CHAPTER 2

THE DEDUCTION FOR QUALIFIED BUSINESS INCOME FOR PASS-THROUGH ENTITIES

LECTURE NOTES

OVERVIEW

For Federal income tax purposes, the distinctions among forms of business organization are critical. This chapter discusses the tax treatment of sole proprietorships, partnerships, S corporations, regular corporations, and limited liability companies. It also discusses the deduction added to the Federal tax law by the Tax Cuts and Jobs Act (TCJA) of 2017. Key topics include the changes due to TCJA of 2017 and how they affect tax liabilities as well as planning, such as for the form of business organization, that taxpayers should consider.

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2018 Edition. For major changes, see the Preface of the text.

- NEW chapter covering both an introduction to entities and the new deduction for qualified business income (§ 199A).
- Added extensive coverage of the QBI deduction, including a Concept Summary and multiple examples to assist students in navigating this challenging provision.
- Developed significant end-of-chapter materials illustrating the § 199A rules (including Discussion Questions, Computational Exercises, Problems, and Research Problems).

THE BIG PICTURE

When Amy graduates from college, she plans to use her knowledge to start businesses. She will generate income from advertising on her social media sites and will use her artistic and marketing talents to find work using several web platforms. Amy is wondering if she should form a corporation or a limited liability company or just be a sole proprietor. She is also curious whether, for tax and legal purposes, she should set her activities up as one business or two.

After reading this chapter, you can help Amy with her questions, including aiding her in better framing the questions should she decide to seek assistance from an attorney on business entity formation matters, or a CPA for tax and accounting assistance.

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TAX TREATMENT OF VARIOUS BUSINESS FORMS

1. Business forms include sole proprietorships, partnerships (covered in Chapters 10 and 11), S corporations (covered in Chapter 12), regular corporations, and limited liability companies.

2. A key piece of the TCJA of 2017 was to lower the corporate income tax rate from a progressive tax rate structure (with rates from 15 percent to 35 percent) to a flat tax of 21 percent.

3. For businesses that do not operate as regular corporations, the TCJA of 2017 allows a special deduction for noncorporate taxpayers with business income.

Sole Proprietorships

4. A sole proprietorship is not a separate taxable entity. Net income or loss from the proprietorship is computed on Schedule C and reported as part of the proprietor's income on Form 1040. Thus, the proprietor pays tax on the profits of the proprietorship.

5. The proprietor reports all the net profit from the business, regardless of the amount actually withdrawn during the year.

6. Income and expenses retain their character when reported by the proprietor.

   Example: Sean Cooper operates a candy store as a sole proprietorship. He earned a profit of $75,000 during the year and withdrew $40,000 from the proprietorship. Sean must report the $75,000 as net income from the proprietorship on his personal tax return.

7. Beginning in 2018, a deduction for qualified business income (§ 199A) is available for sole proprietors. In general, this deduction is 20% of proprietorship net income and is claimed on the proprietor's Form 1040 in determining taxable income.

Partnerships

8. Partnerships are tax-reporting, but not taxpaying, entities. A partnership reports its income on Form 1065.

9. Each partner receives a Schedule K–1 that reports the partner's share of ordinary business income (loss) along with each separately reported item allocated to the partners according to the partnership's profit and loss sharing agreement.

   a. Schedule K–1 items are reported on each partner's tax return. (See Example 2 in the text.)

   b. Individual partners can claim the deduction for qualified business income (to the extent available) on his or her Form 1040.

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Corporations

10. There are two types of corporations for tax purposes: corporations governed by Subchapter C (C corporations) and corporations governed by Subchapter S (S corporations).

11. S corporations have the following characteristics:

    a. Generally, they do not pay Federal income taxes.

    b. Similar to partnerships in that operating income (loss) flows through to the shareholders. Like partnerships, all income and expense items are not aggregated when computing ordinary business income (loss). Certain items retain their separate character.

    c. Income and expense items “pass through” to shareholders, who report their share of the partnership items on their own returns. Items are allocated to shareholders according to their stock ownership interests.

12. Regular C corporations are subject to entity-level taxation. Other characteristics include:

    a. A C corporation reports its income and expenses on Form 1120.

    b. Dividends paid are not deductible by the corporation.

       Example: A C corporation has revenues of $80,000, has operating expenses of $60,000, and paid dividends of $10,000. Net income for the year is $20,000, since the dividends are not deductible by the corporation.

    c. When a corporation distributes its income, the shareholders report dividend income on their own returns. Since the corporation pays tax on corporate income, this entity-level tax, along with the tax paid by shareholders on the distribution of that income as a dividend, results in income earned by a C corporation being subject to “double taxation.”

13. Taxation of Dividends.

    a. Closely held corporation shareholders try to convert dividend distributions into tax-deductible expenses.

       (1) One common way is to increase compensation to shareholder-employees.

       (2) The IRS scrutinizes compensation and other economic transactions (e.g., loans, leases, and sales) between closely held corporations and their shareholders for reasonableness.

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b. Dividend eligibility for the capital gains rates alleviates some of the double taxation effect. The current tax rate applicable to qualified dividend income (and long-term capital gains) is 15%, (20% for high-income taxpayers; 0% for lower-income taxpayers).

14. Comparison of Corporations and Other Forms of Doing Business. When comparing C corporations to other business forms, there are a number of factors to consider including:
- Tax rates.
- Character of business income.
- Business losses.
- Employment taxes.
- State taxes.

a. *Tax Rates.* Due to the TCJA of 2017, a flat rate of 21% applies to corporate taxable income for taxable years beginning after 2017.

(1) Historically, a graduated corporate tax rate structure was applied for corporations that ranged from 15% to 39% (flat 35% over $18,333,333). (See Exhibit 2.1 in the text.)

(2) The marginal rates for individuals range from 10% to 37%. Therefore, in many cases, the tax burden will be greater if a business is operated as a corporation. (See Example 3 in the text.)

(3) In other cases, when the corporate marginal tax rate is lower than the individual marginal rate, the corporate form of doing business presents tax savings opportunities.

(4) To explore the various tax situations, see Examples 5, 6, and 7 in the text.

b. *Character of Business Income.* With a C corporation, tax attributes of the income and expense items do not pass through to the shareholders. As a result, if the business is expected to generate tax-favored income (e.g., tax-exempt income or long-term capital gains), it may be better to choose a different business form.

c. *Pass-Through of Losses.* Since C corporation losses have no effect on the taxable income of the shareholders, one of the non-C corporation forms of business may be desirable if business losses are anticipated. (See Example 8 in the text.)

d. *Employment Taxes.* The net income of a proprietorship is subject to the self-employment tax (15.3%), as are some partnership allocations of income to partners.

(1) Wages paid to a shareholder-employee of a C or S corporation are subject to payroll taxes.

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(2) A deduction is available to an individual for part of self-employment taxes paid.

e. *State Taxes.* At the entity level:

(1) State corporate income taxes and/or franchise taxes are applicable to corporations.

(2) Some states impose a franchise tax on all business forms (including partnerships and S corporations). If a business will be operating in multiple states, state taxes become more important.

(3) At the owner level, the income of sole proprietorships, S corporations, and partnerships (along with dividend distributions) is subject to state individual income taxation.

f. The tax attributes of the various forms of business entities are compared in Concept Summary 2.1 in the text.

15. Nontax Considerations. Nontax considerations may override tax considerations. Factors to consider include:
- Limited liability for corporate shareholders. Unlimited liability for sole proprietors and general partners in partnerships.
- Ability to raise large amounts of capital using the corporate form.
- Free transferability of ownership interests in corporation.
- Continuity of life for the corporate form of business.
- Centralized management of a corporation. Limited partnerships may also have centralized management, which is essential for the smooth operation of a widely held business.

Limited Liability Companies

16. A limited liability company (LLC) offers a very important nontax advantage (unlimited liability) plus the tax advantage of being treated as a partnership (or proprietorship, in the case of a single-member LLC) and avoiding the double taxation problem associated with C corporations.

a. All 50 states and the District of Columbia recognize LLCs.

b. LLC owners are called members.

c. The tax advantage of LLCs is that qualifying businesses may be treated as proprietorships or partnerships for tax purposes, thereby avoiding the problem of double taxation associated with regular corporations.

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17. Entity Classification. The IRS eased the entity classification problem by issuing check-the-box Regulations.

    a. Regulations enable taxpayers to choose the tax status of a business entity without regard to its corporate or noncorporate characteristics.

    b. Under these Regulations, an unincorporated entity with more than one owner is by default classified as a partnership.

    c. An unincorporated entity with only one owner is, by default, classified as a disregarded entity (DRE) and treated as a sole proprietor.

    d. If an entity wants to use its default status, it simply files the appropriate tax return.

    e. Under the default rules, if no election is made, multi-owner entities are treated as partnerships and single-owner entities are sole proprietorships. New entities using a default classification should not file Form 8332 (Entity Classification Election).

    f. If the entity wants to use a status other than the default status, or if it wants to change its status, Form 8832 is used to "check the box" (Reg. §§ 301.7701–1 through –4 and –7).

        (1) An LLC can therefore be taxed as a C corporation or S corporation.

        (2) Since LLCs are not treated as being incorporated under state law, they default to partnership or DRE status.

THE TAX CUTS AND JOBS ACT (TCJA) OF 2017 AND ENTITY TAX RATES

18. A primary goal for tax reform in 2017 was to lower the Federal income tax rate for C corporations, improving the international competitiveness of U.S. corporations and attracting investment in the United States from non-U.S. multinational corporations.

Challenges of Lowering Tax Rates

19. The Tax Reform Act of 1986 lowered the Federal corporate income tax rate from a maximum of 46% to 34%. This led many other industrialized countries to lower their corporate tax rate.

    a. After many years, most of these countries had lowered their rate below 34%, while the United States raised the top corporate rate to 35%.

    b. With U.S. companies facing increasing global competition, most members of Congress and U.S. Presidents favored lowering the corporate tax rate.

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20. One obstacle in lowering tax rates is the related reduction in revenues for the Federal government.

21. Another obstacle to lowering the Federal corporate income tax rate is that most businesses in the United States operate as sole proprietorships, partnerships, or S corporations, rather than as C corporations.

Lowering Tax Rates for Different Business Forms

22. There is more than one way to lower the tax rate on the business income noncorporate taxpayers earn from their businesses.

    a. An alternative rate structure could be applied to business income.

    b. Noncorporate taxpayers could be allowed a special deduction to reduce the income from their business activities, thereby lowering the tax base (and lowering the taxes due).

23. Challenges exist in both of these approaches, as well as in determining what rate is comparable to the corporate tax rate given the double taxation of corporate income.

24. Leading up to the TCJA of 2017, the reasonable compensation approach was considered in the proposals of the Tax Reform Act of 2014 and the House Republican Tax Reform Blueprint released in June 2016.

25. In the discussions in late 2017 that led to enactment of the TCJA of 2017, both the reasonable compensation approach (in the House bill) and business deduction approach (in the Senate bill) were debated. Ultimately, the business deduction approach was selected.

    a. Under the TCJA of 2017, § 199A (Qualified Business Income) was added to the Internal Revenue Code, allowing up to a 20% deduction on the qualified business income of noncorporate taxpayers.

    b. As with most of the changes made by the TCJA of 2017 for individuals, the deduction for qualified business income is temporary; it is in effect from 2018 through 2025.

26. The purpose of the deduction is to reduce the tax on business income derived outside of the C corporate form.

THE DEDUCTION FOR QUALIFIED BUSINESS INCOME

27. With the reduction in the corporate income tax rate to 21% in 2018, Congress needed to provide a means of reducing the taxes on businesses that operate in different business forms (e.g., sole proprietors, partnerships, and S corporations). Congress accomplished

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this with the creation of the deduction for qualified business income, which applies to noncorporate taxpayers.

28. The deduction for qualified business income is 20% of qualified business income (QBI).

General Rule

29. At its most basic level, § 199A permits an individual to deduct 20% of the qualified business income generated through a sole proprietorship, a partnership, or an S corporation.

30. In general, the deduction for qualified business income is the lesser of:

    a. 20% of qualified business income (QBI), or

    b. 20% of modified taxable income.

31. There are three limitations on the QBI deduction: an overall limitation (based on modified taxable income), another that applies to high-income taxpayers, and a third that applies to certain types of services businesses.

The Overall Limitation: Modified Taxable Income

32. In all cases, the § 199A deduction may not exceed 20% of the taxpayer's modified taxable income.

33. Modified taxable income is taxable income before the deduction for qualified business income, reduced by any net capital gain.

Definition of Qualified Business Income

34. Qualified business income (QBI) is defined as the ordinary income less ordinary deductions a taxpayer earns from a "qualified trade or business" conducted in the United States by the taxpayer (e.g., from a sole proprietorship).

35. Qualified business income does not include certain types of investment income, such as:
    - Capital gains or capital losses.
    - Dividends.
    - Interest income (unless "properly allocable" to a trade or business).
    - Certain other investment items.

    Nor does qualified business income include:
    - The "reasonable compensation" paid to the taxpayer with respect to any qualified trade or business.
    - Guaranteed payments made to a partner for services rendered.

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36. Although the statute is not clear, many practitioners believe that § 1231 transactions should be included in qualified business income. This (and other questions) will remain unresolved until the Treasury Department issues guidance.

Definition of a Qualified Trade or Business

37. For taxpayers who fall below critical taxable income thresholds established under § 199A ($315,000 for married taxpayers filing jointly; $157,500 for all other taxpayers), the scope of a qualified trade or business (QTB) is broad.

    a. In general, it includes any trade or business other than providing services as an employee.

    b. As a result, the deduction is available to sole proprietors, independent contractors, and noncorporate owners of S corporations, partnerships, and LLCs.

38. Taxpayers with Multiple Businesses. The deduction for qualified business income must be determined separately for each qualified trade or business and then combined. This combined amount is then compared to the overall modified taxable income limit.

Limitations on the QBI Deduction

39. Once the taxable income thresholds—$315,000 for married taxpayers filing jointly and $157,500 for all other taxpayers—are reached, § 199A imposes two independent limitations:

    a. The QBI deduction is capped based on the percentage of the W–2 wages paid by the business or based on a smaller percentage of W–2 wages paid by the business and a percentage of the cost of its depreciable property used to produce QBI.

    b. The QBI deduction generally is not available for income earned from "specified service" businesses. "Specified service" businesses include doctors, dentists, lawyers, accountants, consultants, investment advisers, entertainers, and athletes (among others), but not engineers and architects.

40. In all cases, the QBI deduction can never exceed 20% of the taxpayer's modified taxable income (taxable income before the QBI deduction reduced by any net capital gain, including qualified dividend income).

41. Concept Summary 2.2 in the text provides a flowchart to assist in applying these rules.

Limitation Based on Wages and Capital Investment

42. The W–2 Wages/Capital Investment Limit limits the 20% QBI deduction to the greater of:

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a. 50% of the “W−2 wages” paid by the QTB.

b. 25% of the “W−2 wages” paid by the QTB plus 2.5% of the taxpayer’s share of the unadjusted basis immediately after acquisition of all tangible depreciable property (including real estate) used in the QTB that has not been fully depreciated prior to the close of the taxable year.

43. W−2 Wages Limit. For labor-intensive businesses, 50% of the W−2 wages paid by the business will likely be the relevant limit on the QBI deduction. (See Examples 13 and 14 in the text.)

44. W−2 Wages/Capital Investment Limit.

a. For capital-intensive businesses (e.g., real estate), an alternate limit exists. It begins with 25% of W−2 wages paid by the QTB and adds to this amount 2.5% of the unadjusted basis (immediately after acquisition) of “qualified property.”

b. Given the broad-based changes to MACRS made by the TCJA of 2017—allowing taxpayers to expense (via § 179 and/or bonus depreciation) property other than real estate—the “depreciable period” for “qualified property” under § 199A is a minimum of 10 years. (See Example 15 in the text.)

c. Many owners of pass-through businesses, especially landlords, have no employees. As a result, the 25% of W−2 wages plus 2.5% of the unadjusted basis of qualified property is most likely to affect them. (See Example 16 in the text.)

45. Phase-In of W−2 Wages/Capital Investment Limit.

a. The W−2 Wages/Capital Investment Limit does not apply to taxpayers with taxable income before the QBI deduction less than the threshold amount ($315,000 for married taxpayers filing jointly; $157,500 for all others).

b. If taxable income before the QBI deduction exceeds the threshold amount by more than $100,000 (married filing jointly) or $50,000 (all other taxpayers), the W−2 Wages/Capital Investment Limit must be used.

c. If the taxpayer’s taxable income before the QBI deduction is between these two amounts and the W−2 Wages/Capital Investment portion of the QBI deduction is capping the deduction, then the general 20% QBI amount is used, but reduced as follows:

(1) Determine difference between the general 20% QBI deduction amount and the W−2 Wages/Capital Investment amount.

(2) Determine the Reduction Ratio.

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(3) Determine the Reduction in the W−2 Wages/Capital Investment Limit.

(4) Determine QBI amount.

d. See Example 17 in the text for an illustration of these calculations.

Limitation for "Specified Services" Businesses

46. For high-income taxpayers, § 199A excludes any "specified service trade or business" from the definition of a qualified trade or business.

47. A specified service trade or business includes those involving:
    - The performance of services in certain fields, including health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services.
    - Services consisting of investing and investment management, trading or dealing in securities, partnership interests, or commodities.
    - Any trade or business where the business's principal asset is the reputation of one or more of its employees or owners.

48. Architects and engineers are specifically excluded from this definition.

49. According to the legislative history of the TCJA of 2017, the taxable income thresholds where the QBI deduction is phased out for "specified service" businesses were set by Congress "to deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20% deduction under the provision."

50. Example 18 in the text illustrates that the QBI deduction phaseout for a "specified services" business is based on taxable income before the QBI deduction (not on QBI). Any income that contributes to taxable income can cause the "specified services" QBI deduction to be reduced.

51. Phase-In of the "Specified Services" Limit.

    a. In computing the qualified business income with respect to a "specified services" business, the taxpayer takes into account only the "applicable percentage" of QBI and the components of the W−2 Wages/Capital Investment Limit. (See Example 19 in the text.)

    b. A second complication with "specified services" businesses with modified taxable income in the phaseout range is that—in addition to the amount of QBI, W−2 wages, and unadjusted basis of property being subject to a limitation—the W−2 Wages/Capital Investment limitation might also apply. (See Example 20 in the text.)

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c. Compare Examples 20 and 22 in the text to demonstrate the implications (and disadvantages) of having a "specified services" business.

d. An even more complex setting is having multiple businesses—some "specified services" and others not. (See Example 23 in the text.)

Treatment of Losses

52. If a taxpayer has a qualified business loss in one year, no QBI deduction is allowed, and the loss is carried over to the next year to reduce QBI (but not below zero).

53. The statute indicates that if a taxpayer has more than one QTB and the net results of all businesses create a loss, the net loss is carried forward to the following year. (See Example 24 in the text.)

Coordination with Other Rules

54. The deduction for qualified business income operates along with other rules (e.g., how to determine business income).

55. The QBI deduction does not reduce the tax bases for self-employment taxes or the net investment income tax (NIIT).

56. In computing an individual's alternative minimum taxable income (AMTI), qualified business income is not changed by any of the AMT's preferences or adjustments (like depreciation), that usually apply in determining AMTI.

Considerations for Partnerships and S Corporations

57. The deduction for qualified business income applies to taxpayers other than corporations. The QBI deduction is available to individuals, trusts, and estates.

58. Although the earlier examples involved sole proprietors, the same result would occur if the business income was instead generated by a partnership or S corporation. (See Example 25 in the text.)

59. Partnerships and S corporations might use a tax year other than a calendar year. (See Example 26 in the text.)

Open Issues

60. Guidance from the Treasury Department is needed to resolve interpretive questions, including the following:

a. What businesses are considered "specified service trades or businesses"?

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b. How is the wage limit applied if a business uses a professional employer organization (PEO) to manage its workforce?

c. Are capital gains and losses from the disposition of business assets included in the term *qualified business income*?

d. When can an individual's trades or businesses be separated or combined?

e. If an individual has businesses in separate legal entities, is each a separate business or must they be combined?

f. When is rental real estate considered a qualified trade or business?

g. How are losses from one business netted against income from other businesses?

TAX PLANNING

Corporate versus Noncorporate Forms of Business Organization

61. The form of business organization affects the application of various tax rules including tax rates, deductions, tax accounting methods, and tax years.

62. The decision on what form to use can change as a business grows.

Optimizing the Deduction for Qualified Business Income

63. Some planning is possible to increase the deduction or perhaps to avoid losing the deduction.

64. As the Treasury Department releases guidance, some of these planning ideas might not be needed (or might not be allowed).

    a. For taxpayers with taxable income above the $157,500 threshold ($315,000 if married filing jointly), consider converting any contractor payments to employee wages to increase the 50% of W–2 wages limitation.

    b. For a married couple who does not reside in a community property state and has "specified services" business income above the thresholds that allow a QBI deduction, determine whether it might be better to file separate tax returns, enabling the spouse with QBI to qualify for the QBI deduction.

    c. Depending on Treasury Department guidance, consider how businesses can be combined or separated, including perhaps placing one or more in separate legal entities, to increase the QBI deduction.

    d. Employees might consider whether they can become self-employed in their field (which would enable the QBI deduction).

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THE BIG PICTURE

As Amy begins her career, the simplest entity to use is a sole proprietorship. If the risks for her business, such as injury to customers, are minimal, she will likely find that forming an LLC or a corporation to reduce her personal risk, is not warranted.

If, however, Amy wants a more formal structure or a legal structure to reduce her personal risk, an S corporation should work well as it allows her income and losses to flow through to her individual tax return. As her income grows, she might consider converting to a C corporation due to the 21% maximum rate, although she must also consider the effect of double taxation.

Amy must also consider the QBI deduction (assuming she does not operate as a C corporation) as well as state and local taxes.

RESEARCH PROBLEMS

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

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