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¶ 96,300

Section 199A Deduction for Qualified Business Income

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¶ 96,300 Section 199A Deduction for Qualified Business Income

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¶ 96,301. Introduction

Enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA), Code Sec. 199A provides a 20 percent deduction for qualified business income (QBI) from sole proprietorships, S corporations, partnerships, and LLCs taxed as partnerships. The deduction (QBI deduction), which is available to both itemizers and nonitemizers, is claimed by individuals on their personal tax returns as a reduction to taxable income.

> ***Example***: In 2018, Joe receives a salary of $100,000 from his job at XYZ Corporation and $50,000 of qualified business income from a side business that he runs as a sole proprietorship. Joe has no other items of income or loss. Joe's QBI deduction for 2018 is $10,000 (20 percent of $50,000).

The QBI deduction, which is available for tax years beginning after December 31, 2017 and before January 1, 2026, is also available to estates and trusts.

The deduction is subject to complicated restrictions and limitations, but the rules that apply to individuals with taxable income below certain thresholds are simpler and more permissive than the ones that apply above those thresholds.

The sections that follow provide an in-depth explanation of the eligibility requirements for the QBI deduction, how the deduction is calculated, and the limitations on the amount of the deduction.

¶ 96,303. Eligible Taxpayers

The Code Sec. 199A deduction for qualified business income (QBI deduction) is available to individuals who are sole proprietors, partners in partnerships, members in LLCs taxed as partnerships (hereafter, "partners"), and shareholders in S corporations (Code Sec. 199A(a)).

The QBI deduction is claimed by individual taxpayers on their personal tax returns. The deduction reduces taxable income, and is available to both non-itemizers and itemizers (Code Sec. 63(b); Code Sec. 63(d)). The deduction is not used in computing adjusted gross income, so it does not affect limitations based on adjusted gross income (Code Sec. 62(a)).

Trusts and estates are also eligible for the QBI deduction (Code Sec. 199A(f)(1)(B)). Special rules for trusts and estates are discussed at ¶96,350.

¶ 96,305. Qualified Trade or Business

Qualified business income (QBI) is determined for each qualified trade or business of the taxpayer. The term "qualified trade or business" means any trade or business other than:

(1) a specified service trade or business (Code Sec. 199A(d)(1)(A)); and

(2) the trade or business of performing services as an employee (Code Sec. 199A(d)(1)(B)).

The prohibition on employees claiming the QBI deduction for their employment income is without exception (¶96,305.40). By contrast, the prohibition on claiming the deduction for income from a specified service trade or business (¶96,305.10) does not apply to individuals with taxable income below certain threshold amounts (¶96,305.20) and is phased in for those with taxable income above the thresholds.

96,305.05 Trade or Business Requirement; Implications for Rental Real Estate Activities

In order to be a qualified trade or business, an activity must rise to the level of being a trade or business (Code Sec. 199A(d)(1)). Because the term "trade or business" is not defined in the Code, the determination of whether an activity rises to that level is subject to different interpretations. Under Code Sec. 162, for example, an activity must be regular, continuous, and substantial to be considered a trade or business. While the IRS has adopted the Code Sec. 162 definition of "trade or business" in some areas (most recently for the net investment income tax, in Reg. Sec. 1.1411-1(d)(12)), it has specified different criteria in other areas.

> ***Observation:*** The definition of "trade or business" for purposes of Code Sec. 199A is relevant to many types of activities, but none more so than rental real estate. The status of such activities became a prominent question in 2013, when the 3.8 percent net investment income tax (NIIT) went into effect, because trades and businesses are exempt from NIIT. With the 20 percent QBI deduction being contingent on an activity having trade or business status, the question has taken on new prominence in 2018.
>
> An emerging consensus among practitioners and expert commentators is that most rental real estate activities other than those involving triple net (NNN) rentals will qualify as trades or businesses for purposes of Code Sec. 199A, because such rental activities typically involve the regular provision of substantial services to tenants. So, even if the IRS adopts the relatively strict Code Sec. 162 definition of trade or business (as it did for NIIT), most non-NNN rental activities will meet the criteria. Also, the fact that last-minute changes were made to Code Sec. 199A to make the QBI deduction more readily available to rental property owners (see ¶96,320), is seen an indication that Congress intended that rental income would be eligible for the QBI deduction.

While it's reasonable to speculate that the IRS will take the same approach to defining trade or business for the QBI deduction as it did with NIIT – simply stating that the phrase has the same meaning as it does for Code Sec. 162 – the definition will remain unknown until the IRS provides additional guidance.

96,305.10 Specified Service Trades or Businesses

Certain types of businesses defined as "specified service business" are not considered qualified businesses for individuals whose taxable income exceeds certain thresholds discussed at ¶96,305.20. A specified service trade or business means any trade or business involving the performance of services in the fields of –

- health,
- law,
- accounting,
- consulting,

- financial services,
- brokerage services,
- actuarial science,
- athletics, or
- performing arts (Code Sec. 199A(d)(2)(A), via reference to Code Sec. 1202(e)(3)(A), but excluding the words "engineering" and "architecture").

Specified service trades or businesses also include 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 (Code Sec. 199A(d)(2)(A), via reference to Code Sec. 1202(e)(3)(A), but adding the words "or owners").

> ***Observation:*** While some of the items listed above are reasonably clear in their meaning, others are open to interpretation. For example, determining whether an individual is engaged in consulting will be difficult in many cases; identifying businesses where the principal asset is the reputation or skill of employees or owners, even more so (see additional discussion, below). Many questions in this area will not be resolved until the IRS provides guidance.

> ***Practice Tip:*** Before digging into the often-difficult question of whether a given client's business is a specified service trade or business, practitioners should determine what the client's taxable income will be for the year. If it's below the applicable threshold, it won't matter if the taxpayer's activity is a specified trade or business. See ¶96,305.20. The taxable income thresholds are high enough to make the rule disqualifying specified service trades or businesses inapplicable to many taxpayers.

Specified service trades or businesses also include trades or businesses which involve the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities (Code Sec. 199A(d)(2)(B)). For this purpose, the terms "security" and "commodity" have the same meanings as those provided in the rules for the mark-to-market accounting method for dealers in securities (Code Sec. 475(c)(2) and Code Sec. 475(e)(2), respectively).

Engineering and Architecture Are Not Specified Service Trade or Businesses. Engineering and architecture services are specifically exempted from the definition of a specified service trade or business (Code Sec. 199A(d)(2)(A)).

> ***Gray Area:*** The exemption for engineering and architecture services was added to Code Sec. 199A at Conference Committee in order to preserve an exemption found in repealed Code Sec. 199 (which was effectively replaced by Code Sec. 199A). Unlike Code Sec. 199, which specifically limited the exemption for engineering and architecture to services performed with respect to the construction of real property, Code Sec. 199A includes no such limitation. For engineering, the absence of restrictive language would appear to extend the exemption to engineers who provide services with respect to personal and possibly intangible property (e.g., software engineering). But until the IRS weighs in, the scope of the engineering and architecture exemption will be a gray area.

Trades or Businesses Where the Reputation or Skill of Owners or Employees Is the Principal Asset. One of the biggest challenges for tax practitioners will be determining if a taxpayer's business falls under the heading of a specified trade or business because "the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners"

(hereafter, "reputation and skill clause"). This is because there is no guidance or relevant case law to guide practitioners under either Code Sec. 199A or Code Sec. 1202 (the obscure Code section from which Code Sec. 199A incorporates the reputation and skill clause by reference).

> ***Observation:*** Based on just the language in the Code, it would be difficult to conclude with certainty that the reputation and skill clause applies to any particular business. There are many businesses for which the reputation and skill of employees and owners are important. But what does it mean for reputation and skill to be *the principal asset* of a business? In what situations is such an "asset" more important than a business's customer list, or the collection of tangible and intangible property that enables its skilled and unskilled workers to create value? Until the IRS provides guidance, this will continue be a gray area.

96,305.20 Special Rule for Taxpayers with Income Below Specified Thresholds

The rule disqualifying specified service trades or businesses from being considered a qualified trade or business does not apply to individuals with taxable income of less than $157,500 ($315,000 for joint filers) (Code Sec. 199A(e)(2)(A)). After an individual reaches the threshold amount, the restriction is phased in over a range of $50,000 in taxable income ($100,000 for joint filers) (Code Sec. 199A(d)(3)).

The threshold amount is indexed for inflation (Code Sec. 199A(e)(2)(B)). The exclusion from the definition of a qualified business for specified service trades or businesses is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return). Application of the exclusion for taxpayers with taxable income within the phase-in range, is discussed at ¶96,305.30.

96,305.30 Phase-in of Specified Service Trade or Business Limitation

Once an individual's taxable income reaches the specified threshold amount, in computing his or her QBI deduction with respect to a specified service trade or business, the taxpayer takes into account only the applicable percentage of items considered in determining qualified business income and the W-2 wage limitation (which is discussed at ¶96,320). The applicable percentage with respect to any tax year is 100 percent reduced by the percentage equal to the ratio of the taxable income of the taxpayer for the tax year in excess of the threshold amount bears to $50,000 ($100,000 in the case of a joint return) (Code Sec. 199A(d)(3)).

> ***Example:*** Tom, an unmarried taxpayer, has taxable income of $187,500, of which $150,000 is attributable to an accounting sole proprietorship that is a specified service trade or business. Assume that the sole proprietorship's W-2 wages are high enough that the W-2 wage limitation will not affect Tom's deduction. Tom has an applicable percentage of 40 percent [$187,500 - $157,500 (Tom's threshold amount) = $30,000 / $50,000 (phaseout range) = 60 percent; 100 percent – 60 percent = 40 percent]. In determining qualified business income, Tom takes into account 40 percent of $150,000, or $60,000. Since the W-2 wage limitation doesn't apply, Tom's QBI deduction is $12,000 (20% of $60,000).

96,305.40 Trade or Business of Performing Services as an Employee

The trade or business of performing services as an employee is not a qualified trade or business (Code Sec. 199A(d)(1)(A)). Thus, employees cannot claim the QBI deduction against their employment income. There are no exceptions to his rule, which applies to taxpayers at all levels of taxable income (i.e., it isn't phased in like the rule disqualifying specified service trades or businesses).

Although the disqualification of employees is one of Code Sec. 199A's clearer provisions, it can nonetheless be expected to give rise to a great deal of controversy between taxpayers and the IRS. Such conflicts will result from the fact that while employees are ineligible for the QBI deductions, independent contractors are not. The IRS has a long history of challenging worker classifications (i.e., employee vs independent contractor) in the context of employment taxes. Such disputes are resolved by applying a set of factors used to determine the degree of control that the payer has over the worker. For a discussion of worker classification, see ¶360,970.

> ***Observation:*** In determining worker classifications, courts give little or no weight to designations made by workers or those paying them, focusing instead on substance of the work relationship. As a result, workers and employers who attempt to change a worker's classification from employee to independent contractor without a substantive change in the work relationship are unlikely to prevail if challenged by the IRS.
>
> ***Practice Tip:*** Because a 20 percent deduction sounds alluring, some clients may have an exaggerated sense of the tax benefits of being reclassified as an independent contractor, absent a large pay increase. Helping a client understand that switching from paying payroll taxes to paying self-employment tax would erase most of the tax benefit of the QBI deduction will put them in a better position to weigh the pros and cons of such a change, and to negotiate an appropriate deal with their employer if they decide to pursue it.

¶ 96,310. Qualified Business Income (QBI)

Qualified business income (QBI) means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer (Code Sec. 199A(c)(1)).

QBI does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income, which are eligible for a separately calculated 20 percent deduction, but are not included in the definition of QBI. See ¶96,340.

96,310.10 Reasonable Compensation and Guaranteed Payments Are Not QBI

QBI does not include reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business. Similarly, QBI does not include any guaranteed payment for services rendered with respect to the trade or business, and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services (Code Sec. 199A(c)(4)).

Example: Charlotte is a partner in, and sales manager for, the XYZ partnership, a domestic business that is not a specified service trade or business. During the tax year, she receives guaranteed payments of $250,000 from XYZ for her services to the partnership as its sales manager. In addition, her distributive share of XYZ's ordinary income (it's only item of income or loss) was $175,000. Charlotte's qualified business income from XYZ is $175,000.

Reasonable Compensation. S corporations have long had an incentive to classify payments made to shareholder-employees as dividends rather than wages, because the latter are subject to employment taxes and the former are not. The IRS, however, can recharacterize "dividends" that are paid lieu of reasonable compensation for services performed for the S corporation (Rev. Rul. 74-44). So, "reasonable compensation" of an S corporation shareholder refers to any amounts paid by the S corporation to the shareholder, up to the amount that would constitute reasonable compensation. For a discussion of reasonable compensation of S shareholders, see ¶31,927.

Example: Robert is the sole shareholder and CEO of ABC, Inc., an S corporation that is a qualified trade or business. ABC has net income in 2018 of $250,000 *after* deducting Robert's $100,000 salary. ABC makes payments of $350,000 to Robert in 2018, of which it classifies $100,000 as wages and $250,000 as dividends. Assume that reasonable compensation for someone with Robert's experience and responsibilities is $200,000. Robert's qualified business income from ABC in 2018 is $150,000, which is its net income of $250,000, minus the $100,000 of "dividends" that are actually reasonable compensation ($200,000 reasonable compensation - $100,000 of payments classified as wages by ABC). The $200,000 treated as reasonable compensation is not QBI.

Guaranteed Payments. Guaranteed payments include payments made by a partnership, without regard to its income, to a partner, for services provided to the partnership (Code Sec. 707(c)). Partnerships are not required by federal tax law to make guaranteed payments to partners who provide services to the partnership, and are not constrained by a reasonableness standard if they choose to do so. To the extent a partnership makes such payments to a partner, the partnership's ordinary income (and qualified business income) is reduced by the amount of the payment because guaranteed payments are deductible to the partnership. To the partner receiving the guaranteed payment, the payment is ordinary income but is not qualified business income (Code Sec. 199A(c)(4)(B)). For a discussion of guaranteed payments, see ¶25,550.

Example: Marie and Joan are the equal owners of Acme, a partnership that is a qualifying trade or business. In 2018, Acme had $1,050,000 of ordinary income *before* deducting $250,000 in guaranteed payments made to Marie and Joan for their services to Acme ($125,000 each), and $800,000 of ordinary income *after* deducting the guaranteed payments ($1,050,000 - $250,000). Marie and Joan's qualified business income for 2018 is $800,000, or $400,000 each. The guaranteed payments Marie and Joan receive are not QBI. If, instead, Acme had $550,000 in ordinary income after paying a total of $500,000 in guaranteed payments to Marie and Joan for their services ($1,050,000 - $500,000 = $550,000), Marie and Joan would each have QBI for 2018 of $275,000.

Observation: Guaranteed payments can be paid not only for services rendered, but also for the use of capital. Code Sec. 199A(c)(4)(B) excludes only guaranteed payments for services from QBI.

96,310.20 QBI Includes Only Items Included in Determining Taxable Income

The determination of qualified items of income, gain, deduction, and loss, only takes into account such items to the extent they are included or allowed in the determination of taxable income for the tax year (Code Sec. 199A(c)(3)(A)(ii)).

> ***Example:*** During the tax year, a qualified business has $100,000 of ordinary income from inventory sales, and makes an expenditure of $25,000 that is required to be capitalized and amortized over five years under applicable tax rules. Qualified business income is $100,000 minus $5,000 (current-year ordinary amortization deduction), or $95,000. The qualified business income is not reduced by the entire amount of the capital expenditure. It is only reduced by the amount deductible in determining taxable income for the year.

96,310.30 Qualified Items Must Be Domestic

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States (Code Sec. 199A(c)(3)(A)(i)).

In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all the income is taxable under Code Sec. 1 (income tax rates for individuals) for the tax year, the term "United States" is considered to include Puerto Rico for purposes of determining the individual's qualified business income (Code Sec. 199A(f)(1)(C)(i)).

¶ 96,315. Calculating the QBI Deduction for Each Trade or Business

The deductible amount for each qualified trade or business is the lesser of -

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

(2) the greater of –

(a) 50 percent of the W-2 wages (defined below) with respect to the trade or business; or

(b) the sum of 25 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

(Code Sec. 199A(b)(2)). The amount in "(2)", referred to hereafter as "the W-2 wage limitation," is discussed at ¶96,320.

After calculating the QBI deduction amount for each trade or business, the taxpayer totals the amounts. Code Sec. 199A's requirement that the deductible amount be calculated separately for each trade or business may reduce the overall deduction by preventing W-2 wages from one business from being used to increase the deductible amount from another.

> ***Example:*** Marty owns stock in two S corporations, Company A and Company B, which are both qualified businesses. Marty's share of Company A's qualified business income and W-2 wages are $0 and $100,000 respectively. His share of the corresponding items for Company B are $250,000 and $0. Assume that neither company has any qualified property, so the W-2 wages

limitation will be based on 50% of W-2 wages. Marty's QBI deduction for Company A is $0 (the lesser of 20% of $0 and 50% of $100,000). Marty's QBI deduction for Company B is also $0 (the lesser of 20% of $250,000 and 50% of $0).

If Marty had instead been able to combine the qualified business income and W-2 wages for his two business and then calculate his deduction, his QBI deduction would have been $50,000 (the lesser of 20% of $250,000 (total qualified business income) or 50% of $100,000 (total W-2 wages)). But because Code Sec. 199A(b)(1)(A) requires that the deduction be calculated separately for each business and then totaled, Company A's W-2 wages cannot be used to ease the limitation on Marty's QBI deduction for company B.

Observation: The taxpayer in the example would have had a better result had he been able to group the two companies before calculating the deduction in a manner akin to the grouping of activities for the passive activity loss rules. Code Sec. 199A does not provide a grouping option, but it does grant the Treasury Secretary broad power to prescribe regulations to carry out the purposes of the section. Although the section takes a different approach than the one used for the passive activity loss rules - focusing on "trades or businesses" instead of "activities" - there doesn't appear to be anything in the section that would preclude the Secretary from implementing an elective grouping regime.

For most taxpayers, the total of their QBI deduction amounts for all qualified businesses will be their QBI deduction for the year. But before the final QBI deduction is determined, Code. Sec. 199A requires taxpayers to perform a series of additional calculations, discussed at ¶96,360. These additional calculations will only change the QBI deduction in two situations: (1) the taxpayer has qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income (see ¶96,345), or (2) the taxpayer's taxable income (reduced by any net capital gain) is less than his or her qualified business income.

¶ 96,320. W-2 Wage Limitation on QBI Deduction

The W-2 wage limitation on the deduction for qualified business income is based on either W-2 wages paid, or W-2 wages paid plus a capital element. This limitation is phased in above a threshold amount of taxable income (see ¶96,320.50).

96,320.10 The W-2 Wage Limitation Amount

Specifically, the W-2 wage limitation is the greater of -

(1) 50 percent of the W-2 wages paid with respect to the qualified trade or business; or

(2) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property (Code Sec. 199A(b)(2)(B)).

Example: Susan owns and operates a sole proprietorship that sells cupcakes. The business is not a specified service business and Susan's filing status for Form 1040 is single. The cupcake business pays $100,000 in W-2 wages and has $350,000 in qualified business income. For the sake of simplicity, assume the business had no qualified property, and that Susan has no other items of income or loss (putting her taxable income at a level where she's fully subject to the W-2 wage limitation). Susan's QBI deduction is $50,000, which is the lesser of (a) 20 percent of $350,000 in qualified business income ($70,000), or (b) the greater of (i) 50 percent of W-2

wages ($50,000) or (ii) 25 percent of W-2 wages plus 2.5 percent of qualified property ($25,000) ($25,000 ($100,000 x 25 percent) + $0 (2.5 percent x $0)).

The first of the two alternatives for calculating the W-2 wage limitation (50 percent of W-2 wages) is the one that will apply to the great majority of businesses that have employees. The second approach (25 percent of W-2 wages plus 2.5 percent of qualified property) will mainly apply to real estate businesses and other businesses that have high ratio of qualified property to W-2 wages.

Code Sec. 199A(b)(5) provides that the IRS must provide rules for applying the limitation in cases of a short tax year in which the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the year.

96,320.20 W-2 Wages Defined

W-2 wages are the total wages subject to wage withholding under Code Sec. 3401(a), elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the tax year of the taxpayer (Code Sec. 199A(b)(4)(A)).

> ***Practice Tip:*** "Total wages subject to wage withholding" will generally correspond with the amount on Form W-2, Box 1. "Elective deferrals" and "deferred compensation" correspond with the amount in Box 12.

As practitioners await IRS guidance on Code Sec. 199A, they may find Rev. Proc. 2006-47 helpful. Rev. Proc. 2006-47 provides guidance on determining W-2 wages under now-repealed Code Sec. 199, which included the same definition of W-2 wages as Code Sec. 199A, and a similar W-2 wage limitation.

For purposes of the QBI deduction, W-2 wages do not include –

> (1) any amount which is not properly allocable to the qualified business income as a qualified item of deduction (Code Sec. 199A(b)(4)(B)); and
>
> (2) any amount which was not properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for such return (Code Sec. 199A(b)(4)(C)).
>
> ***Observation:*** Under these rules, reasonable compensation paid to an S corporation shareholder falls within the definition of W-2 wages for purposes of applying the W-2 wage limitation. Guaranteed payments to a partner, by contrast, would not be considered W-2 wages for this purpose. For a discussion of impact of entity type on the determination of W-2 wages, see ¶96,320.30.

In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the Commonwealth of Puerto Rico, if all the income is taxable under Code Sec. 1 (income tax rates for individuals) for the tax year, the determination of W-2 wages with respect to the taxpayer's trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules for remuneration paid for services in Puerto Rico. Code Sec. 199A(f)(1)(C)(ii).

96,320.30 Impact of Entity Type on the Determination of W-2 Wages

As discussed in ¶96,320.20, W-2 wages include wages subject to wage withholding under Code Sec. 3401(a), that are properly included in a return filed with the SSA.

Reasonable compensation paid to an S corporation shareholder - which is subject to withholding and is reported to the SSA on Form W-3 - meets these criteria and therefore falls within the definition of W-2 wages for the purposes of the W-2 wage limitation (assuming that the compensation is properly allocable as a deduction in determining qualified business income).

> ***Example 1:*** Joseph owns and operates an art gallery as a single owner S corporation of which he is the sole employee. Assume that the gallery is qualified trade or business, and that it has no qualified property. Joseph pays himself a reasonable salary of $250,000 which is timely reported to the SSA, and the S corporation has $600,000 in qualified business income, after deducting Joseph's salary. Joseph's QBI deduction is $120,000 (20% of $600,000 of QBI). The W-2 wage limitation doesn't reduce the deduction because 50% of corporation's $250,000 in W-2 wages is $125,000, an amount greater than 20% of QBI.

Guaranteed payments to a partner in a partnership, by contrast, do not meet the definition of W-2 wages. Such payments are not subject to withholding (partners pay estimated taxes, instead), and are reported to the IRS, not the SSA. Thus, guaranteed payments fail two of the tests for W-2 wages. Because they don't count as W-2 wages, such payments are of no help to partners constrained by the W-2 wage limitation.

> ***Example 2:*** Assume the same facts as Example 1, except that Joseph and his wife, Jeanine, are equal partners in a partnership which owns the art gallery. Joseph receives compensation in the form of a guaranteed payment of $250,000. The partnership has $600,000 in qualified business income, after deducting Joseph's guaranteed payment. In this scenario, because the partnership has no W-2 wages, the W-2 wage limitation amount is $0. Accordingly, Joseph and Jeanine's QBI deduction on their joint return is $0, which is the lesser of $120,000 (20% of $600,000 of QBI) and $0 (50% of W-2 wages).

The result in Example 2 would be the same if the taxpayer's business was a sole proprietorship, as the Code does not provide sole proprietors with any means to pay themselves W-2 wages.

> ***Example 3:*** Assume the same facts as Example 1, except that the art gallery is a sole proprietorship. Because a sole proprietor's salary paid to himself doesn't meet the definition of W-2 wage and is not deductible, the business has no W-2 wages, and its qualified business income is $850,000 (after adding back Joseph's non-deductible salary). Accordingly, Joseph's QBI deduction is $0, which is the lesser of $170,000 (20% of $850,000 of QBI) and $0 (50% of W-2 wages). The only difference with the partnership scenario in Example 2 is that the amount of the forfeited QBI deduction is greater, because QBI is greater.

As the examples show, S corporations with shareholder-employees have an advantage over the other entity types in situations where a potential QBI deduction may be limited or zeroed out by the W-2 wage limitation.

> ***Observation:*** There's no indication that the sharply divergent tax results discussed above were intended by Congress. By enacting Code Sec. 199A, Congress clearly chose to favor business owners over employees on the theory that doing so would promote job creation. But did it also intend to favor S corporation shareholders over partners and sole proprietors? Probably not. So, there's a pretty good chance that the rules for determining W-2 wages will eventually be changed in a way that puts the different types of entities on more equal footing.

96,320.40 Qualified Property Defined

For purposes of the qualified business income (QBI) deduction, qualified property is defined to mean tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the tax year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the tax year (Code Sec. 199A(b)(6)(A)). The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date 10 years after that date, or (2) the last day of the last full year in the applicable recovery period that would apply to the property under Code Sec. 168 (without regard to Code Sec. 168(g)) (Code Sec. 199A(b)(6)(B)).

> ***Example:*** Walter is a sole proprietor of a widget-making company that is a qualified trade or business. The company buys a widget-making machine for $300,000 and places it in service in 2020. The business has no employees in 2020. The W-2 limitation in 2020 is the greater of (a) 50 percent of W-2 wages, or $0, or (b) the sum of 25 percent of W-2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: $300,000 x .025 = $7,500. The amount of the limitation on any QBI deduction Walter may claim for the business is $7,500.

In the case of property that is sold, for example, the property is no longer available for use in the trade or business and is not taken into account in determining the limitation (Joint Explanatory Statement of the Committee of Conference (TCJA)).

The IRS is required to provide guidance applying rules similar to the rules of Code Sec. 179(d)(2) to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital. Similarly, the IRS must provide guidance prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital (Code Sec. 199A(h); Joint Explanatory Statement of the Committee of Conference (TCJA)).

96,320.50 Phase-in of W-2 Wage Limitation

The application of the W-2 wage limitation phases in for a taxpayer with taxable income in excess of the following threshold amounts: $315,000 for joint filers and $157,500 for all other taxpayers, indexed for inflation. Thus, for a taxpayer with taxable income below these thresholds, the W-2 limitation does not apply. For purposes of phasing in the wage limit, taxable income is computed without regard to the 20 percent deduction (Code Sec. 199A(b)(3)(A)).

The W-2 wage limitation applies fully for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return). For a taxpayer with taxable income within the phase-in range, the wage limit applies as follows. With respect to any qualified trade or business, the taxpayer compares –

> (1) the tentative QBI deduction amount (20 percent of the taxpayer's qualified business income with respect to the qualified trade or business); with

(2) the W-2 wage limitation amount (see ¶96,320.10) with respect to the qualified trade or business (Code Sec. 199A(b)(3)(B)).

If the amount determined under (2) is less than the amount determined under (1), (that is, if the wage limit is binding), the taxpayer's deductible amount is the amount determined under (1), reduced by the same proportion of the difference between the two amounts as the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return) (Code Sec. 199A(b)(3)(B); Joint Explanatory Statement of the Committee of Conference (TCJA)).

> ***Example:*** Christine, a married taxpayer who files a joint return, has taxable income of $345,000, of which $200,000 is qualified business income from the JKL partnership. Assume that Christine's allocable share of JKL's W-2 wages is $60,000, and that the partnership had no qualified property. The tentative QBI deduction amount is $40,000 (20% of $200,000). The W-2 wage limitation amount is $30,000 (50% of $60,000). The difference between the two amounts is $10,000. The proportion of the excess of taxable income over the threshold amount is 30% (($345,000 taxable income - $315,000 threshold amount for a joint filer) / $100,000 phase-in range for a joint filer). So, to determine Christine's QBI deduction, $3,000 ($10,000 x 30%) is subtracted from the $40,000 tentative QBI deduction, to get $37,000.

¶ 96,325. Special Rules for Partnerships and S Corporations

TCJA provides that, in the case of a partnership or S corporation, the business income deduction applies at the partner or shareholder level (Code Sec. 199A(f)(1)(A)(i)).

Each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the tax year equal to the shareholder's pro rata share of W-2 wages of the S corporation, and a pro rata share of qualified property equal to the shareholder's allocable share of pro rata share depreciation (Code Sec. 199A(f)(1)(A)).

Similar rules apply to a partner in a partnership, who takes into account his or her allocable share of all of same items mentioned in the preceding paragraph. The partner's allocable share of W-2 wages is required to be determined in the same manner as the partner's allocable share of wage expense (which is typically the same as the partner's allocable share of ordinary income). The partner's allocable share of qualified property is equal to the shareholder's allocable share of depreciation. If the partnership agreement does not provide for special allocations of depreciation, the partner's allocable share of qualified property will be the same as the partner's allocable share of ordinary income (Code Sec. 199A(f)(1)(A)).

¶ 96,327. Special Rules for Trusts and Estates

Code Sec. 199A(f)(1)(B) provides that trusts and estates are eligible for the 20-percent deduction. The section further provides that rules similar to the ones under now-repealed Code Sec. 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital.

¶ 96,330. Carryover Losses

If the net amount of qualified business income from all qualified trades or businesses during the tax year is a loss, it is carried forward as a loss from a qualified trade or business in the next tax year. Similar to a qualified trade or business that has a qualified business loss for the current tax year, any deduction allowed in a subsequent year is reduced (but not below zero) by 20 percent of any carryover qualified business loss (Code Sec. 199A(c)(2); (Joint Explanatory Statement of the Committee of Conference (TCJA))).

> ***Example:*** Sean has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Sean is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Sean has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. The QBI deduction amounts from the business are $4,000 (20% of $20,000) and $10,000 (20% of $50,000), respectively, for a total of $14,000. This amount is reduced by $6,000 (20% of the $30,000 carryover loss), for a QBI deduction of $8,000.

¶ 96,340. Treatment of Investment Income

Qualified items of income, gain, deduction, and loss do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include –

(1) any item taken into account in determining net long-term capital gain or net long-term capital loss;

(2) dividends, income equivalent to a dividend, or payments in lieu of dividends;

(3) interest income other than that which is properly allocable to a trade or business;

(4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business;

(5) the excess of foreign currency gains over foreign currency losses from Code Sec. 988 transactions, other than transactions directly related to the business needs of the business activity;

(6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (i.e., not treated as capital assets); and

(7) any amount received from an annuity that is not used in the trade or business of the business activity (Code Sec. 199A(c)(3)(B)).

¶ 96,350. REIT Dividends, Cooperative Dividends, and Publicly Traded Partnership Income

Qualified REIT Dividends. A QBI deduction is allowed for 20 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the tax year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend or a qualified dividend (Code Sec. 199A(e)(3)).

Qualified Cooperative Dividends. A qualified cooperative dividend means a patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization, or a taxable or tax-exempt cooperative that is described in Code Sec. 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962 (Code Sec. 199A(e)(4)).

Qualified publicly traded partnership income. Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer), the sum of the (1) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the tax year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) Code Sec. 707(a) payments for services) from a publicly traded partnership not treated as a corporation, and (2) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of Code Sec. 751) (Code Sec. 199A(e)(5)).

¶ 96,360. Determining the Final Amount of the QBI Deduction

Code Sec. 199A(a) provides a complex set of calculations for determining a taxpayer's final QBI deduction, which are used after the QBI deduction for each of the taxpayer's trades or businesses have been determined (see ¶96,315 and ¶96,320).

Most of the complexity in determining the final deduction results from the way Code Sec. 199A(a) handles qualified cooperative dividends, and qualified publicly traded partnership income. Imbedded within the complex set of calculations, however, is a simpler calculation ("standard calculation") that applies to taxpayers who do not have any income of the aforementioned types. For such taxpayers, the basic calculation will provide the same result as the more complex calculations. The standard calculation is discussed at ¶96,360.10.

The more complex set of calculations ("complex calculation"), which must be used for taxpayers who have qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income, is discussed at ¶96,360.20.

96,360.10 Determining the Final QBI Deduction – Standard Calculation

For a taxpayer eligible for the QBI deduction who does not have any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income, the QBI deduction amount is the lesser –

> (1) the sum of the taxpayer's QBI deduction for all qualified trades or businesses (reduced, but not below zero, by 20 percent of any carryover qualified business loss); or
>
> (2) an amount equal to 20 percent of the taxpayer's taxable income (reduced by any net capital gain) (Code Sec. 199A(a)).

The effect of reducing taxable income by any net capital gain is to ensure that the QBI deduction does not exceed 20 percent of income taxed at regular rates. The amount in (2), above (hereafter referred to as the "taxable income limitation"), will only apply in situations where taxable income is less than the taxpayer's total QBI from all qualified trades or businesses (reduced by any QBI loss carryover).

> ***Example 1:*** Cynthia has a part-time job at BigCo, a company in which she has no ownership interest. In addition, she owns and operates LittleCo, a sole proprietorship that is a qualified trade or business. Cynthia is paid wages of $40,000 by BigCo, and has $100,000 in qualified business income from LittleCo. She has no other items of income or loss. She has a total of $25,000 in above-the-line and itemized deductions ("individual deductions"). Her taxable income, prior to applying any QBI deduction, is $115,000 ($40,000 in wages from BigCo + $100,000 income from LittleCo - $25,000 in deductions). Cynthia's QBI deduction is $20,000, which is the lesser of the sum of the QBI deductions for all of her qualified businesses ($20,000 = 20% x $100,000 QBI from LittleCo) or an amount equal to 20 percent of her taxable income (reduced by any net capital gain) ($23,000 = 20% x ($115,000 taxable income - $0 net capital gain)).
>
> ***Example 2:*** Assume the same facts as Example 1, except that Cynthia doesn't have a job at BigCo. In this scenario, her taxable income, prior to applying any QBI deduction, is $75,000 ($100,000 income from LittleCo - $25,000 in individual deductions). Cynthia's QBI deduction is $15,000, which is the lesser of the sum of the QBI deductions for all of her qualified businesses ($20,000 = 20% x $100,000 QBI from LittleCo) or an amount equal to 20 percent of her taxable income (reduced by any net capital gain) ($15,000 = 20% x ($75,000 taxable income - $0 net capital gain)).
>
> ***Observation:*** Cynthia's QBI deduction is $5,000 lower in Example 2 than it was in Example 1, because the taxable income limitation applied. The limitation was triggered because Cynthia didn't have any non-QBI income, such as wages from employment, to offset her individual deductions (which reduced her taxable income below the amount of her qualified business income). In Example 2, if Cynthia had $25,000 of non-QBI income of any type other than a net capital gain (e.g., taxable interest income, spousal wages, gambling winnings, etc.) to offset her individual deductions, the taxable income limitation would not have applied, and she would have been able to claim a full QBI deduction equal to 20% of her QBI.

96,360.20 Determining the Final QBI Deduction – Complex Calculation

The set of calculations for determining a taxpayer's final QBI deduction discussed in this section can be used for any taxpayer eligible for the deduction. Taxpayers who do not have any qualified cooperative dividends, or qualified publicly traded partnership income, however, can use a

simplified version of the calculation, discussed at ¶96,360.10. For taxpayers who have such items, the calculations for determining the deduction are as follows:

The QBI deduction is an amount equal to the sum of –

(1) the lesser of –

(a) the sum of the taxpayer's QBI deduction for all qualified businesses (including any carryover loss from a prior tax year) plus 20 percent of the aggregate amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income; or

(b) an amount equal to 20 percent of the excess (if any) of taxpayer's taxable income for the tax year over the sum of any net capital gain and qualified cooperative dividends, *plus*

(2) the lesser of –

(a) 20 percent of qualified cooperative dividends for the tax year; or

(b) taxable income (reduced by net capital gain).

The amount determined under (2), above, may not exceed the taxpayer's taxable income for the tax year (Code Sec. 199A(a), Code Sec. 199(b)).

¶ 96,370. Treatment of Agricultural and Horticultural Cooperatives

For tax years beginning after December 31, 2017, but not after December 31, 2025, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of –

(1) 20 percent of the cooperative's taxable income for the tax year; or

(2) the greater of 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business or the sum of 25 percent of the W-2 wages of the cooperative with respect to its trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property of the cooperative (Code Sec. 199A(g)(1)).

A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (1) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (2) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (3) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing (Code Sec. 199A(g)(3)).

Appendix. Text of Internal Revenue Code Section 199A

Sec. 199A. Qualified Business Income

(a) In general

In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of -

(a)(1) the lesser of -

(a)(1)(A) the combined qualified business income amount of the taxpayer, or

(a)(1)(B) an amount equal to 20 percent of the excess (if any) of -

(a)(1)(B)(i) the taxable income of the taxpayer for the taxable year, over

(a)(1)(B)(ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

(a)(2) the lesser of -

(a)(2)(A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or

(a)(2)(B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

(b) Combined qualified business income amount

For purposes of this section -

(b)(1) In general

The term "combined qualified business income amount" means, with respect to any taxable year, an amount equal to -

(b)(1)(A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus

(b)(1)(B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

(b)(2) Determination of deductible amount for each trade or business

The amount determined under this paragraph with respect to any qualified trade or business is the lesser of -

(b)(2)(A) 20 percent of the taxpayers qualified business income with respect to the qualified trade or business, or

(b)(2)(B) the greater of -

(b)(2)(B)(i) 50 percent of the W-2 wages with respect to the qualified trade or business, or

(b)(2)(B)(ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

(b)(3) Modifications to limit based on taxable income

(b)(3)(A) *Exception from limit*. In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, paragraph (2) shall be applied without regard to subparagraph (B).

(b)(3)(B) *Phase-in of limit for certain taxpayers* -

(b)(3)(B)(i) In general -

If -

(b)(3)(B)(i)(I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and

(b)(3)(B)(i)(II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business, then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

(b)(3)(B)(ii) *Amount of reduction*. The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as -

(b)(3)(B)(ii)(I) the amount by which the taxpayers taxable income for the taxable year exceeds the threshold amount, bears to

(b)(3)(B)(ii)(II) $50,000 ($100,000 in the case of a joint return).

(b)(3)(B)(iii) *Excess amount*. For purposes of clause (ii), the excess amount is the excess of -

(b)(3)(B)(iii)(I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

(b)(3)(B)(iii)(II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

(b)(4) Wages, etc.

(b)(4)(A) *In general*. The term "W-2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section

6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

(b)(4)(B) *Limitation to wages attributable to qualified business income.* Such term shall not include any amount which is not properly allocable to qualified business income for purposes of subsection (c)(1).

(b)(4)(C) *Return requirement.* Such term shall 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 (including extensions) for such return.

(b)(5) Acquisitions, dispositions, and short taxable years

The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.

(b)(6) Qualified property

For purposes of this section:

(b)(6)(A) *In general*. The term "qualified property" means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167 -

(b)(6)(A)(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(b)(6)(A)(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

(b)(6)(B) *Depreciable period*. The term "depreciable period" means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of -

(b)(6)(B)(i) the date that is 10 years after such date, or

(ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to subsection (g) thereof).

(c) Qualified business income

For purposes of this section -

(c)(1) In general

The term "qualified business income" means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income.

(c)(2) Carryover of losses

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year.

(c)(3) Qualified items of income, gain, deduction, and loss

For purposes of this subsection -

(c)(3)(A) *In general*. The term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are -

(c)(3)(A)(i) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting qualified trade or business (within the meaning of section 199A) for nonresident alien individual or a foreign corporation or for a foreign corporation each place it appears), and

(c)(3)(A)(ii) included or allowed in determining taxable income for the taxable year.

(c)(3)(B) *Exceptions*. The following investment items shall not be taken into account as a qualified item of income, gain, deduction, or loss:

(c)(3)(B)(i) Any item of short-term capital gain, shortterm capital loss, long-term capital gain, or long-term capital loss.

(c)(3)(B)(ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).

(c)(3)(B)(iii) Any interest income other than interest income which is properly allocable to a trade or business.

(c)(3)(B)(iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting qualified trade or business for controlled foreign corporation).

(c)(3)(B)(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).

(c)(3)(B)(vi) Any amount received from an annuity which is not received in connection with the trade or business.

(c)(3)(B)(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

(c)(4) Treatment of reasonable compensation and guaranteed payments

Qualified business income shall not include -

(c)(4)(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(c)(4)(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(c)(4)(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

(d) Qualified trade or business

For purposes of this section -

(d)(1) In general

The term "qualified trade or business" means any trade or business other than -

(d)(1)(A) a specified service trade or business, or

(d)(1)(B) the trade or business of performing services as an employee.

(d)(2) Specified service trade or business

The term "specified service trade or business" means any trade or business -

(d)(2)(A) which is described in section 1202(e)(3)(A) (applied without regard to the words engineering, architecture,) or which would be so described if the term "employees or owners" were substituted for "employees" therein, or

(d)(2)(B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

(d)(3) Exception for specified service businesses based on taxpayers income

(d)(3)(A) *In general*. If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), then -

(d)(3)(A)(i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

(d)(3)(A)(ii) only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

(d)(3)(B) *Applicable percentage*. For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of -

(d)(3)(B)(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(d)(3)(B)(ii) $50,000 ($100,000 in the case of a joint return).

(e) Other definitions

For purposes of this section -

(e)(1) Taxable income

Taxable income shall be computed without regard to the deduction allowable under this section.

(e)(2) Threshold amount

(e)(2)(A) *In general*. The term "threshold amount" means $157,500 (200 percent of such amount in the case of a joint return).

(e)(2)(B) *Inflation Adjustment*.

In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to -

(e)(2)(B)(i) such dollar amount, multiplied by

(e)(2)(B)(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting calendar year 2017 for calendar year 2016 in subparagraph (A)(ii) thereof. The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

(e)(3) Qualified REIT dividend

The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which -

(e)(3)(A) is not a capital gain dividend, as defined in section 857(b)(3), and

(e)(3)(B) is not qualified dividend income, as defined in section 1(h)(11).

(e)(4) Qualified cooperative dividend

The term "qualified cooperative dividend" means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which -

(e)(4)(A) is includible in gross income, and

(e)(4)(B) is received from -

(e)(4)(B)(i) an organization or corporation described in section 501(c)(12) or 1381(a), or

(e)(4)(B)(ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.

(e)(5) Qualified publicly traded partnership income

The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of -

(e)(5)(A) the net amount of such taxpayers allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) which is not treated as a corporation under section 7704(c), plus

(e)(5)(B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

(f) Special rules

(1) Application to partnerships and S corporations

(f)(1)(A) *In general*. In the case of a partnership or S corporation -

(f)(1)(A)(i) this section shall be applied at the partner or shareholder level,

(f)(1)(A)(ii) each partner or shareholder shall take into account such persons allocable share of each qualified item of income, gain, deduction, and loss, and

(f)(1)(A)(iii) each partner or shareholder shall be treated for purposes of subsection (b) as having W-2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such persons allocable share of the W-2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary). For purposes of clause (iii), a partners or shareholders allocable share of W-2 wages shall be determined in the same manner as the partners or shareholders allocable share of wage expenses. For purposes of such clause, partners or shareholders allocable share of the unadjusted basis immediately after acquisition of qualified property shall be determined in the same manner as the partners or shareholders allocable share of depreciation. For purposes of this subparagraph, in the case of an S corporation, an allocable share shall be the shareholders pro rata share of an item.

(f)(1)(B) *Application To Trusts and Estates*. Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

(f)(1)(C) *Treatment of trades or business In Puerto Rico -*

(f)(1)(C)(i) In general. In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico.

(f)(1)(C)(ii) Special rule for applying limit. In the case of any taxpayer described in clause (i), the determination of W-2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

(f)(2) Coordination with minimum tax

For purposes of determining alternative minimum taxable income under section 55, qualified business income shall be determined without regard to any adjustments under sections 56 through 59.

(f)(3) Deduction limited To Income taxes

The deduction under subsection (a) shall only be allowed for purposes of this chapter.

(f)(4) Regulations

The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section, including regulations -

(f)(4)(A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and

(f)(4)(B) for the application of this section in the case of tiered entities.

(g) Deduction allowed to specified agricultural or horticultural cooperatives

(g)(1) In general

In the case of any taxable year of a specified agricultural or horticultural cooperative beginning after December 31, 2017, there shall be allowed a deduction in an amount equal to the lesser of -

(g)(1)(A) 20 percent of the excess (if any) of -

(g)(1)(A)(i) the gross income of a specified agricultural or horticultural cooperative, over

(g)(1)(A)(ii) the qualified cooperative dividends (as defined in subsection (e)(4)) paid during the taxable year for the taxable year, or

(g)(1)(B) the greater of -

(g)(1)(B)(i) 50 percent of the W-2 wages of the cooperative with respect to its trade or business, or

(g)(1)(B)(ii) the sum of 25 percent of the W-2 wages of the cooperative with respect to its trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property of the cooperative.

(g)(2) Limitation

The amount determined under paragraph (1) shall not exceed the taxable income of the specified agricultural or horticultural for the taxable year.

(g)(3) Specified agricultural or horticultural cooperative

For purposes of this subsection, the term "specified agricultural or horticultural cooperative" means an organization to which part I of subchapter T applies which is engaged in -

(g)(3)(A) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product,

(g)(3)(B) the marketing of agricultural or horticultural products which its patrons have so manufactured, produced, grown, or extracted, or

(g)(3)(C) the provision of supplies, equipment, or services to farmers or to organizations described in subparagraph (A) or (B).

(h) Anti-abuse rules

The Secretary shall -

(h)(1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and

(h)(2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

(i) Termination

This section shall not apply to taxable years beginning after December 31, 2025.

<HISTORY>

Amendments

2017 - Section 199A was added to the Code by Section 11011(a) of Pub. L. 115-97, December 22, 2017.

Effective Date

Section 11011(e) of Pub. L. 115-97 provides, "The amendments made by this section shall apply to taxable years beginning after December 31, 2017."