ROBERT S. SCHWARTZ, Esq. is a Shareholder in Lindabury, McCormick, Estabrook & Cooper, P.C. of Westfield, New Jersey, former Chair of the New Jersey State Bar Association Taxation Section, and frequent contributor to The Practical Tax Lawyer.

A fundamental 2018 tax planning consideration is whether a business historically operated as a “pass-through” (viz., absence of C corporation status) should convert to a C corporation in order to take advantage of a new, low 21 percent Federal corporate income tax rate, as well as the other business income tax reducing provisions of the new H.R. 1 commonly known as Tax Cuts and Jobs Act (the “Act”) available to C corporations, such as a 100 percent deduction for dividends received of foreign source income from a foreign subsidiary. Converting to C corporation status could be the most tax-efficient action for a given trade or business, not considered just for a year or two, but over a longer, more important time horizon. A conversion implicates possible state taxation distortions or complications as well as perhaps the same for a pass-through business’s qualified retirement plans. This article takes as a given these and other possible tax and non-tax conversion issues that pass-through business owners should consider in deciding whether to remain a pass-through business.

The topics of this article are new Section 199A allowing a 20 percent of “x” income tax deduction in arriving at taxable income for owners of pass-through businesses; new Section 461(l) limiting business loss deductions of owners of pass-through businesses; and amendments to Section 172 also limiting such loss deductions. These provisions are effective for tax years beginning after December 31, 2017. As of the writing of this article, there are not yet Treasury regulations or IRS guidance, and no Joint Committee Staff “Blue Book” published. Many of the particular rules are not self-explanatory and one grasps for the rationale. Section 199A is a perfect mess.

Example 1 involves one Luther, a luthier whose manufacturing shop is located rural Pennsylvania. Luther builds and repairs mandolins and dulcimers as well as repairs all other stringed instruments such as guitars. During 2018 he operates through an S corporation, and is classified as an employee of the S corporation. He is unmarried and has no investments and is neither
a borrower nor a lender. He takes the standard deduction. The S corporation generates $90,000 of gross revenue. Expenses, including materials, but excluding W-2 wages that constitute “reasonable compensation,” are $60,000. Consequently, the S corporation generates “qualified business income” of $30,000 within the meaning of Section 199A(c) (“QBI”). Example 1 shows that at $15,000 reasonable compensation W-2 wages the “combined qualified business income amount” (Section 199A(b)(1)(A)) equals $6,000. $6,000 is the lesser of (A) 20 percent of $30,000 QBI or (B) the greater of (i) 50 percent of Luther’s W-2 wages or (ii) 25 percent of Luther’s W-2 wages plus 2.5 percent of $30,000 of eligible depreciable property basis. The presence of Section 199A(b)(2) causes one to examine the “deductible amount” for Luther’s business. This amount per se is not the Section 199A allowed deduction. It happens to equal $6,000. In actuality, Luther’s allowed deduction found at Section 199A(a) equals $3,600, which refers to the lesser of the “combined qualified business income amount” of $6,000 (or $13,500 depending on interpretation) or 20 percent of Luther’s taxable income determined before the Section 199A deduction. The deduction is a big one for Luther amounting to 12 percent of his S corporation’s profit (12 percent of $30,000 = $3,600). Congress intended this result. Congress did not intend such a big deduction for otherwise qualifying taxpayers with higher taxable incomes.

Consequently, owner-taxpayers with taxable incomes over “threshold amounts” (Section 199A (e)(2)) of $157,500 single return/$315,000 joint return, but not over $207,500 single return/$415,000/joint return, all to be indexed for inflation, are subject to the Section 199A (b)(3) rules. As to taxpayers with taxable incomes over the threshold amounts of $157,500 single return/$315,000 joint return, but not over $207,500 single return/$415,000/joint return, if the greater of 50 percent of an owner-taxpayer’s share of W-2 wages or 25 percent thereof plus 2.5 percent of unadjusted basis property, is less than 20 percent of the owner-taxpayer’s share of QBI or 25 percent thereof plus 2.5 percent QBI computation base is disregarded and the 20 percent of QBI computation base is reduced in proportion to the ratio of the amount by which the taxpayer’s taxable income exceeds his threshold amount ($157,500 single return/$315,000 joint return) up to $50,000 single return/$100,000 joint return. I think of this rule as a “cut back” rule.

Examples 2, 3, and 4 illustrate the operation of the cut back rule. In each case, Luther’s S corporation generates $90,000 of gross income. Expenses, including materials and a new woodcutting machine, are alternatively $80,000, $120,000 and $60,000. The S corporation generates QBI of either $210,000 or $170,000. Following the Section 199A(c)(4) definition, expenses for QBI purposes exclude W-2 wages that constitute reasonable compensation. For illustration, reasonable compensation wages are posited at the varying amounts of $80,000, $120,000 and $60,000.

In Example 2 Luther’s taxable income before Section 199A deduction of $198,000 exceeds the threshold amount ($157,500) but not that amount plus the statutory additional amount ($50,000) or $207,500. The 199A(b)(2)(A) amount (20 percent of QBI) exceeds the 199A(b)(2)(B) amount (the greater of 50 percent wages or 25 percent wages plus 2.5 percent qualified property basis). In statutory words, the Section 199A(b)(2)(B) amount is less than the Section 199A(b)(2)(A) amount. Under these circumstances, Section 199A(b)(3)(B) reduces the 199A(b)(1)(A) “combined qualified business income amount” from $42,000 to $40,380 (81 percent of the $2000 excess of (A) over (B)). The exercise is academic to the Section 199A deduction, however, because following Section 199A (a) 20 percent of Luther’s pre-199A $198,000 taxable income ($39,600) is less than the cut back “combined qualified business income amount” of $40,380.

Example 3 not only illustrates the operation of the cut back rule where taxable income exceeds the threshold amount ($157,500), but not the cut back amount plus the statutory additional amount ($50,000), but also illustrates where the Section 199A(b)(2)(A) amount does not exceed the Section 199A(b)(2)(B) amount. In statutory words, the Section 199A(b)(2)(B) amount “is not less than” the Section 199A(b)(2)(A) amount. Under these circumstances, Section 199A (b)(3)(B) does not reduce the 199A(b)(1)(A) “combined qualified business income amount.” Moreover, Section 199A(b)(1)(A) directs the reader to the sum of (A) 20 percent of $170,000 QBI plus (B) the greater of (i) 50 percent of Luther’s $120,000 W-2 wages or (ii) 25 percent of Luther’s W-2 wages plus 2.5 percent of $100,000 of eligible depreciable property basis. Arriving at the resulting sum of $94,000 of “combined qualified business income amount” is academic to the Section 199A deduction, however, because following Section 199A
(a) 20 percent of Luther’s pre-199A $158,000 taxable income ($31,600) is the lesser amount.

Example 4 is just like Example 3 but wages considered reasonable compensation are $60,000 rather than $120,000. The Section 199A(b)(2)(A) amount exceeds the Section 199A(b)(2)(B) amount. Under these circumstances, Section 199A(b)(3)(B) reduces the 199A(b)(1)(A) “combined qualified business income amount” by 145 percent of the $4,000 excess of (A) over (B) or $5,800 to $28,200. The exercise is not academic to the Section 199A deduction, because following Section 199A $28,200 is less than 20 percent of Luther’s pre-199A taxable income of $158,000 ($31,600). Luther’s deduction is cut back by Section 199A(b)(3)(B). Closer to the words of the statute, the “limit” has been “modified.”

The examples more generally illustrate that the Section 199A(a) deduction varies as a function of (1) the extent to which pre-Section 199A taxable income exceeds the threshold amount; (2) “QBI” amounts; and (3) W-2 wages-reasonable compensation amounts. The Section 199A deduction can also vary as a result of the unadjusted basis of the eligible depreciable property. There are going to be millions of variations on the themes of the Section 199A deduction because the variables are so different for so many taxpayers. One wonders whether this mass of variation will develop into identifiable patterns over the next eight years.

Chart One shows Luther’s Federal employment taxes at the three alternative reasonable compensation levels and Chart Two shows Luther’s total Federal taxes. The lower is Luther’s reasonable compensation the lower are his taxes. There is no new tax issue raised by this observation in the case of S corporations and their shareholder-employees: reducing one’s employment taxes by reducing one’s wages can be abusive. There are several Tax Court cases within the last few years. A good example is Sean McAlary Ltd., Inc. v. Commissioner, T.C. Summary Opinion 2013-62. This summary non-precedential opinion began as an IRC Section 7436 employment tax audit and independent contractor versus employee status determination for associated brokers. But as the audit went, the IRS determined Mr. McAlary’s S corporation, real estate brokerage business paid him unreasonably low compensation. Judging the issue as a mixed question of fact and law the IRS employed an expert to analyze the extent to which $240,000 of 2006 distributions to Mr. McAlary should be reclassified as wages. Based upon such sources as the California Occupational Employment Statistics Study and the Risk Management Association Annual Statement Studies, the IRS’ expert concluded $100,755 was reasonable compensation. Pointing out that determining reasonable compensation is “not an exact science,” the Court held instead the amount of $83,200. The taxpayer relied upon the corporation’s 2004 incentive-based compensation corporate resolution that led to a formula that determined $24,000 in compensation for 2006. The court found the document was unpersuasive because it was not a product of arm’s length negotiations.

Notwithstanding or aside from cases such as this, Section 199A(c)(4) excludes only “reasonable compensation” wages from the QBI numerical base, not all wages. Section 199A(f)(4) states that the Secretary shall prescribe such regulations as are necessary to carry out the purposes of Section 199A, including regulations, “for requiring or restricting the allocation of . . . wages under this section and such reporting requirements. . . .” This presumably evidences vague concerns about the possibility of unintended tax benefits to a given taxpayer from the special allocation of a disproportionate share of Section 199A(b)(2)(A) QBI amount. What is the imagined tax abuse? By varying compensation amounts or allocations of compensation amounts, Luther or one of several owners of another pass-through business with other employees might invest their extra after-tax income to buy a better new piece of equipment or hire an apprentice luthier or other persons. Imagine Asa, a senior at the TriRegional Vocational Technical High School, is interested in the luthier field. Luther hires Asa at a minimum wage to apprentice. Upon information and belief, Section 199A was intended by Congress to cause just this behavior by the Luthers of this country. Further, compensation levels often are the main driver of accruing benefits in qualified pension plans such that a person in Luther’s position or other business owners may not get ahead as a result of setting compensation at the bottom of the reasonable range, not to mention below it. Real or imagined abuses concerning amounts of wages paid to non-owner employees are seemingly much less likely and wages paid to them ordinarily should be “reasonable compensation” for purposes of Section 199A.
The Section 199A deduction is allowed only to taxpayers who are owners of “qualified trades or businesses.” One can foresee Section 199A Treasury regulation reference to the long-standing Section 162 case law definition of a trade of business. Nevertheless, or maybe because Congress had this definition in mind, Section 199A(d)(1)(B) expressly excludes as “qualified” the long-standing “trade or business of performing services [exclusively] as an employee”. Section 199A(d)(1)(A) further expressly excludes in part by reference to Section 1202(e)(2)(A) any pass-through trade or business that constitutes a “service business” in following fields: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading or dealing in securities (broadly defined), partnership interests or commodities and any other trade or business where the “principal asset of such trade or business is the reputation or skill of one or more of its employees.” Presumably Treasury regulations will adopt a “predominant character” test to distinguish “service businesses” in these fields from businesses that merely employ persons who perform these kinds of services within a business of different character. Despite or maybe because of this broad definition, “engineering” and “architecture” operations were carved out of the excluded businesses list by the Conference Committee. General contractors and real estate developers, who frequently employ staff engineers or architects, should be safely outside of the “service business” definition. Maybe the IRS will issue comfort guidance for professional engineering and architectural firms.

Concerning the meaning of some of the occupational terms that are not self-explanatory as applied to a given situation, as well as the quoted catch-all, especially as it may apply to architects and engineers, legal developments are going to be important to clarify meanings. In addition, the canon of construction that (unless excepted from the rule) all deductions are matters of legislative grace and should be construed against taxpayers, will inform the IRS and courts concerning eligibility for the Section 199A deduction. See, e.g., Deputy v. Du Pont, 308 U.S. 488 (1940) (deductions are matters of “legislative grace” construed narrowly in favor of the government). Often, however, this principle does not inform those preparing tax returns in situ so tax lawyers prepare for controversy business.

As perhaps what will prove to be a counter balance to forces broadening the scope of Section 199A deduction eligibility to unspecified reputation/skill centered service businesses, Section 199A(d)(3) does carve out across the board 199A deduction eligibility for many taxpayer-owners of all such ineligible businesses. The exception applies in full, if an owner-employee (or self-employed owner) has taxable income not exceeding $157,500 single return/$315,000 joint return threshold amounts. The exception phases out once an owner-employee (or self-employed owner) has taxable income exceeding these limits, and beyond them, plus $50,000 for single return filers and $100,000 for joint return filers. The Conference Report refers to phase out as the “phase in of the limitation.”

The Section 199A(d)(3) formulation is best shown by example. Assume Chris is a newly minted percentage member of CPA, LLC, and files a joint return. Assuming family taxable income of $365,000, the “phase in of the limitation” results in this percentage: $50,000/$100,000 = 50 percent ($365,000 is half way between the $315,000 joint return threshold amount and the $415,000 top deduction eligible taxable income level.) For purposes of computing his joint return Section 199A deduction, Chris reduces by 50 percent his share of each of LLC “qualified business income,” “W-2 wages” and unadjusted basis of qualifying tangible, depreciable property. How the IRS will structure information tax reporting for taxpayers like Chris is an open consideration. A possibility is the IRS will add three lines to the existing Schedule K-1 or create a new “K-1-199A” to account for these three computation factors. In addition, especially larger pass-through service businesses are going to invest in more tax accounting capacity; they will probably decide to give every owner the new form that includes Section 199A relevant information; some small as well as large organizations will not be set up in time for the 2018 tax return filings by April 15, 2019.

Example 5 illustrates the business loss side of Section 199A. It also brings into play new Section 461(l)—a new “trade or business loss” deduction limitation rule—and loss limiting amendments to the Section 172 net operating loss carryover rules. In Example 5, assume that Jacob’s share of an S corporation’s Section 199A loss from a qualified trade or business equals ($50,000). He files as a single taxpayer, is active in the business and he has no other income or deductions aside from the S corporation activities. Section 199A(c)(2) states that this loss “shall be treated as a loss from a qualified trade or business in the succeeding taxable year.” Section
199A provides no other language about the tax consequences of a Section 199A qualified business loss.

In the context of explaining the working of the Senate's original 23 percent Section 199A deduction, the Conference Report sets forth a joint tax return hypothetical concerning H’s ($50,000) qualified business loss carryforward from a prior year and W’s ($40,000) qualified business loss for the year of the Section 199A deduction computation. The hypothetical presents as a given the ($50,000) loss was not used as a deduction in the prior year but does not indicate a statutory limitation and/or facts as to why not. The hypothetical reduces H’s otherwise stated to be $34,500 Section 199A deduction for the year by $11,500 to account for H’s ($50,000) loss carryforward to the taxable year (23 percent of $50,000 = $11,500) (reflecting the pre-Conference Agreement proposed 23 percent Section 199A deduction). Presumably the reduction to the deduction in this manner is intentional to avoid a sort of double tax benefit to H and W. W’s ($40,000) loss for the year, meanwhile, also reduces H’s $34,500 deduction by another $9,200 (23 percent of $40,000 = $9,200). The Section 199A deduction thus is reduced all the way to $13,800.

The hypothetical is silent about the use of W’s ($40,000) loss for the taxable year. Presumably it remains available for use aside from Section 199A, because the use of the ($40,000) qualified trade or business loss that year, coupled with a further $9,200 reduction of H’s Section 199A deduction, avoids a sort of double tax benefit to H and W. One further supposes that if the hypothetical suggests W’s qualified trade or business loss can’t be used until the next year, notwithstanding a Section 199A deduction cut back to account for its presence, definitely there is no double tax benefit, but such a rule would be overkill.

Getting back to Jacob in Example 5, there is no Section 199A deduction for an S corporation business loss year. Jacob filing separately has $300,000 of compensation, however, so he could claim the ($50,000) loss against this income for 2018, because we are assuming Jacob has actively participated in S corporation’s business. Change the example to Jacob is married to Sara in 2018, and Sara has gross income of $100,000 consisting of dividends and interest. Jacob’s loss would reduce their joint taxable income by ($50,000), because the loss is trade or business loss for the year that flows onto their joint Form 1040 and is not barred by Section 469 because again we are assuming Jacob has actively participated in S corporation’s business.

Assuming the S corporation generates a Section 199A deduction in 2019, has there been a double counting of a tax benefit, if the ($50,000) 2018 loss does not reduce the 2019 Section 199A deduction, or if necessary to fully recover the 2018 tax benefit of the loss, a later year’s Section 199A deduction, by a total of 20 percent of ($50,000) or $10,000? The hypothetical can be read to indicate Jacob’s 2019 Section 199A deduction is subject to reduction, and any loss that may be unused in computing the reduction carries forward to reduce Section 199A deductions in later years. A further question arises: What does the Act say about the use of the ($50,000) loss for 2018 outside of Section 199A? New Section 461(l) provides for limitations on business loss use against other taxable income of taxpayers other than C corporations. Section 461(l) expressly provides it is to be applied after the application of the Section 469 passive activity loss rule limitations on loss utilization. No similar mention is made of Section 199A. The operation of Section 461(l) is best shown by example.

Section 461(l) requires the determination of Jacob’s “excess business loss” for 2018. This phrase is defined as the excess of a taxpayer’s “aggregate deductions … attributable to trades or businesses” over the sum of “aggregate gross income or gain” plus the “stated amount.” The stated amount is $250,000 for a single filer and $500,000 for joint filers, and these amounts are to be adjusted for inflation beginning in 2019. Assume Jacob files separately for 2018, and Jacob has no gross income from any sources other than his S corporation. The formula works by comparing Jacob’s “aggregate” business deductions of $950,000 to the sum of Jacob’s pass-through gross income of $900,000 and a $250,000 stated amount. Comparing the resulting $1,150,000 to Jacob’s business deductions totaling $950,000, Jacob realized no 2018 excess business loss. Consequently, as far as Section 461(l) is concerned, Jacob can claim a ($50,000) loss deduction for 2018 reducing Jacob’s $300,000 compensation income by ($50,000).
determined under the Section 172 rules as amended by the Act. **Example 6** presents a business loss fact pattern of ($800,000) of excess business loss amount under Section 461(l) that cannot reduce the taxpayer’s taxable income from other sources for the loss year, such as wages, dividends and interest and that equals or becomes a part of a taxpayer’s Section 172 net operating loss carryforward deduction.13

The Act amends the “old” Section 172 in a number of important ways. The long-standing two-year carry-back of a given year’s net operating loss is repealed for such losses arising in taxable years beginning after December 31, 2017. The 20-year carryforward period is replaced with an unlimited carryforward period. As amended, Section 172 limits the use of the net operating loss carryforward deduction to a maximum of 80 percent of what otherwise is the taxpayer’s taxable income for a later carryforward year. Consequently, a Section 461(l) excess business loss that becomes part of or equals the Section 172 net operating loss carryforward deduction to the next tax year is likewise subject to the 80 percent of taxable income limit. This “80 percent of TI” limitation serves as a kind of minimum tax base for pass-through businesses. It might hurt in some situations where the limit applies because business losses often translate in practice into insufficient funds to timely make estimated tax payments or pay income taxes shown as due on the return.

A logical business loss use framework taking into account Sections 199A, 461(l) and 172 would work this way. A current year Section 461(l) loss deduction ought to take priority as a freely allowed loss, subject, however, to pre-Act loss use limitations such as Section 469, and in the case of S corporations and partnerships, the “limitation to basis.” Any Section 461(l) excess loss amount becomes part of the unlimited Section 172 net operating loss carryforward deduction to the next following taxable years in order, subject to the Section 172 80 percent of taxable income limitation on the use of this deduction. If there is another Section 461(l) non-excess loss for the next year, the Section 461(l) loss should be allowed for that year in priority to the Section 172 net operating loss carryforward deduction. Thus, consistent with amendments to Section 172, the loss carryforward to that year continues to carry forward to later years indefinitely. Any Section 461(l) excess loss for the next year is added to this open-ended Section 172 loss carryforward, as well.

Meanwhile, a Section 199A deduction for a taxable year happens to be a use or lose deduction. Act Section 11011(d)(1) amends Section 172(d) to provide that no Section 199A deduction is allowed in computing a Section 172(c) net operating loss. Consequently, an unused Section 199A deduction does not enter into the Section 172(a) loss carryforward deduction for a later year. Because of this, the Section 199A deduction ought to be allowed first in computing taxable income for any taxable income year in priority to any Section 172 loss carryforward deduction. Moreover, a Section 199A deduction cutback in later years should occur by limiting the losses used in the cut back calculation to those (of single or joint return filing taxpayers) that have actually reduced taxable income after application of the Section 199A deduction. To the extent taxable income is not reduced by the business’s losses arising in prior years, no Section 199A deduction cut back should occur for the current taxable income year.

The interplay of the three code sections is going to get especially complicated for taxpayers experiencing swings from taxable income years to taxable loss years, depending on such factors as weather for farming businesses, seasonal variations for ski resort operators and many other factors that can cause a particular business or industry to experience considerable fluctuations in profitability over the next eight years. A harmonized system like that presented here seems to comport best with the overall Congressional business tax cuts purposes behind Section 199A and the Act in general.

Finally, whatever the reasoning, the Act amends Section 6662(d)(1) to the effect, where a taxpayer claims the Section 199A deduction, the threshold for the imposition of the 20 percent of the underpaid tax income tax penalty is reduced from an understatement of income tax equal to the greater of 10 percent of the tax required to be shown on the return or $5,000 to five percent of the tax required to be shown on the return or $5,000.

**OTHER NOTEWORTHY PROVISIONS**

Significant amendments to Sections 263A, 448, 460 and 471 allow qualifying small businesses generally favorable tax accounting choices that have been unheard of since at least enactment of the Deficit Reduction Act of 1984’s (P.L. 98-369 “DFRA”) undescriptive, and taxpayer unfriendly, “Accounting Changes.”
Under prior law, the average gross receipts threshold was $10M for purposes of not having to adhere to the Section 263A uniform capitalization rules; for purposes of having to use the accrual method with regard to purchases and sales of inventory items the prior law gross receipts threshold was $1M and for taxpayers in certain industries $10M; the prior law threshold for small contractors not being required to utilize the percentage-of-completion method of accounting for construction contracts was limited to those having average annual gross receipts for the prior three years not exceeding $10M; with respect to the availability of an overall cash method of accounting for C corporations, the prior law threshold was $5M. The Act accounting changes change all the above to apply to any businesses having had average annual gross receipts that do not exceed $25M average for the three prior taxable years. With respect to inventories, qualifying businesses may deduct the inventory expenses as incidental materials and supplies in the taxable year in which they’re used or consumed in the taxpayer’s operations or alternatively deduct them in a manner that conforms to the taxpayer’s financial accounting treatment of inventories. For contractors the change to the eligible size of contractor rule does not change the rule that the contractor’s real estate construction contracts are expected to be completed within two years of commencement of construction. With respect to the new disallowance of excess business interest, discussed below, businesses having had average annual gross receipts that do not exceed $25M average for the three prior taxable years are exempt.

Qualifying small businesses are excluded from the new Section 163(j) business interest expense (“BIE”) limitations (“anti-leveraging legislation”).

The Act amends Section 163(j) to disallow annual business interest expense deductions, in the case, of C corporations, individuals, estates and trusts to any and all, business interest income (“BII”) (distinguish “investment” interest income and also investment interest expense as per Section 163(d)), plus 30 percent of taxable income determined before deductions for depreciation, amortization or the depletion allowance, if any, plus any and all floor plan financing interest for businesses that finance any kind of road worthy vehicles for sale or lease. In the event of disallowance, excess interest expense is carried forward for an indefinite number of years subject to complex limitations.

Amended Section 168(k) substantially increasing year of placement in service deductions of the cost of otherwise capitalized and depreciated new and used business use property is available to all size businesses, while under Section 179, as amended, the maximum annual qualifying investment expense increases from $500,000 to $1M. The $1M amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the year exceeds $2.5M, which is a higher phase out threshold than prior law’s $2M. These amounts are indexed for inflation. The following list of additional property types are eligible through section 179 expensing: heating, ventilation and air conditioning systems, fire, alarm and security systems.14

Amendment of Section 280F increasing the first year cost expensing for business use automobiles from $2560 to $10,000, as well as increasing the three subsequent year depreciation limits by approximately 4 times prior law, thereby allowing cost recovery over 4 years of as much as $41,360. Any remaining cost recovery years are allowed up to $5,760 per year rather than a mere $1,475.

The Act maintains the depreciation period of 39 and 27.5 years for non-residential real and residential rental real property, respectively. The conference agreement provides for a general 15-year depreciation period for “qualified property.” This is a new definition which in part eliminates the separate definitions of qualified leasehold improvements, qualified restaurant property and qualified retail improvement property;

For pass-through entities, such as LLCs and S corporations, that are not per se affected by the limitation, the business interest expense disallowance is first determined at the entity level in the same way as for, for example, the C corporation business interest expense disallowance. Congress was aware, however, of a “double counting” of taxable income possibility that could effectively increase business interest deductions overall to affected owners looking at their forms 1120, 1040, etc. Such an increase could occur whenever the pass-through entity allocated a net taxable income share (whether consisting of netted partnership items of income and expense or partnership separately stated items of income and expense) to a pass-through owner, and that owner also has taxable income from other sources. The chosen limitation is in two parts: (1) prohibit the affected taxpayer from taking into account
its allocable shares of all items for purposes of determining the taxpayer’s overall taxable income for 30 percent of taxable income business interest expenses deductibility purposes; (2) apply a formula to lift the prohibition, to allow a potentially larger business interest expense deduction to the owner as a separate taxpayer, to the extent of the taxpayer’s share of “excess [pass-through entity] taxable income” determined as follows: ratio of excess taxable income to pass-through entity taxable income = ratio of “x” to 30 percent of pass-through entity taxable income. “x” = any excess of 30 percent of pass-through entity taxable income over any amount by which pass-through entity business interest expense exceeds its business interest income. So, for example, if Abe has 100 TI and BIE of 40 and BII of 30, then 30-10 = 20 and a 20/30 ratio translates to a “y”/100 ratio. y = 66.66. Abe’s one-third share of the 66.66 (22.22) is “added” to his or her own taxable income that can potentially be reduced by business interest expense. Abe’s one-third share of the business’s 10 of excess BTE over BTI, or 3.33, is allowed as a deduction, as well as much as another 18.88 of the same excess as to Abe’s TI from all other sources, if any.

Notes

1 I did not specifically address rules for businesses organized as agricultural or horticultural cooperatives. These lines of business receive special favorable treatments.

2 “Qualified business income” can be accurately paraphrased as follows: all items of income, gain, deduction and loss (importantly, excluding as deductions reasonable W-2 wages and reasonable self-employment compensation) effectively connected with the conduct of a trade or business within the United States that are included or allowed in determining taxable income for the taxable year, excluding specified items Congress deems to arise from investment activities rather than Section 199A trade or business activities: all dividends and income equivalent to dividends, such as presumably an S corporation redemption of a taxpayer’s stock treated as a dividend through a combination of Sections 302, 1371 and 1368(c), all capital gain or loss items (which by the way are subject to other provisions dealing with their computation and a separate tax rate schedule to net capital gains under Section 1, as amended), all interest income other than interest income “properly allocable” to the trade or business, annuity payments not received in connection with the trade or business, and income from the following activities: all commodities transactions, foreign currency trading transactions, notional principal contract transactions, and lastly any and all items of deduction or loss “properly allocable” to all of these investment activity items. The definitional reference to Section 954(c) effectively connected income interestingly brings into play Subpart F in what will be largely domestic trade or business activities, but they need not be only domestic activities. Section 199A (c)(1) excludes from the definition of QBI “qualified” REIT and cooperative dividends and qualified publicly traded partnership income.

3 It may prove an academic exercise in cases, but one follows Section 199A(b)(2), and for taxable income threshold exceeding taxpayers, (b)(3) as well, by making a “determination” of the taxpayer’s “deductible amount for each trade or business.” This “deductible amount” is not per se the Section 199A deduction—the calculation does not set the gear. It’s only the first shift motion into neutral in a double clutch shift that obtains the “combined qualified business income amount”. Doing the Section 199A(a) calculation is the shifting into gear in the sense the Section 199A(a) calculation yields the allowable deduction.

4 The higher the percentage and/or the “excess amount” the greater the reduction to the IRC 199A(b)(2)(A) 20 percent of QBI amount. It tends to go down to the greater of the 50 percent or 25 percent-2.5 percent. This calculation fact indicates an incentive to raise wages and/or capital investment, but I am not sure many pass-through owners will see it that way. The calculation can be academic as exemplified.

5 Treasury may or may not promulgate regulations, and if so, they may be of limited scope. In the absence of regulations, the IRS probably will issue informal guidance in other forms such as Revenue Rulings or Procedures, Announcements and when asked by taxpayer’s PLRs. All references to Treasury regulations are met to cover IRS informal guidance whatever the form.

6 Hartwick College v. U.S., 801 F 2d 608 (2nd Cir. 1986) (provisions regarding charitable deductions are liberally construed in favor of taxpayers).

7 Double tax benefits have been frowned on by the federal courts who have made their own rules to prevent it. See, e.g. Ilfeld v. Hernandez, 292 U.S. 62 (1934) (in the absence of a statute or regulation authorizing it, no deduction will be allowed to the consolidated group for a stock investment loss upon liquidation of two subsidiaries stock, because in earlier years the group claimed deductions for their operating losses. “. . . a purpose [arguably present in subject statute or regulations] so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers.”). Cf., e.g. Hillsboro National Bank v. Commissioner; United States v. Bliss Dairy, 460 U.S. 370 (1983) (taxation on a transactional rather than a tax year basis: the “tax benefit rule,” by requiring income inclusion in the later year, cancels out an earlier deduction when in the later year there occurs an event fundamentally inconsistent with the premises on which the deduction had been based.)

8 This follows from a doubtful, more narrow reading of Section 199A(c)(2) that a qualified trade or business loss amount is carried over to the next year for all IRC purposes.

9 Assume Jacob’s 2018 $300,000 salary constitutes reasonable compensation.

10 If Jacob’s 2018 W-2 wages-reasonable compensation were $250,000, there would have been no deductible loss. Employment tax-wise, Jacob saves 2.9 percent worth of
Medicare tax on $50,000 as well as the .9 percent Medicare surtax on $50,000 or a total $1900 at the lower wage level.

11 Section 461(l)(1) uses the term “other than a corporation.” S corporations don’t ordinarily pay taxes in and of themselves, although there are exceptions for realized built-in gains (IRC 1374) and excessive passive gross receipts (IRC 1375). As written the quoted phrase would allow the use of S corporation level losses against these kinds of S corporation income, if any, subject to other IRC limitations on such loss use. By contrast, Section 461(l)(4) singles out owners of S corporations and partnerships as subject to the Section 461 loss limitations. Section 461(l) thus appears not to apply to S corporations subject to these taxes.

12 The language of Section 461(l) can be read to add to $900,000 business gross income Jacob’s $300,000 salary for example. I believe this is a sort of “double counting” interpretation and, therefore, Treasury or the courts would find Congress did not have this interpretation in mind.

13 Example 6 also is indicative of limiting 199A(c)(2)’s scope to for purposes of the Section 199A deduction.

14 The Section 199 business expense deduction is repealed as obsolete.
EXAMPLE 1
Luther Below TI Threshold
199A(b)(3)(A)
2018

90,000 GI
(60,000) Bus. Exp. before Wages
30,000 QBI

W-2 Wages 15,000
("Reasonable Compensation")

“Deductible Amount”
Lesser of (A) 20% of 30,000 QBI or 6000
or (B) 7500, which is the greater of (i) 50% of 15,000 W-2
Wages or 7500 and (ii) 25% of 15,000 W-2
Wages plus 2.5% of the 30,000 unadjusted basis
of tangible property used in the business as of year
end for not more than the greater of 10 yrs. or the
last day of last full year of the 168 recovery period
for the property in question or 4500

“CQBI” = (A) = 6000
((B) not apply since $157,5000 TI threshold not crossed and
presumably also CQBI definition also excludes (B))

alternatively “CQBI”=(A)+(B) above 13,500
(presumably (B) part of CQBI because threshold not crossed)

“Allowed as Deduction”
Lesser of CQBI of 13,000
or 20% of 18,000 pre-199A TI = 3600

(3600) 199A Deduction
11,400 post-199A BTI

1537 Tax on 26400 TI
with 12,000 Standard Ded.
EXAMPLE 2
Luther Above TI Threshold; Below TI Threshold plus 50,000/100,000
199A(b)(2)(B) amount less than 199A(b)(2)(A) amount
2018

High Wage

290,000 GI
(80,000) Bus. Exp. before Wages

210,000 QBI

W-2 Wages 80,000
(“Reasonable Compensation”)

“Deductible Amount”

Lesser of (A) 20% of 210,000 QBI or 42,000
or (B) 40,000, which is the greater of (i) 50% of 80,000 W-2
wages or 40,000 and (ii) 25% of 80,000 W-2
wages plus 2.5% of the 100,000 unadjusted basis
of tangible property used in the business as of year
end for not more than the greater of 10 yrs. or the
last day of last full year of the 168 recovery period
for the property in question or 22,500.

“CQBIA” = disregard (B) and reduce (A) by 81% of 2000
(because amount under (B) is less than amount under (A))

“Allowed as Deduction”

Lesser of CQBIA of 40,380 (42,000-1630)
or 20% of 198,000 pre-199A TI = 39,600

(39,600) 199A Deduction
90,400 post-199A BTI

32,377 Income Tax on 158,400
with 12,000 Standard Ded.
EXAMPLE 3
Luther Above TI Threshold; Below TI Threshold plus 50,000/100,000
199A(b)(2)(B) amount is not less than 199A(b)(2)(A) amount
2018

290,000 GI
(120,000) Bus. Exp. before Wages

170,000 QBI

W-2 Wages 120,000
(“Reasonable Compensation”)

“Deductible Amount”

Lesser of (A) 20% of 170,000 QBI or 34,000
or (B) 60,000, which is the greater of (i) 50% of 120,000 W-2
Wages or 60,000 and (ii) 25% of 120,000 W-2
Wages plus 2.5% of the 100,000 unadjusted basis
of tangible property used in the business as of year
end for not more than the greater of 10 yrs. or the
last day of last full year of the 168 recovery period
for the property in question or 32,500.

“CQBIA” = (A) plus (B) or 94,000
(199A(b)(1)(A) “sum of” (b)(2)(A) and (b)(2)(B))

“Allowed as Deduction”
Lesser of CQBIA of 94,000
or 20% of 158,000 pre-199A TI = 31,600

(31,600) 199A Deduction
18,400 post-199A BTI

27,505 Income Tax on 138,600
with 12,000 Standard Ded.
EXAMPLE 4
Luther Above TI Threshold; Below TI Threshold plus 50,000/100,000
199A(b)(2)(B) less than 199A(b)(2)(A)
2018
Low Wage

290,000 GI
(120,000) Bus. Exp. before Wages
170,000 QBI

W-2 Wages 60,000
("Reasonable Compensation")

“Deductible Amount”

Lesser of (A) 20% of 170,000 QBI or 34,000
or (B) 30,000, which is the greater of (i) 50% of 60,000 W-2
Wages or 30,000 and (ii) 25% of 60,000 W-2
Wages plus 2.5% of the 100,000 unadjusted basis
of tangible property used in the business as of year
end for not more than the greater of 10 yrs. or the
last day of last full year of the 168 recovery period
for the property in question or 17,500.

“CQBI” = disregard (B) and reduce (A) 145% of 4000
(because amount under (B) is less than amount under (A))

“Allowed as Deduction”

Lesser of CQBI of 28,200
or 20% of 158,000 pre-199A TI = 31,600

(28,200) 199A Deduction
81,000 post-199A BTI

25,441 Income Tax on 129,800
with 12,000 Standard Ded.
EXAMPLE 5
New Section 461 Loss Limitation and Section 199A
199A(b)(2)(B) is not less than 199A(b)(2)(A)
2018

900,000 GI
(650,000) Bus. Exp. before Wages
250,000 QBI

300,000 W-2 Wages
“Reasonable Compensation”

“Deductible Amount”

Lesser of (A) 20% of 300,000 QBI or 60,000
or (B) 150,000, which is the greater of (i) 50% of 300,000 W-2
Wages or 150,000 and (ii) 25% of 300,000 W-2
Wages plus 2.5% of the 100,000 unadjusted basis
of tangible property used in the business as of year
end for not more than the greater of 10 yrs. or the
last day of last full year of the 168 recovery period
for the property in question or 77,500.

“CQBIA” = (A) plus (B) or 210,000
(199A(b)(1)(A) “sum of” (b)(2)(A) and (b)(2)(B))

“Allowed as Deduction”
Lesser of CQBIA of 210,000
or 20% of pre-199A TI
Pre 199A TI = (50,000)

(00) 199A Deduction
(50,000) post-199A BT Loss

461(l) “Excess Loss”
(950,000) Aggregate Ded.
1,150,000 Aggregate GI,
plus $250,000
No Excess Loss
EXAMPLE 6

New Section 461(l) Loss Limitation and Section 199A
199A(b)(2)(B) is not less than 199A(b)(2)(A)
2018

1,900,000 GI
(2,650,000) Bus. Exp. before Wages
(750,000) QBL

300,000 W-2 Wages
“Reasonable Compensation”

“Deductible Amount”

Lesser of (A) 20% of (750,000) QBLoss or 00
or (B) 150,000, which is the greater of (i) 50% of 300,000 W-2
Wages or 150,000 and (ii) 25% of 300,000 W-2
Wages plus 2.5% of the 100,000 unadjusted basis
of tangible property used in the business as of year
end for not more than the greater of 10 yrs. or the
last day of last full year of the 168 recovery period
for the property in question or 77,500.

“CQBIA” = (A) plus (B) or (750,000) + 150,000=00
(199A(b)(1)(A) “sum of” (b)(2)(A) and (b)(2)(B))

“Allowed as Deduction”
Lesser of CQBIA of 00
or 20% of pre-199A TI
Pre 199A TI = (750,000)=00

(750,000) QBL
(750,000) pre-199A,
199A BTLoss

461(l) “Excess Loss” =
2,950,000 Aggregate Ded.
(2,150,000) Aggregate GI
Plus $250,000
(800,000) Excess Loss
Carryover “as if” IRC 172 NOL
**CHART ONE**

S corporation and Luther 2018 Federal Employment Taxes at Varying Levels of Luther Reasonable Compensation

| Ex. 2. | @ 120,000 | 18,360 |
| Ex 3. | @ 80,000 | 12,240 |
| Ex. 4. | @ 60,000 | 9,180 |

**CHART TWO**

Luther 2018 Total Federal Taxes at Varying Levels of Luther Reasonable Compensation

| Ex. 2. | @ 120,000 | 45,865 |
| Ex 3. | @ 80,000 | 44,617 |
| Ex. 4. | @ 60,000 | 34,621 |