution then, all of which will be taxable when removed, is a reduction in taxable income of $42,600. Not a good result.

One thing Jeff could do is what we'll call a "Mega-Roth." Instead of making a pre-tax elective deferral, Jeff would make a $24,500 Roth deferral. Additionally, the plan would provide for after-tax employee contributions. Such contributions are subject to ACP testing (which would not be relevant here, since Jeff has no employees), as well as the limit on annual additions under Code Section 415. Jeff would not be subject to the 25-percent deduction limit, as no tax deduction would be involved.

At his income level, Jeff could make an after-tax contribution of $36,500. The plan would also provide for in-plan conversions of non-Roth amounts to Roth. Immediately after the deposits are made, Jeff would elect to have his after-tax account converted to Roth. As he has basis in the account, and the account has not had a chance to have any earnings, the conversion is effectively tax-free. The end result is a Roth account with $61,000, the earnings on which will never be taxed.

Jeff, of course, gets no tax deduction for any of his contributions, but his Section 199A deduction is back to $28,750, and his retirement account will never be taxed.

Conclusion

As illustrated above, the impact of the Code Section 199A deduction on pension contributions can be positive, negative, or neutral. The important part of your job as a consultant is to know where advanced planning is needed and to work with your clients' tax advisors to make the right choices. ■