TCJA Section 199A - Qualified Business Income Deduction
What it means to Individuals, Estates, Trusts and Entity Selection

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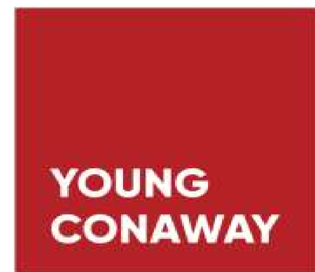
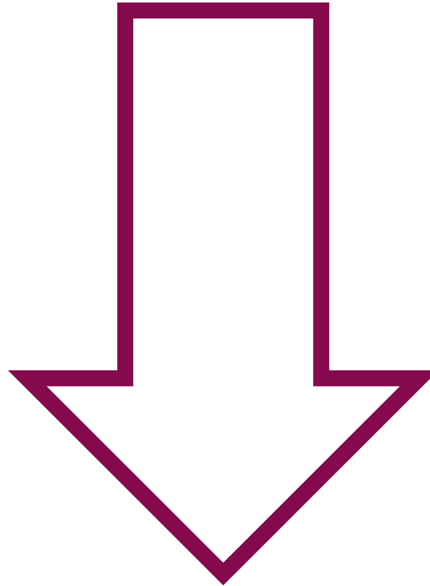


Agenda

- TCJA Section 199A – the mechanics – a 30,000 foot overview
- Application of 199A to estates and trusts
- Aggregation and combination rules under 199A
- Choice of entity selection considerations

Corporate Tax Rates Reduced (after 2017)

- Prior rates: 15%, 25%, 34%, and 35% (Personal Service Corporation paid at the 35% rate)
- For tax years beginning in 2018: Flat 21% (including Personal Service Corporation)



Qualified Business Income Deduction: Section 199A

Overview

- Applies to non-corporate taxpayers
  - Individuals (including children subject to the Kiddie tax)
  - Estates
  - Non-granter trusts
- Applies to tax years beginning 2018 → 2025
- Applies to income from an S Corporation, Schedule E real estate rentals*, partnerships, or sole proprietors
- Applies only to QBI effectively connected with conduct of a trade or business within the U.S.
- QBI includes items of income, gain, deduction, and loss
- No distinction between passive and active income
- Effectively reduces top rate of 37% to 29.6%

*That rise to the level of a trade/business

QBI Does Not Include

Overview

- Certain investment income, including short-term and long-term capital gains
- Reasonable compensation paid to the taxpayer
- Guaranteed payments paid to the taxpayer

Section 199A (QBI deduction) Does Not Apply To

- Computation of Net Investment Income Tax (NIIT)
- Computation of SSA benefits
- Computation of S. E. Tax

The Big Question – currently the QBI deduction computation does not consider certain "adjustment to income", such as the SEP deduction, 50% of S.E. tax deduction and the deduction for S.E. health insurance. Will Congress change this?

QBI – The Basic Calculation

- Qualified Business Income x 20%
- Limited to 20% of NET taxable income
  - Net of capital gains

QBI Examples: Example #1

- John is a married accountant with business income of $150,000
  - QBI Deduction: $150,000 x .20 = $30,000
  - Net Taxable Income: $200,000
  - $200,000 x .20 = $40,000
  - QBI deduction is not limited
- Mary is a married accountant with business income of $250,000
  - QBI Deduction: $250,000 x .20 = $50,000
  - Net Taxable Income: $200,000
  - $200,000 x .20 = $40,000
  - QBI deduction is limited to $40,000

QBI – Wage/Asset Limitation

- Wage Limitation does not apply if taxable income does not exceed $315,000
    - Limitation phases in when taxpayer’s taxable income exceeds $315,000 for MFJ ($157,500 for others)
    - Phase-in is over the next $100,000 of taxable income for MFJ ($50,000 for others)

QBI – Wage/Asset Limitation

- If taxable income > $415,000 - MFJ ($207,500 for others) - the deduction cannot exceed the greater of:
  - 50% of (allocated share of) W-2 wages of the trade or business, **or**
  - 25% of (allocated share of) W-2 wages of the trade or business, **PLUS** 2.5% of the unadjusted basis of all qualified property held by and available for use in the T/B at the close of the year

QBI Examples: Example #2

- Bruce is married and has a yard cleaning company and has taxable income of $600,000 and the QBI amount from the company is $100,000. The company pays wages of $50,000 and has nominal assets.
- Lesser of:
  - $100,000 x .20 = $20,000
  - Limited to: $50,000 (wages) x .50% = $25,000
  - Bruce's QBI deduction is not limited

QBI Examples: Example #3

- Bruce also owns a commercial rental property that generates $8,000 of QBI, assume the property is fully depreciated and there are no employees
- The QBI deduction is $0

QBI Examples: Example #4

- Same as example #3 except the building is not fully depreciated and was purchased for $250,000, which includes land cost of $50,000
  - QBI deduction is $8,000 x .20 = $1,600
  - ($0 wages x .25) **PLUS** $200,000 (net of land) x .025 = $5,000
  - QBI deduction of $1,600 is not limited

QBI Examples: Example #5

- Jordon is married and has a widget producing business that generates $100,000 of QBI. His taxable income is over $415,000. In addition, he paid wages of $30,000 and has qualified property of $50,000.
  - $100,000 x .20 = $20,000
  - Wage Test 1: $30,000 x .50 = $15,000
  - Wage Test 2: ($30,000 x .25) + ($50,000 x .025) = $8,750
  - QBI deduction is limited to $15,000 (the greater of $15,000 or $8,750)

QBI Deduction for Specified Service Industry

- Generally does not apply
- Exception if taxable income of individual does not exceed $315,000 (MFJ), $157,500 (for others)
- Exception is phased-out over the next $100,000 (MFJ), $50,000 (for others)
- QBI deduction does not apply to the business of performing services as an employee
- Specified services include any trade or business involving the performance of services in the field of:
  - health, law, accounting, actuarial sciences, 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 or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interest, or commodities (but not engineers and architects)

QBI Examples: Example #6

- John is a married accountant with business income of $150,000
    - QBI Deduction: $150,000 x .20 = $30,000
    - Net Taxable Income: $500,000
    - QBI deduction is not available

Quick Reference Chart – The QBI Deduction

MFJ:

(Net) Taxable Income	Specified Services	Other Businesses
<$315,000	QBI x 20%	QBI x 20%
$315,000-$415,000	Phase-out of Deduction (W-2/ Asset Limitations Apply)	Phase-in of W-2/Asset Limitation Rule
>$415,000	No Deduction	Full W-2/Asset Limitation Rule APPLIES

Other than MFJ (Including Trusts and Estates):

<$157,500	QBI x 20%	QBI x 20%
$157,500-$207,500	Phase-out of Deduction (W-2/ Asset Limitations Apply)	Phase-in of W-2/Asset Limitation Rule
>$207,500	No Deduction	Full W-2/Asset Limitation Rule APPLIES

W-2 Wages

- Paid with respect to employment during the calendar year
- Limited to wages paid attributable to QBI
- Wages do not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date for such return (including extensions)

Qualified Property

- With respect to a qualified trade or business
- Tangible property (personal or real), subject to the allowance for depreciation under Section 167
  - Does not include land
  - Held for use in a qualified t/b at the close of the taxable year
  - Used at any point during the taxable year in the production of qualified business income
  - Depreciation period has not ended before the close of the taxable year

Qualified Property – Continued

- Depreciable period
  - Beginning on the date placed in service by the taxpayer
  - Ending on the later of
    - date which is 10 years after such date, or
    - the last day of full year in the applicable recovery period that would apply to the property under Section 168

Section 199A Application to Trusts, Estates and Beneficiaries

- A trust or estate is treated as a passthrough entity to the extent it allocates QBI and other items to its beneficiaries and is treated as an individual to the extent it retains the QBI and other items

Section 199A – Grantor Trusts

- To the extent the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by that person

Section 199A – Non-Grantor Trusts and Estates

- Trust or estate must allocate qualified items of deduction in computing QBI
- Depletion, amortization, and depreciation that are otherwise properly included in the computation of QBI are included in such computation, regardless of how they may otherwise be allocated between the trust or estate and its beneficiaries
- QBI is to be allocated to each beneficiary and to the trust or estate based on relative proportion of DNI for the taxable year, or is to be retained by the trust or estate
- If no DNI for the taxable year, all items are allocated to the trust or estate

ESBTs

- S portion
- Grantor portion
- Non-S portion

Threshold and Anti-Abuse Rules

- $157,500 → $207,500 in 2018
- Increased by COLA 2019 → 2025
- Taxable income of estate/trust is determined before taking into account any distribution deduction under section 651 or 661
- Trusts formed or funded with significant purpose of receiving a deduction under Section 199A will not be respected
- Two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor(s), beneficiaries and if the principal purpose* for establishing such trusts or for contributing additional cash or other property, is the avoidance of Federal income tax. Spouses will be treated as one person. Reg. Section 1.643 (f)-1

*significant non-tax purpose

Planning For Trusts

- If holding fully depreciated real property that has no basis, consider transferring business interest to a CRT
- Making a Section 645 election may hurt the estate/trust's QBI deduction

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(vi) Example. (i) Computation of DNI and inclusion and deduction amounts.

(A) Trust's distributive share of partnership items. Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W-2 wages. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $50,000 (including W-2 wages of $25,000, miscellaneous expenses of $20,000, and depreciation deductions of $5,000) to Trust. These items are properly included in Trust's DNI. Trust's share of PRS' unadjusted basis of qualified depreciable property is $125,000. PRS distributes $5,000 of cash to Trust in 2018.

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(B) Trust's activities. In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produced $100,000 of gross income and $150,000 of expenses directly allocable to operation of the bakery (including W-2 wages of $50,000, rental expense of $75,000, and miscellaneous expenses of $35,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of section 199A.)

Example: Prop. Reg. § 199A-6(d)(3)(vi)

Trust also has zero unadjusted basis of qualified depreciable property in the bakery. For purposes of computing its section 199A deduction, Trust has properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under §1.199A-4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000).

Example: Prop. Reg. § 199A-6(d)(3)(vi)

Accordingly, Trust has the following items which are properly included in Trust's DNI:

Interest Income	15,000
Dividends	25,000
Tax-exempt interest	15,000
Net business loss from PRS and bakery	(45,000)
Trustee commissions	3,000
State and local taxes	5,000

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(C) Allocation of deductions under §1.652(b)-3. (1) Directly attributable expenses. In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under §1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 ($55,000 from PRS and $100,000 from the bakery) and direct business expenses of $200,000 ($50,000 from PRS and $150,000 from the bakery). In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under §1.652(b)-3(a) to Trust's business income.

Example: Prop. Reg. § 199A-6(d)(3)(vi)

Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under §1.652(b)-3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.

(2) Non-directly attributable expenses. The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust's remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(D) <u>Amounts included in taxable income</u>. For 2018, Trust has DNI of $2,000. Pursuant to Trust's governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax-exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(ii) Section 199A deduction. (A) Trust's W-2 wages and QBI. For the 2018 taxable year, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W-2 wages. Trust also has $125,000 of unadjusted basis in qualified depreciable property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of §1.652(b)-3(a)).

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(B) Section 199A deduction computation. (1) A's computation. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has W-2 wages from Trust of $37,500. A also has W-2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A's interest in Trust), which A has properly aggregated under §1.199A-4 with the Trust's trade or businesses (the family's restaurant and bakery), for a total of $40,000 of W-2 wages from the aggregate trade or businesses. A has $100,000 of QBI from non-Trust trade or businesses in which A owns an interest. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has (negative) QBI from Trust of ($23,500). A's total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A's taxable income exceeds the threshold amount for 2018 by $200,000. A's tentative deduction is $15,300 (.20 x $76,500), limited under the W-2 wage limitation to $20,000 (50% x $40,000 W-2 wages). Accordingly, A's section 199A deduction for 2018 is $15,300.

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(2) B's computation. For 2018, B's taxable income is below the threshold amount so B is not subject to the W-2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust's DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of B pursuant to section 199A(c)(2).

Aggregation & Combinations Under Section 199A

- Trust or estates can be owners of multiple QBI related activities through LLCs, S Corporations, REITS and PTPs and will need to compute the QBI deduction for each of them. Is there a way to aggregate the multiple activities? If so, are there any restrictions?
- Same as the last situation, except that one of the LLCs received by the trustee is an interest in a professional sports team, which is considered a specified service under the new rules. Can this activity be combined with other non-specified service activities to compute QBI for the trust or estate?
- In what situations, if any, can a specified service (such as a consulting business) be combined with a non-specified service business?

Example: Prop. Reg. § 199A-6(d)(3)(vi)

(3) Trust's computation. For 2018, Trust's taxable income is below the threshold amount so it is not subject to the W-2 wage limitation. Because Trust retained 25% of Trust's DNI, Trust is allocated 25% of its QBI, which is ($11,750). Trust's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to section 199A(c)(2).

Permissive Aggregation of Trades and Businesses

Proposed Regulations allow – but do not mandate (except in certain circumstances) – the aggregation of multiple QTBs owned directly by individuals and/or the individual's share of QBI, W-2 wages, and UBIA of qualified property from trades or businesses operated through RPEs.

- RPEs cannot aggregate; only individuals, estates, and trusts can aggregate

Four factors to aggregate

(1) same person, or group of persons, must directly or indirectly, own 50% or more of each trade or business to be aggregated for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income

- No attribution between siblings

(2) all the items attributable to each trade or business to be aggregated must be reported on returns within the same taxable year, not considering short taxable years

Four factors to aggregate

(3) none of the aggregated trades or businesses may be an SSTB

(4) two out of three of the following enumerated factors demonstrating that the businesses are in fact part of a larger, integrated trade or business must exist

(a) the trades or businesses provide products and services that are the same or customarily offered together

(b) the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources

(c) the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies)

Operational Rules for Aggregating

- If an individual chooses to aggregate, it must combine the QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses for purposes of applying the wage and property limitations

- Owners of RPE do not have to aggregate in same manner

Consistency and Reporting Requirements:

- Once aggregated must consistently report aggregated trades or businesses in all subsequent taxable years, but can add a new business to the aggregation and can disaggregate under certain factual changes
- If one chooses to aggregate, one must attach statement to return with certain information
- IRS can disaggregate for failure to provide information

How To Determine Which Trades Or Businesses MAY Be Aggregated

Ownership →	Taxable year →	No SSTB →	Necessary factors
Does the same person or group of persons, directly or indirectly, own 50% or more of each trade or business to be aggregated?	Does such ownership exist for the majority of the applicable taxable year? Are all items attributable to each trade or business to be aggregated reported on returns with the same taxable year?	Are any of the trades or businesses to be aggregated an SSTB?	Do the trades or businesses exhibit at least 2 of the following 3 factors? 1). Products and services provided are the same or customarily provided together 2). Shared facilities or shared significant centralized business elements 3). Operated in coordination with, or reliance on, one or more of the businesses in the aggregated group

Selected Clarifications In Proposed Regulations

- "Reasonable compensation" concept does not apply outside the context of S corporations for purposes of section 199A
  - Concept is not extended to partnerships
  - Wage income received by an employee is never QBI

Selected Clarifications In Proposed Regulations

- Narrow construction of what constitutes a trade or business where the principal asset of such trade or business is the reputation or skills of one or more of its employees or owners, thereby causing it to be characterized as an SSTB
  - Trade or business in which a person receives fees, compensation, or other income for endorsing products or services
  - Trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's likeness, name, signature, voice, trademark, or any other symbols associated with an individual's identity
  - Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format
  - Fees, compensation, or other income is defined to include receipt of a partnership interest or receipt of stock in an S corporation and the corresponding income, deductions, gains or losses

Required Aggregation of Activities for Specified Service Trade or Business

The strict taxable income limitations applicable to an SSTB create an incentive to separate out related activities – e.g., administrative functions and rental real estate – into distinct entities, in an effort to avoid having them aggregated with the SSTB, and to separately qualify those activities for the QBI deduction.

- While the statutory provisions of the Act did not prohibit this strategy, the Proposed Regs have directly addressed it by implementing rules mandating aggregation of certain activities that are to be integrated into the SSTB.
- The Proposed Regs state that an SSTB includes any trade or business that provides 80% or more of its property or services to an SSTB, so long as the two entities share 50% or more common ownership.
  - ➢ Further, even if a trade or business provides less than 80% of its property or services to a commonly-controlled SSTB, while the entire business is not treated as an SSTB, to the extent that it does provide property or services to the commonly-owned SSTB, that portion will be treated as income earned in an SSTB and, therefore, ineligible for the QBI deduction.
  - ➢ There is a *de minimis* exception to the above that permits the trade or business to provide up to 10% of its gross receipts in property or services to a commonly-controlled SSTB without disqualifying any portion of its income for the QBI deduction (Note: the threshold is lowered to 5% for trades or businesses with gross receipts greater than $25 million).
  - ➢ To illustrate: A dentist owns a dental practice and also owns an office building. The dentist rents half the building to the dental practice and half the building to unrelated persons. Under the Proposed Regs, the renting of half of the building to the dental practice will be treated as an SSTB.
- In addition, the Proposed Regs provide that if a trade or business has 50% or more common ownership with an SSTB and shared expenses – including wages or overhead expenses with the SSTB – it is treated as incidental to an SSTB and, therefore, as an SSTB, if the trade or business represents no more than 5% of gross receipts of the combined business.

PANEL DISCUSSION – CHOICE OF ENTITY

For much of the past thirty years, the highest corporate tax rate has exceeded or been about the same as the highest tax rate for individuals. What opportunities – or pitfalls – does the slash in the corporate tax rate open up?

Entity Selection
New Considerations Under New Rules

- The new 21% flat rate for C corporations eliminates any opportunity to benefit from a run through the lower 15% rate bracket previously available.
- The basic structure of the corporate tax system remains the same – corporate earnings are taxed twice, once when earned and again when distributed. Even with the preferential rate on qualified dividends, the C Corp. structure may be less tax-efficient than pass-through entity choices.
  - The double tax means that $100 of C Corp. earnings nets $64.15 upon distribution to an individual shareholder when dividend income is taxed at the 15% rate and the 3.8% Net Investment Income Tax applies – a *35.85%* combined tax rate
  - If a QBI deduction is available, the C Corp. structure is substantially less attractive

Entity Selection Considerations (cont'd)

- Earnings left within a C Corp. won't be subject to the shareholder level tax, creating an incentive to accumulate earnings instead of distributing them.
  - The accumulated earnings tax functions as a disincentive – when a C Corp. accumulates earnings beyond the "reasonable needs of the business" a second level of corporate tax can be imposed at a 20% rate.
  - The personal holding company tax may also apply to a C Corp. which has a small number of shareholders and derives most of its income from "passive" sources (dividends, interest, and rents, for example) – the penalty is the same – a second corporate tax at a 20% rate.
  - *Deemed dividends* provide a relief valve for avoiding the taxes – but they can be an expensive cure.
  - These taxes have been dead letters for a long time but may regain importance under the flat rate C Corp. tax regime.

Entity Selection Considerations (cont'd)

- Reasonable compensation may take on added significance, particularly for pass-through entities. There are several reasons:
  - Even if all of an S Corp.'s pass-through income is taxed at the same income tax rate, compensation is subject to payroll taxes as well, giving the IRS an incentive to assure that a stockholder/employee is being compensated adequately for services provided to the S Corp.
  - Regardless of the choice of entity, QBI doesn't include reasonable compensation or, in the case of a tax partnership, guaranteed payments. If a QBI deduction is in play, the IRS again has incentive to assure that every owner/employee is being compensated properly.
    - ***Note, however,*** the recently issued Proposed Regs do not extend the principle of "reasonable compensation" to impute the concept to partnerships and proprietorships – thereby providing a distinct advantage to these structures over an S corp. in maximizing available QBI.
  - In a C Corp. structure in which the C Corp. can demonstrate the requisite need to accumulate earnings (and thus avoid the accumulated earnings tax), the IRS has considerable incentive to assure payment of reasonable compensation which, in turn, reduces corporate income that qualifies for the low C Corp. tax rate and, instead, exposes it to payroll taxes and earned income.

ENTITY SELECTION CONSIDERATIONS (CONT'D)

- For many businesses currently organized as pass-through entities, converting to C Corp. status for the presumed benefit of a lower rate won't make sense
  - In any case, a careful analysis of the business's assets is important – for example, it might be tax-advantageous to leave some assets, such as real property, within the pass-through entity even if the decision is made to conduct business operations through a C Corp.
  - If assets are stripped off, assure that appropriate rental agreements between the pass-through entity and the C Corp. are in place.

Entity Selection Considerations (cont'd)

- What about converting a C Corp. to an S Corp. to take advantage of the QBI deduction?
  - Some C Corp. stockholders may not qualify to hold stock in an S Corp. – generally, corporations, partnerships and many types of trusts aren't eligible S Corp. stockholders.
  - A C Corp. with two classes of stock outstanding can't make an effective S election, unless the only difference in classes are voting power.
  - A C Corp. with substantial accumulated earnings may be able to make an S election but may not be able to maintain it for more than three years. A deemed dividend distribution may be a fix, but may be expensive.
  - A change in the method of accounting for inventory may, as a practical matter, rule out such an election.

Factors Influencing Entity Selection

- Taxable Income Threshold Limits
  - Below the Threshold Amount
  - Within the Threshold Range
  - Greater than the Threshold Range
- Specified Service Trade or Business
- W-2/Unadjusted Basis of Qualified Property
- Reasonable Compensation Requirements
- Need to Retain Earnings
- State Tax Considerations

Choice of Entity Example #1

- Paul owns an HVAC business. Paul performs $120,000 worth of services for the business annually, by reasonable compensation standards. The business pays out $250,000 in W-2 wages to individuals other than Paul and owns no qualified property. The business earns $315,000 in annual profit, before attributing any compensation to Paul for his services.
- Paul is married, and he and his wife file a joint income tax return.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$195,000**	**$315,000**
QBI Deduction	**--**	***($ 39,000)***	***($ 58,200)****
Dividends (Net of 21% Corp. Tax Paid)	**$154,050**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($ 52,600)**	**($ 48,370)**
Tax on Dividends	**($ 24,020)**	**--**	**--**
Net to Paul	**$231,750**	**$262,400**	**$266,630**

* If these figures represent the total income of Paul and his wife, and they take the standard deduction of $24,000, their QBI deduction will be capped at 20 percent of their taxable income (without regard to the QBI deduction itself), which would be 20 percent of ($315,000 minus $24,000).

Choice of Entity Example #2

Same facts, except the business earns $600,000 in annual profit, before attributing any compensation to Paul for his services.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$480,000**	**$600,000**
QBI Deduction	**--**	***($ 96,000)***	***($115,200)****
Dividends (Net of 21% Corp. Tax Paid)	**$379,200**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($127,780)**	**($121,060)**
Tax on Dividends	**($ 66,960)**	**--**	**--**
Net to Paul	**$413,960**	**$472,220**	**$478,940**

* If these figures represent the total income of Paul and his wife, and they take the standard deduction of $24,000, their QBI deduction will be capped at 20 percent of their taxable income (without regard to the QBI deduction itself), which would be 20 percent of ($600,000 minus $24,000).

CHOICE OF ENTITY EXAMPLE #3

Same facts, except the business earns $600,000 in annual profit, before attributing any compensation to Paul for his services, ***and***

(i) the business is a specified service business; or

(ii) the business utilizes independent contractors instead of employees and therefore pays no wages.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$480,000**	**$600,000**
QBI Deduction	**--**	***Not eligible***	***Not eligible***
Dividends (Net of 21% Corp. Tax Paid)	**$379,200**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($161,380)**	**($161,380)**
Tax on Dividends	**($ 66,960)**	**--**	**--**
Net to Paul	**$413,960**	**$438,620**	**$438,620**

CHOICE OF ENTITY EXAMPLE #4

Same facts, except the business earns $550,000 in annual profit, before attributing any compensation to Paul for his services, ***and***

(i) the business is a specified service business; or
(ii) the business utilizes independent contractors instead of employees and therefore pays no wages.

Also, Paul wishes to maintain a reserve of $200,000 annually to allow for future flexibility in growth.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$430,000**	**$550,000**
QBI Deduction	**--**	***Not eligible***	***Not eligible***
Dividends (Net of 21% Corp. Tax Paid)	**$139,700**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($143,880)**	**($143,880)**
Tax on Dividends	**($ 21,320)**	**--**	**--**
QBI Taxed but Not Distributed	**--**	**($200,000)**	**($200,000)**
Net to Paul	**$220,100**	**$206,120**	**$206,120**

Tendencies * to Keep in Mind on Entity Selection

If the taxpayer has taxable income less than the QBI threshold amount (MFJ $315K):

- A pass-through entity will typically be preferable to a C-corporation
- In determining the type of pass-through entity, an LLC taxed as a partnership (or disregarded and taxed as a proprietorship) is likely to provide somewhat better tax treatment than an S-corporation
  - Below the threshold, the payment of wages is immaterial to determination of the QBI deduction
  - Unlike an S-corporation, there is no requirement that a partnership/proprietorship pay reasonable compensation to its owners, so available QBI is not otherwise “wasted” by payment of wages

Applies equally to a specified service trade or business or a qualified trade or business

* **Note: These are intended as guidelines, and not to be applied as hard and fast rules**

TENDENCIES (CONT'D)

If the taxpayer has taxable income greater than the QBI threshold amount (MFJ $315K), but less than the upper limit of the QBI phase-out range (MFJ $415K):

- A pass-through entity will typically be preferable to a C-corporation
- In determining the type of pass-through entity, an LLC taxed as a partnership (or disregarded and taxed as a proprietorship) is likely to provide somewhat better tax treatment than an S-corporation
  - In this range, W-2 wages paid are taken into account and can have a positive impact on determination of the QBI deduction
  - However, any benefit to be gained by the addition of reasonable compensation payments to owners required in an S-corporation is often outweighed by the corresponding reduction to available QBI

The S-corporation analysis here does not apply to a specified service trade or business, and W-2 wages (including to owners) have a greater impact in this range that must be accounted for

Tendencies (Cont'd)

If the taxpayer has taxable income greater than the upper limit of the QBI phase-out range (MFJ $415K):

- *Specified Service Trade or Business* – QBI does not apply once a taxpayer's taxable income exceeds the upper limit of the QBI phase-out range, and is not a factor in entity selection
- *Qualified Trade or Business* – While a pass-through entity will typically be preferable to a C-corporation, once a taxpayer's taxable income exceeds the upper limit of the QBI phase-out range, the QBI deduction is fully subject to the Wage/Asset limitation rules which must be accounted for in the entity selection process

TENDENCIES (CONT'D)

Caveat:

A company's need to retain earnings of any significance in the trade or business may override the tendencies for any of the scenarios outlined above, and weigh heavily in favor of operating as a C-corporation with the 21% flat rate