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Section 199A Deductions – Pass Thru Tax Breaks

Section 199A deduction also known as the Qualified Business Income Deduction (QBID) arises from the Tax Cuts & Jobs Act of 2017. This is a significant tax break for small business owners but there are rules and limits of course.

Section 199, without the A, is the section covering Domestic Production Activities Deduction. Section 199A is seemingly modeled after this (or at least a portion was ripped off by legislators) since the mathematics and reporting is similar between Section 199A and Section 199. Recall that Domestic Production Activities Deduction was reported on Form 8903 and eventually deducted on line 35 of Form 1040 (rumor is it's now dead).

However, it appears that Section 199A Qualified Business Income deduction is a deduction from adjusted gross income to arrive at taxable income (what we nerds call a below-the-line deduction, from AGI). This is contrasted with an adjustment to gross income to arrive at adjusted gross income (what we nerds call an above-the-line deduction, for AGI).

It is unclear how Form 1040 will be modified to accommodate this new deduction- personal exemptions no longer exist so there is room to replace one deduction with another. We'd all despise seeing Form 1040 move to three pages. Yuck.

"The line" is essentially lines 37 and 38 of the Form 1040 which represent adjusted gross income (AGI).

This information is current as of **September 21, 2018**. As with any major revision to the tax code, there will be modifications and interpretations which will change how Section 199A can be used. **August 8, 2018** the IRS released Proposed Regulations 1.199A as printed in the Federal Register. Here is our summary of the major issues updated by these regulations-

www.wcgurl.com/8317

The Proposed Regulations PDF can be viewed here-

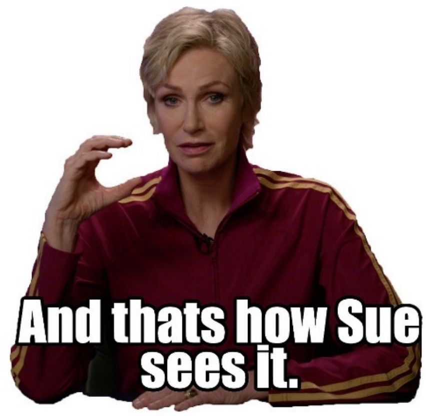
www.wcgurl.com/8321

Also, we recently created fictitious tax returns for Fred Flintstone operating an S corporation (he bought Slate Rock and Gravel from Mr. Slate). You can side by side the differences between 2017 and 2018, using the new tax brackets, the new standard deduction and the Qualified Business Income Deduction (QBID) along with Section 199A. Your can see all 9 examples here-

www.wcgurl.com/8313

Here is an executive summary as we see it.

Defining Terms



Pass-thru entities and structures include-

- Sole proprietorships (no entity, Schedule C).
- Real estate investors (no entity, Schedule E).
- Disregarded entities (single member LLCs).
- Multi-member LLCs.
- Any entity taxed as an S corporation.
- Trusts and estates, REITs and qualified cooperatives.

Specified Service Trade or Business is defined as-

- Traditional service professions such as doctors, attorneys, accountants, actuaries and consultants.
- Performing artists who perform on stage or in a studio.
- Paid athletes.
- Anyone who works in the financial services or brokerage industry.
- And now the hammer… "any trade or business where the principal asset is the reputation or skill" of the owner. Why didn't they just start with this since everything else would have been moot. Oh well…

Interestingly, removed from the traditional service profession are engineers and architects. But an engineer operating a business based on his or her reputation or skill is still a specified service trade.

Sit on the ledge, sure, but don't jump off a bridge just yet. The specified service trade or business problem only comes up when your taxable income exceeds the limits. So, a financial advisor making $150,000 might still enjoy the Section 199A deduction. Keep reading!

Income Limits

- Based on taxable income including all sources (not just business income). Also limited to 20% of taxable income.

  See **Line 43 of 2017's Form 1040** to assess your 2018 taxable income using 2017 as a proxy, adjusted for itemized deductions and exemptions (or lack thereof).
- Single is $157,500 completely phased out by $207,500 (adjusted for inflation)
- Married filing jointly is $315,000 completely phased out by $415,000 (adjusted for inflation)

Calculating the Qualified Business Income Deduction

The basic deduction is 20% of net qualified business income which is huge. If you make $200,000, the deduction is $40,000 times your marginal tax rate of 24% which equals $9,600 in your pocket. Who says Obamacare isn't affordable now? Here is the exact code-

(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-

(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or
(B) the greater of-

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

(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.

There are some devils in the details of course. The best way is to show some examples-

- Wilma makes $100,000 in net business income from her sole proprietorship but also deducts $5,000 for self-employed health insurance, $7,065 for self-employment taxes and $10,000 for a SEP IRA. These are not business deductions- they are adjustments on Form 1040 to calculate adjusted gross income. Her deduction is the lessor of 20% of $100,000 (net business income) or 20% of her taxable income, which could be less (see Pebbles below). This might change as the IRS clarifies.

- Barney owns three rentals with net incomes of $20,000 and $5,000, with one losing $8,000 annually. These are aggregated to be $17,000. He would deduct 20% of $17,000.

- Barney has passive losses that carried forward and are "released" because he now has net rental income, those passive losses are taken first. With using the same example above with $10,000 in passive loss carried forward, Barney's deduction would equal $17,000 less $10,000 or 20% of $7,000.

- Pebbles earns $100,000 but reports $80,000 of taxable income on her tax return due to other deductions such as her itemized deductions. Her Section 199A deduction would be $16,000 since it limited by the lessor of 20 % of $100,000 or $80,000.

- Mr. Slate operates an online retailer S corporation which pays $100,000 in W-2 wages and earns $400,000 in net qualified business income. Because he is considered a "high earner" by exceeding the income limits, his deduction is limited to 50% of the W-2 or $50,000 which is less than 20% of $400,000.

- If Mr. Slate instead operates as a sole proprietor and earns $500,000 but does not pay any W-2 wages, his deduction is the lessor of 50% of the W-2 wages (or $0 in this example) or 20% of the $500,000. If he paid out $200,000 in wages and had $300,000 in net business income, his Section 199A deduction would be the lessor of 50% of $200,000 or 20% of $300,000.

  In other words, he would deduct $60,000 ($60,000 is less than $100,000, even in Canada). **He would want to create an LLC, tax it as an S corporation and pay out W-2 wages to maximize his Section 199A deduction.**

- If Mr. Slate instead operates as a specified service trade as defined previously, he would completely phase out of the Section 199A deduction by exceeding the income limit of $207,500 and $415,000. **This is the specified service trade "gotchya."**

- If Mr. Slate was married and operated a specified service trade, and the taxable income considering all income sources (spouse, investments, etc.) exceeded $315,000 but was less than $415,000, there would be a sliding scale of deduction eligibility. Silly rabbit, tax reform doesn't mean tax simplification.

- Fred… yes, we can't neglect Fred… is single and operates an S Corp as an accountant. Days of busting up rocks for Mr. Slate are in the rear-view mirror. He earns $100,000 in net qualified business income after paying $50,000 in W-2 wages to himself.

  Fred is a clearly a specified service trade but because he earns less than $157,500 total ($150,000 in this example) he can take advantage of the full Section 199A deduction of 20% of $100,000. The question of reasonable salary is not being entertained here… focus on the W-2 to income relationship.

- Betty becomes a slumlord and earns $500,000 in rental income. No W-2 since she is operating the properties as an individual (and converting passive income into earned income vis a vis a W-2 would be silly). Let's say she purchased the properties for a $1,000,000 (unadjusted basis). The math would go like this-

  - 20% x $500,000 is $100,000 (straight calculation).
  - 50% of $0 is $0 (W-2 limit calculation).
  - 2.5% of $1,000,000 is $25,000 (depreciable asset limit calculation).

  Section 199A is limited to the lessor of $100,000 as compared to the greater of $0 (W-2) and $25,000 (depreciable assets).

Takeaways

- No entity is penalized under the new tax law. Some entities and situations might not qualify or be limited in some fashion, but the high-water mark in terms of taxation is the old 2017 tax law.

- Taxable income becomes a big deal for two reasons! First, $1 over $157,500 or $315,000 starts the specified service business disqualification and W-2 limitation (and there is also a depreciation component that we are glossing over in this summary). Second, the Section 199A deduction is limited by 20% of taxable income from all sources (what would be reported on your tax returns).

- W-2 wages include all W-2 wages, not just those paid to the owner(s). Converting a 1099 contractor to a W-2 employee might be beneficial.

- It appears that self-employment taxes will still be calculated on the net business income BEFORE the Section 199A deduction since the deduction is taken "below the line" on Form 1040. So you could earn $100,000 and deduct $20,000 under Section 199A, but still pay self-employment taxes on $100,000. This remains unclear however and we will await further IRS guidance.

- **S corporations remain a critical tax saving tool for two reasons**. First, the usual self-employment tax savings remains intact for all business owners including specified service trades or businesses. Second, a business owner might need to pay W-2 wages to himself or herself to not be limited by income, and only corporations can pay W-2 wages to owners (in other words, an LLC cannot without an S Corp election).

Section 199A Optimization

As you can see, there is some optimization that is necessary for a small business owner to get the most from the Section 199A deduction. On one hand we want to reduce W-2 salaries to shareholders to minimize self-employment taxes. On the other hand, we want to increase W-2 salaries so they do not limit the amount of Section 199A that is deducted.

This seems straightforward since payroll taxes are 15.3% plus some unemployment and other insidious stuff and the Section 199A Qualified Business Income deduction is 20%. However, the 20% Section 199A deduction must be multiplied by the marginal tax rate to obtain the true tax benefit. Even at a 37% marginal tax rate, the additional payroll taxes might exceed the Section 199A deduction tax benefit. Again, optimization is important.

Section 199A Decision Tree

Remember that taxable income is all income for the household.

Specified Service Trade or Business

- If taxable income is less than $157,500 / $315,000 then the 20% deduction is fully available.

- If taxable income is greater than $157,500 / $315,000 but less than $207,500 / $415,000 then a partial deduction is available.

- If taxable income is greater than $207,500 / $415,000 then you are hosed.

All Others

- If taxable income is less than $157,500 / $315,000 then the 20% deduction is fully available.

- If taxable income is greater than $157,500 / $315,000 but less than $207,500 / $415,000 then a partial deduction is available with the W-2 and depreciable asset limit calculations phase in.

- If taxable income is greater than $207,500 / $415,000 then the 20% deduction is compared to the full W-2 and depreciable asset limit calculations (see Betty above).

Book Updates

Our book, **Taxpayer's Comprehensive Guide to LLCs and S Corps**, had been updated to the **2018 Edition** which includes Section 199A business deduction information.

The following pages are taken from our book and show some examples of the calculations-

S Corp Section 199A Deduction

We are going to walk you through a handful of examples comparing non-S Corp scenarios such as sole proprietorships, single-member LLCs (disregarded entity) and other pass-through environments to those same situations being taxed as an S corporation. We will demonstrate the benefits of the Section 199A deduction, and how it plays into the "should I elect S Corp?" question.

Aside from the usual suspects such as not earning more than $35,000 or operating in Tennessee or New York City, every scenario provides an additional benefit by electing S Corp status on top of the Section 199A deduction.

Section 199A Calculation

There are four variables you need to assign values to, a definition to consider, one tax bracket to memorize and two phase-out numbers to understand.

- Taxable Income- You need to determine the amount the entire household reports as taxable income, not just the business income. See Line 43 of your Form 1040 from 2017 to gain perspective of where you are. Write down 20% of this number.

- W-2 and Depreciable Assets- You need to calculate the total amount of W-2 wages the business pays including staff. Write down 50% of this number. You need to calculate the unadjusted basis (the value immediately after purchase before depreciation) of any depreciable assets the business owns. Write down 2.5% of this number (this becomes important for real estate investors).

- Qualified Business Income- Take your net business income after expenses, and write down 20% of this number.

- Specified Service Trade or Business- Does your business survive on the reputation or skill of its owner(s)? Are you an accountant, actuary, attorney, consultant, financial advisor, medical doctor, paid athlete or performing artist?

- ▲ End of 24%- The 24% tax bracket ends at $157,500 for single taxpayers and $315,000 for married taxpayers. The next tax bracket leaps to 32%. The 24% to 32% jump is clearly intentional and draws a line in the sand between middle class and upper middle class in our opinion. The Section 199A benefit might erode after the 24% marginal tax bracket depending on your situation.

- ▲ Phase Out- The income phase out period is $50,000 for single and $100,000 for married.

Section 199A Deduction Limits

We explained the decision tree elsewhere in our book, however we want to illustrate the iteration in a different way. The question becomes, “How do I figure out my Section 199A deduction?” Besides using expensive tax software and professional advice, you can consider this flowchart.

If your taxable income is in the 24% marginal tax bracket or less, stop. You are done and can select the lower of 20% of your qualified business income or 20% of your taxable income.

Assuming now that your taxable income is in the 32% marginal tax bracket or above, you must worm in some additional Section 199A limitations based on the following-

- ▲ Non Specified Service Business- You must now consider the Section 199A deduction based on W-2 wages or depreciable assets, and use the most restrictive of all Section 199A calculations. If you are in the income phase-out range (or the deduction limitation phase-in range, however you want to view the nomenclature), there is a linear, sliding scale of limitation based on W-2 wages and depreciable assets. In other words, the deeper into the phase-out range you are, the limiting effect of W-2 / assets becomes stronger. No need to hurt ourselves with the calculus at this point.

- ▲ Specified Service Business- You must now reduce your Section 199A deduction on a linear, sliding scale that reaches $0 as you move along the phase-out range (which is $50,000 for single taxpayers and $100,000 for married taxpayers). W-2 wages or depreciable assets come into play, but in a different way (near the end we provide an example of the phaseout). Your Section 199A simply ends after $207,500 (single) and $415,000 (married).

Section 199A Examples

We created a handful of examples on the follow pages with two intentions. One, to demonstrate how the Section 199A deduction is calculated and Two, to show that an S Corp remains a critical tax reduction vehicle. Brace yourself for nauseating spreadsheets that are only meaningful to the spreadsheet designer. We hope our commentary and explanations make sense, and that the logic of the step-by-step iteration becomes clear. We might be dreaming…

If you are reading this in a bound book, we have intentionally made it so the explanation is on the right side and the ridiculous explosion of numbers is on the left. If you are reading the PDF version you might have to print the pages or arrange for side-by-side viewing.

Section 199A Basic Comparisons

Joe Public earning $100,000 with and without additional taxable income.

ln		Vanilla		Other Income	
		No S	S Corp	No S	S Corp
1	Business Income	100,000	100,000	100,000	100,000
2	less W-2 Wages inc. SEHI, HSA, etc.	0	35,000	0	35,000
3	less Payroll Taxes	0	2,678	0	2,678
4	Net Business Income Section 199A	100,000	62,323	100,000	62,323
5	Adjustments to 1040 / NBI				
6	less Social Security Tax	5,726	0	5,726	0
7	less Medicare Tax	1,339	0	1,339	0
8	less SEHI, HSA, etc.	0	0	0	0
9	Other Taxable Income	0	0	60,000	60,000
10	Adjusted Gross Income*	92,935	97,323	152,935	157,323
11	Itemized / Std Deductions	24,000	24,000	24,000	24,000
12	Taxable Income Before Section 199A	68,935	73,323	128,935	133,323
13	Section 199A Net Biz Income	20,000	12,465	20,000	12,465
14	Section 199A W-2 Wage Limit	0	17,500	0	17,500
15	Section 199A Taxable Income Limit	13,787	14,665	25,787	26,665
16	Section 199A Benefit	13,787	12,465	20,000	12,465
17	Marginal Income Tax Rate	12%	12%	22%	22%
18	Income Tax Benefit from Section 199A	-1,654	-1,496	-4,400	-2,742
19	plus Self-Employment Tax	14,130	0	14,130	0
20	plus Tax on Line 12 Delta (above)	0	526	0	965
21	plus Payroll Tax	0	5,355	0	5,355
22	Net Tax After Section 199A Benefit	12,475	4,386	9,730	3,578
23	Net S Corp Benefit $		**8,089**		**6,152**

*includes the S Corp W-2

There are several notables, takeaways and explanations-

Assumptions are $100,000 in business income prior to $35,000 in reasonable officer compensation. Married taxpayer with $24,000 as a standard deduction (Line 11), with and without an additional $60,000 in taxable income (Line 9) such as a spouse or pension.

Notice how under an S corporation scenario (the second and fourth columns) the adjusted gross income (Line 10) is higher than a garden variety LLC or sole proprietorship. This is because issuing a W-2 is limiting the amount of Social Security and Medicare taxes paid, and subsequently deducted to ultimately determine taxable income. This has always been the case before and after the Tax Cuts & Jobs Act of 2017. No change.

Taxable Income Before Section 199A Deduction (Line 12) is used for illustration purposes only. The Section 199A deduction will eventually reduce adjusted gross income to arrive at taxable income for income tax purposes (a deduction from AGI). Our illustration is purely for the difference between a non-S Corp and an S Corp. It is not an income tax calculation.

Lines 13, 14 and 15 compute the various Section 199A calculations and will be used to determine any limitations. In this example, since taxable income is below $315,000 the only two limits are Section 199A based on business income (Line 13) and Section 199A based on taxable income (Line 15). The Section 199A based on W-2 limitation is not used.

Line 16 is the selected Section 199A benefit depending on the calculation and income limitation rules.

Notice that under a non-S Corp scenario the limiting factor (or as nerdy military types say, limfac) is Section 199A based on taxable income whereas the S corporation scenario the limiting factor is Section 199A based on net business income. This should make sense.

Line 18 is the income tax benefit based on the Section 199A calculation. Remember we are thinking in terms of taxes, so the Section 199A calculation must be put into an income tax savings context based on marginal tax rates.

Next, we add self-employment taxes to the non-S Corp (Line 19), and income taxes and payroll taxes to the S Corp (Lines 20 and 21) to arrive at the cash in your pocket difference by being taxed as an S corporation. In this example, an S corporation is saving $8,089 for no additional household income and $6,152 with $60,000 in additional income. Of this savings, the bulk remain because of self-employment tax savings.

Fun! Moving on…

Section 199A Health Insurance Comparison

Same situation as before, but with $10,000 in health insurance premiums (Line 8).

		Vanilla		Health Insurance	
ln		No S	S Corp	No S	S Corp
1	Business Income	100,000	100,000	100,000	100,000
2	less W-2 Wages inc. SEHI, HSA, etc.	0	35,000	0	35,000
3	less Payroll Taxes	0	2,678	0	1,913
4	Net Business Income Section 199A	100,000	62,323	100,000	63,088
5	Adjustments to 1040 / NBI				
6	less Social Security Tax	5,726	0	5,726	0
7	less Medicare Tax	1,339	0	1,339	0
8	less SEHI, HSA, etc.	0	0	10,000	10,000
9	Other Taxable Income	0	0	0	0
10	Adjusted Gross Income*	92,935	97,323	82,935	88,088
11	Itemized / Std Deductions	24,000	24,000	24,000	24,000
12	Taxable Income Before Section 199A	68,935	73,323	58,935	64,088
13	Section 199A Net Biz Income	20,000	12,465	20,000	12,618
14	Section 199A W-2 Wage Limit	0	17,500	0	17,500
15	Section 199A Taxable Income Limit	13,787	14,665	11,787	12,818
16	Section 199A Benefit	13,787	12,465	11,787	12,618
17	Marginal Income Tax Rate	12%	12%	12%	12%
18	Income Tax Benefit from Section 199A	-1,654	-1,496	-1,414	-1,514
19	plus Self-Employment Tax	14,130	0	14,130	0
20	plus Tax on Line 12 Delta (above)	0	526	0	618
21	plus Payroll Tax	0	5,355	0	3,825
22	Net Tax After Section 199A Benefit	12,475	4,386	12,715	2,929
23	Net S Corp Benefit $		**8,089**		**9,786**

*includes the S Corp W-2

There are several notables, takeaways and explanations-

Assumptions are $100,000 in business income prior to $35,000 in reasonable officer compensation. Married taxpayer with $24,000 as a standard deduction (Line 11) and no additional taxable income.

$10,000 has been added as self-employed health insurance premiums. This could easily be $7,000 in health insurance premiums and $3,000 in health savings account (HSA) contributions too. Both are considered a taxable fringe benefit when paid by the company (but later deducted $1 for $1 on your individual tax return).

Note the decrease in payroll taxes on Line 3. This is because less wages are being subjected to Social Security and Medicare taxes when considering health insurance, HSA, etc. as a form of officer compensation (reasonable shareholder salary). As a result, Box 1 of the W-2 will show $35,000 but Box 3 and Box 5 will only show $25,000. Form 1120S, Line 7, Officer Compensation will also show $35,000.

In this example, having the S corporation pay for self-employed health insurance increases the savings by approximately $1,800. Recall the language from IRS Fact Sheet 2008-25-

> The health and accident insurance premiums paid on behalf of the greater than 2 percent S corporation shareholder-employee are deductible by the S corporation as fringe benefits and are reportable as wages for income tax withholding purposes on the shareholder-employee's Form W-2. They are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. Therefore, this additional compensation is included in Box 1 (Wages) of the Form W-2, Wage and Tax Statement, issued to the shareholder, but would not be included in Boxes 3 or 5 of Form W-2.

Note that the Section 199A benefit (Line 16) is higher with an S corporation versus a non-S Corp by leveraging the health insurance / HSA aspect of an S Corp.

Section 199A 200k Comparison

New day, different problem. This is an online retailer earning $200,000 in business income.

		Vanilla		Other Income	
ln		No S	S Corp	No S	S Corp
1	Business Income	200,000	200,000	200,000	200,000
2	less W-2 Wages inc. SEHI, HSA, etc.	0	70,000	0	70,000
3	less Payroll Taxes	0	5,355	0	5,355
4	Net Business Income Section 199A	200,000	124,645	200,000	124,645
5	Adjustments to 1040 / NBI				
6	less Social Security Tax	7,979	0	7,979	0
7	less Medicare Tax	2,678	0	2,678	0
8	less SEHI, HSA, etc.	0	0	0	0
9	Other Taxable Income	0	0	100,000	100,000
10	Adjusted Gross Income*	189,342	194,645	289,342	294,645
11	Itemized / Std Deductions	24,000	24,000	24,000	24,000
12	Taxable Income Before Section 199A	165,342	170,645	265,342	270,645
13	Section 199A Net Biz Income	40,000	24,929	40,000	24,929
14	Section 199A W-2 Wage Limit	0	35,000	0	35,000
15	Section 199A Taxable Income Limit	33,068	34,129	53,068	54,129
16	Section 199A Benefit	33,068	24,929	40,000	24,929
17	Marginal Income Tax Rate	24%	24%	24%	24%
18	Income Tax Benefit from Section 199A	-7,936	-5,983	-9,600	-5,983
19	plus Self-Employment Tax	21,315	0	21,315	0
20	plus Tax on Line 12 Delta (above)	0	1,273	0	1,273
21	plus Payroll Tax	0	10,710	0	10,710
22	Net Tax After Section 199A Benefit	13,379	6,000	11,715	6,000
23	Net S Corp Benefit $		**7,379**		**5,715**

*includes the S Corp W-2

There are several notables, takeaways and explanations-

Assumptions are $200,000 in business income prior to $70,000 in reasonable officer compensation. Married taxpayer with $24,000 as a standard deduction (Line 11), with and without an additional $100,000 in taxable income (Line 9) such as a spouse or pension.

Note the spreads in Section 199A deduction benefit on Line 16 and the subsequent income tax benefit from Section 199A on Line 18. This is an interesting example since the extra household income increases the Section 199A deduction significantly.

However, when self-employment taxes and payroll taxes are added back, there is still a material savings even when Social Security limits are reached under the non-S Corp scenario.

If this example had $10,000 in self-employed health insurance premiums the savings on Line 24 would be $9,483 without additional household income (Line 9) and $7,099 with additional household income of $100,000.

Section 199A 250k Comparison

Same online retailer (not a specified service business) showing single versus married.

		Single		Married	
ln		No S	S Corp	No S	S Corp
1	Business Income	250,000	250,000	250,000	250,000
2	less W-2 Wages inc. SEHI, HSA, etc.	0	87,500	0	87,500
3	less Payroll Taxes	0	6,694	0	6,694
4	Net Business Income Section 199A	250,000	155,806	250,000	155,806
5	Adjustments to 1040 / NBI				
6	less Social Security Tax	7,979	0	7,979	0
7	less Medicare Tax	3,348	0	3,348	0
8	less SEHI, HSA, etc.	0	0	0	0
9	Other Taxable Income	0	0	0	0
10	Adjusted Gross Income*	238,673	243,306	238,673	243,306
11	Itemized / Std Deductions	12,000	12,000	24,000	24,000
12	Taxable Income Before Section 199A	226,673	231,306	214,673	219,306
13	Section 199A Net Biz Income	50,000	31,161	50,000	31,161
14	Section 199A W-2 Wage Limit	0	43,750	0	43,750
15	Section 199A Taxable Income Limit	45,335	46,261	42,935	43,861
16	Section 199A Benefit	0	31,161	42,935	31,161
17	Marginal Income Tax Rate	35%	35%	24%	24%
18	Income Tax Benefit from Section 199A	0	-10,906	-10,304	-7,479
19	plus Self-Employment Tax	22,654	0	22,654	0
20	plus Tax on Line 12 Delta (above)	0	1,622	0	1,112
21	plus Payroll Tax	0	13,388	0	13,388
22	Net Tax After Section 199A Benefit	22,654	4,103	12,350	7,021
23	Net S Corp Benefit $		**18,551**		**5,329**

*includes the S Corp W-2

There are several notables, takeaways and explanations-

Assumptions are $250,000 in business income prior to $87,500 in reasonable officer compensation. Itemized deductions are $12,000 as a single taxpayer and $24,000 as a married taxpayer.

Note the spreads in Section 199A deduction benefit on Line 16 and the subsequent income tax benefit on Line 18. In the scenario where the taxpayer is single, he or she is phased out of Section 199A deduction because of income and subsequent W-2 limitations (Line 14).

The example is used to show the limitations of Section 199A due to income based on marital status. However, note that by electing S Corp tax status the Section 199A benefit is identical (Line 16). The difference then becomes the income tax benefit of this deduction which is a factor of marginal tax rates (Line 17).

For couples who are not married, there might be a reason to be legally married without altering your relationship definition just to grab some additional Section 199A benefit.

Section 199A Specified Service Business Comparison Part 1

Same online retailer but compared to an attorney (specified service business). Yuck!

		Retailer		Attorney	
ln		No S	S Corp	No S	S Corp
1	Business Income	250,000	250,000	250,000	250,000
2	less W-2 Wages inc. SEHI, HSA, etc.	0	87,500	0	87,500
3	less Payroll Taxes	0	6,694	0	6,694
4	Net Business Income Section 199A	250,000	155,806	250,000	155,806
5	Adjustments to 1040 / NBI				
6	less Social Security Tax	7,979	0	7,979	0
7	less Medicare Tax	3,348	0	3,348	0
8	less SEHI, HSA, etc.	0	0	0	0
9	Other Taxable Income	0	0	0	0
10	Adjusted Gross Income*	238,673	243,306	238,673	243,306
11	Itemized / Std Deductions	12,000	12,000	12,000	12,000
12	Taxable Income Before Section 199A	226,673	231,306	226,673	231,306
13	Section 199A Net Biz Income	50,000	31,161	50,000	31,161
14	Section 199A W-2 Wage Limit	0	43,750	0	43,750
15	Section 199A Taxable Income Limit	45,335	46,261	45,335	46,261
16	Section 199A Benefit	0	31,161	0	0
17	Marginal Income Tax Rate	35%	35%	35%	35%
18	Income Tax Benefit from Section 199A	0	-10,906	0	0
19	plus Self-Employment Tax	22,654	0	22,654	0
20	plus Tax on Line 12 Delta (above)	0	1,622	0	1,622
21	plus Payroll Tax	0	13,388	0	13,388
22	Net Tax After Section 199A Benefit	22,654	4,103	22,654	15,009
23	Net S Corp Benefit $		**18,551**		**7,645**

*includes the S Corp W-2

There are several notables, takeaways and explanations-

Assumptions are $250,000 in business income prior to $87,500 in reasonable officer compensation. Itemized deductions of $12,000 and both taxpayers are single. Same as previous example, but now we are comparing a non-specified service business (online retailer) to a specified service business (attorney).

Observe the differences in Line 16. Recall the Section 199A decision tree from earlier-

- ▲ If taxable income is less than $157,500 (single) / $315,000 (married) then the 20% deduction for your pass-thru entity is fully available.
- ▲ If taxable income is greater than $157,500 / $315,000 but less than $207,500 / $415,000 then a partial deduction is available. The phase-in of the limit is linear (more explanation later).
- ▲ If taxable income is greater than $207,500 / $415,000 then you are hosed. Sorry.

The attorney should absolutely be an S corporation and enjoy the $7,645 in tax savings. He or she simply won't be enjoying the $18,551 savings of the online retailer. Surely the online retailer should be sued by the attorney to help equalize the balance of tax benefits and preserve the natural order.

Remember that if a specified service trade or business has taxable income that is equal to or less than $157,500 for single taxpayers and $315,000 for married taxpayers, there is no phase-in of the limitations (or Section 199A phasout). Said in another way, if the online retailer and the attorney both earned $150,000 from their respective crafts, the Section 199A savings would be identical.

Let's do one more! Drool…

Section 199A Specified Service Business Comparison Part 2

Big shot surgeon compared to the lowly goat herder (non-specified service trade).

ln		Surgeon		Goat Herder	
		No S	S Corp	No S	S Corp
1	Business Income	600,000	600,000	600,000	600,000
2	less W-2 Wages inc. SEHI, HSA, etc.	0	210,000	0	210,000
3	less Payroll Taxes	0	11,024	0	11,024
4	Net Business Income Section 199A	600,000	378,976	600,000	378,976
5	Adjustments to 1040 / NBI				
6	less Social Security Tax	7,979	0	7,979	0
7	less Medicare Tax	8,034	0	8,034	0
8	less SEHI, HSA, etc.	0	0	0	0
9	Other Taxable Income	0	0	0	0
10	Adjusted Gross Income*	583,986	588,976	583,986	588,976
11	Itemized / Std Deductions	50,000	50,000	50,000	50,000
12	Taxable Income Before Section 199A	533,986	538,976	533,986	538,976
13	Section 199A Net Biz Income	120,000	75,795	120,000	75,795
14	Section 199A W-2 Wage Limit	0	105,000	0	105,000
15	Section 199A Taxable Income Limit	106,797	107,795	106,797	107,795
16	Section 199A Benefit	0	0	0	75,795
17	Marginal Income Tax Rate	37%	37%	37%	37%
18	Income Tax Benefit from Section 199A	0	0	0	-28,044
19	plus Self-Employment Tax	32,028	0	32,028	0
20	plus Tax on Line 12 Delta (above)	0	1,846	0	1,846
21	plus Payroll Tax	0	22,049	0	22,049
22	Net Tax After Section 199A Benefit	32,028	23,895	32,028	-4,149
23	Net S Corp Benefit $		**8,133**		**36,177**

*includes the S Corp W-2

There are several notables, takeaways and explanations-

Well, that’s a lie. There are only two. First, specified service trades or businesses got hosed in the Section 199A calculation. Being a goat herder raking in $600,000 as compared to a surgeon gets a $36,000 bump in tax benefit. If you give it careful consideration, how are these two businesses different? While we are being a bit facetious here, at the same time two business owners are experiencing different tax worlds based on titles. The goat herder could be operating with a staff and not relying his or her reputation or skill.

Second takeaway, although specified service industries such as accountants, doctors, attorneys, etc., are not enjoying the Section 199A deduction benefit, it still pays to be an S corporation. There is still a savings of $8,133 by being an S Corp for the big shot surgeon. You have an obligation as a citizen to reduce your taxes to the minimum allowed.

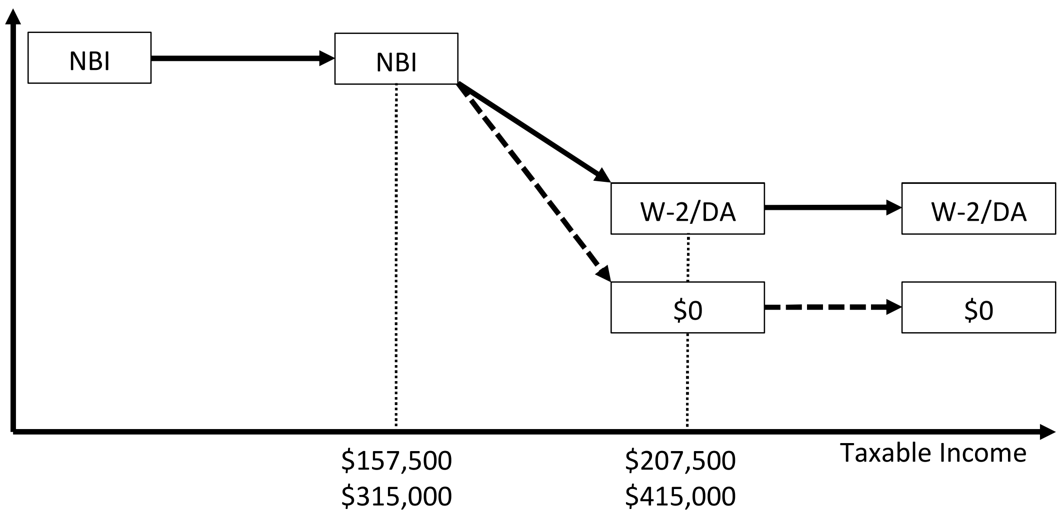
Recall the definition of specified service business or trade-

- ▲ Traditional service professions such as doctors, attorneys, accountants, actuaries and consultants.
- ▲ Performing artists who perform on stage or in a studio.
- ▲ Paid athletes.
- ▲ Anyone who works in the financial services or brokerage industry.
- ▲ And now the hammer… “any trade or business where the principal asset is the reputation or skill” of the owner. Why didn’t they just start with this since everything else would have been moot? Oh well…

Interestingly, removed from the traditional service profession are engineers and architects. But an engineer operating a business based on his or her reputation or skill is still a specified service trade.

Section 199A Phaseout

We haven't had a chance to get this crude drawing to our graphic designer who can pretty it up, so please bear with us. We might lose our minds the next time Congress acts over the holidays and ruins our eggnog. At least Wisconsin won the Orange Bowl which is nice. How does the Section 199A phaseout work?



NBI is short for Net Business Income, and W-2/DA is the limit based on the greater of 50% of W-2 wages paid, or 25% of W-2 wages paid plus 2.5% of unadjusted basis for depreciable assets. The dashed arrow is a specified service trade or business. The Y axis is the Section 199A limit. The Section 199A phaseout should be viewed as where you are going to "end up."

Quick example, step by step-

- Let's say your taxable income is $340,000 which is exactly 25% over the $315,000 income trigger when compared to $415,000. Again, the trigger of the phaseout is based on taxable income and not just net business income.

- We determine your Section 199A upper limit based on net business income, with an adjustment for specific service trades or businesses.

- We next determine your Section 199A lower limit based on W-2 / depreciable asset calculation from above, with a similar adjustment for service people.

- Next, we take the difference, multiply it by the percentage of taxable income that exceeds the trigger (in this example, 25%) and reduce the Section 199A deduction based on net business income by this amount. Huh? A table is coming up.

Here is table that attempts to summarize what the heck we are talking about.

Taxable Income	340,000
Phaseout Trigger	315,000
Amount That Exceeds	25,000
Phaseout Range	100,000
Percentage of Phaseout	25%

Since the taxable income trigger of $315,000 is exceeded by $25,000 and the phaseout range is $100,000 for married taxpayers, we are 25% into the phaseout range. We now have to split these up between non-service and service.

This gets really funky really fast. For the non-service people, the math is straightforward. For the specific service trade or business, we need to determine how much of the remaining phaseout range is available. In this case, 25% of the phaseout range is “used up” leaving 75% remaining.

	Non-Service	**Service**
Net Business Income	300,000	225,000
Section 199A on NBI	60,000	45,000
W-2 Wages Paid	100,000	75,000
Section 199A on W-2	50,000	37,500

Therefore, 75% of the NBI of $300,000 is $225,000. 75% of the W-2 wages paid of $100,000 is $75,000. These remaining amounts are the basis for the original Section 199A calculations of 20% of net business income, or $45,000 above… and 50% of W-2 wages paid, or $37,500 above. This creates an “upper limit” and a “lower limit” which further creates the difference to apply the phaseout range percentage (in this example, 25%).

	Non-Service	**Service**
Section 199A Upper Limit	60,000	45,000
Section 199A Lower Limit	50,000	37,500
Difference	10,000	7,500

Finally, we choose the greater of the Section 199A based on net business income and the Section 199A based on W-2 wages paid. In our example, $60,000 and $45,000 respectively. This is then reduced by the percentage of phaseout range multiplied against the difference. In this example, 25% of $10,000 and 25% of $7,500 for the specified service business.

This summarizes the Section 199A reduction and ultimate deduction.

	Non-Service	Service
Section 199A on NBI	60,000	45,000
Section 199A Reduction	2,500	1,875
Section 199A Deduction	57,500	43,125

This should make sense. Another way to look at this- let's say your taxable income was exactly $415,000. You would be 100% into the phaseout range, so your Section 199A deduction would be reduced by $10,000 (100% of the difference of $10,000) for a non-service trade or business. This would also magically equal the Section 199A limit set by 50% of your W-2 wages paid or $50,000.

Extending this logic would suggest that a specified service trade or business who has $415,000 in taxable income would have his or her Section 199A deduction reduced by 100% since the remaining amount of the phaseout range is 0%.

Section 199A Recap

Hopefully you are still with us and not in the fetal position sucking your thumb. To hammer these points home, the Section 199A won't help everyone and the S corporation still has some shine (although perhaps less in some situations) as an overall tax reduction mechanism.

Here is a summary of the previous examples-

Business	Status	Biz Income	Other Income	Health Ins.	199A Benefit	S Corp Savings
Consultant	Married	100,000			1,496	8,089
Consultant	Married	100,000	60,000		2,742	6,152
Consultant	Married	100,000			1,496	7,518
Consultant	Married	100,000		10,000	1,514	9,786
Retailer	Married	200,000			5,983	7,379
Retailer	Married	200,000	100,000		5,983	5,715
Retailer	Single	250,000			10,906	18,551
Retailer	Married	250,000			7,479	5,329
Retailer	Single	250,000			10,906	18,551
Attorney	Single	250,000			0	7,645
Surgeon	Single	600,000			0	8,133
Goat Herder	Single	600,000			28,044	36,177

Missing Guidance For Schedule C

There are some things we are unsure about. One example is 401k or defined benefits contribution. This is typically an adjustment on Form 1040 separate from Schedule C. Will these amounts get filtered back into the Section 199A calculation when basing it on Schedule C net business income? Probably… since this would be a double dip. Same with self-employment taxes and health insurance We'll have to wait and see on handling the C.

Missing Guidance for Mixed Income Sources

What happens if big shot surgeon owns a gaggle of rentals which throws off $100,000 in net business income? Assume that he or she is phased out of the Section 199A deduction based on the specified service trade of being a doctor. Can he or she still get the Section 199A deduction based on the rental income? We would like to think so, but we'll have to wait and see.

But wait! What if the surgeon owned the rental as a self-rental, leasing it back to his S corporation surgery center? Rules already exist for self-rentals where the rental income cannot offset otherwise non-deductible passive activity rental losses. Can a person take a Section 199A deduction net rental income that includes self-rental income? The short answer is, We don't know.

Compartmentalizing specified service income away from non-service (i.e., retail) income might be a great tax strategy but with unknown ramifications. It is difficult to consider that the intent was to have specified service income taint all other business income without some allocation. The spirit was to limit the specified service trades and businesses from double dipping on self-employment taxes and Section 199A benefits after a certain income threshold.

However, if the spirit of the rule is dwarfed by interpretive silliness which we all know might happen at least in the short-term, then we might have to leverage a C Corp to keep service income (taint) away from the remainder of qualified business income. For example, the same big shot surgeon earns $200,000 as a surgeon but also earns $500,000 from rental activity. Do we have to put the $200,000 in a C corporation just to grab Section 199A benefit on the $500,000 (of course using the 2.5% depreciable asset limitation)? We will have to wait and see.

Some of these issues are casually addressed in the Proposed Regulations 1.199A. Here is our summary-

www.wcgurl.com/8317

The Proposed Regulations PDF can be viewed here-

www.wcgurl.com/8321

Revoke S Corp

The hot question since the passage of the Tax Cuts & Jobs Act of 2017 and Section 199A is, "Should I revoke S Corp status and go to C Corp?" The answer is No.

Quick Numbers-

S Corp Income	100,000	200,000	300,000
Salary	40,000	80,000	120,000
Payroll Tax	6,120	12,240	18,360
Income Tax	6,980	24,150	44,266
Total Tax S Corp	13,100	36,390	62,626
C Corp Income	100,000	200,000	300,000
C Corp Tax	21,000	42,000	63,000
Dividends	79,000	158,000	237,000
Dividend Tax	0	23,700	44,556
Total C Corp Tax	21,000	65,700	107,556
S Tax Rate	13.1%	18.2%	20.9%
C Tax Rate	21.0%	32.9%	35.9%
Delta	**7.9%**	**14.7%**	**15.0%**

Assumptions included Section 199A deduction for the S corporation's shareholder plus $24,000 in standard deduction, in addition to the 3.8% surtax on top of the 15% capital gains tax rate for the $300,000 column. As you can see, a C Corp does not make sense after you add in capital gains tax on the dividends. This in turn makes sense- the lawmakers didn't set out to kill S corporations. They set out to give every business owner a tax break. Geez… half of Congress (535 doesn't divide evenly, we get it) probably run S corporations on the side.

So, please pump the brakes on the "I wanna dump my S Corp for the magical tax arbitrage offered by a C Corp" nonsense.