September 2018

The September newsletter is packed with clarification of the new section 199A tax deduction. Every monthly newsletter is available on my website.

I would also like to mention that over the past few years I have helped many of you and others with planning for retirement. If you have an old 401k that you left behind or would like to discuss getting an IRA started, I would love to sit with you and discuss your options. We can start an IRA for as little as $25/mo.

New IRS 199A Regulations Benefit Out-of-Favor Service Businesses

If you operate an out-of-favor business (known in the law as a "specified service trade or business") and your taxable income is more than $207,500 (single) or $415,000 (married, filing jointly), your Section 199A deduction is easy to compute. It's zero.

This out-of-favor specified service trade or business group includes any trade or business

- involving the performance of services in the fields of health, law, consulting, athletics, financial services, and brokerage services; or
- where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; or
- that involves the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests, or commodities. For this purpose, a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities [Internal Revenue Code Sections 475(c)(2) and 475(e)(2), respectively].

If you were not in one of the named groups above, you likely worried about being in a reputation or skill out-of-favor specified service business. If you were worried, you joined a large group of worried businesses, because many businesses depend on reputation and/or skill for success.

For example, the National Association of Realtors believed real estate agents fell into this out-of-favor category.

But don't worry. The IRS has come to the rescue by regulating the reputation and/or skill provision down to almost nothing. The reputation and/or skill out-of-favor specified service business includes you if you

- receive fees, compensation, or other income for endorsing products or services;
- license or receive fees, compensation, or other income for the use of your image, likeness, name, signature, voice, trademark, or any other symbols associated with your identity; or

- receive fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

Example. Harry is a well-known chef and the sole owner of multiple restaurants, each of which is a single-member LLC—disregarded tax entities that are taxed as proprietorships. Due to Harry's skill and reputation as a chef, he receives an endorsement fee of $500,000 for the use of his name on a line of cooking utensils and cookware.

Results. Harry's restaurant business is not an out-of-favor business, but his endorsement fee is an out-of-favor specified service business.

If you have questions about how the law will treat your business income for the new Section 199A 20 percent tax deduction, please give us a call, and we'll examine your situation.

Does Your Rental Qualify for a 199A Deduction?

The IRS, in its new proposed Section 199A regulations, defines when a rental property qualifies for the 20 percent tax deduction under new tax code Section 199A.

One part of the good news on this clarification is that it does not require that we learn any new regulations or rules. Existing rules govern. The existing rules require that you know when your rental is a tax law–defined rental business and when it is not. For the new 20 percent tax deduction under Section 199A, you want rentals that the tax law deems businesses.

You may find the idea of a rental property as a business strange because you report the rental on Schedule E of your Form 1040. But you will be happy to know that Schedule E rentals are often businesses for purposes of not only the Section 199A tax deduction but also additional tax code sections, giving you even juicier tax benefits.

Under the proposed regulations, you have two ways for the IRS to treat your rental activity as a business for the Section 199A deduction:

1. The rental property qualifies as a trade or business under tax code Section 162.
2. You rent the property to a "commonly controlled" trade or business.

Your rental qualifying as a Section 162 trade or business gets you other important tax benefits:

- Tax-favored Section 1231 treatment
- Business use of an office in your home (and, if it's treated as a principal office, related business deductions for traveling to and from your rental properties)
- Business (versus investment) treatment of meetings, seminars, and conventions

If your rental activity doesn't qualify as a Section 162 trade or business, it will qualify for the 20 percent Section 199A tax deduction if you rent it to a commonly controlled trade or business.

How to Find Your Section 199A Deduction with Multiple Businesses

If at all possible, you want to qualify for the 20 percent tax deduction offered by new tax code Section 199A to proprietorships, partnerships, and S corporations (pass-through entities).

Basic Rules—Below the Threshold

If your taxable income is equal to or below the threshold of $315,000 (married, filing jointly) or $157,500 (single), follow the three steps below to determine your Section 199A tax deduction with multiple businesses or activities.

Step 1. Determine your qualified business income 20 percent deduction amount for each trade or business separately.

Step 2. Add together the amounts from Step 1, and also add 20 percent of

- real estate investment trust (REIT) dividends and
- qualified publicly traded partnership income.

This is your "combined qualified business income amount."

Step 3. Your Section 199A deduction is the lesser of

- your combined qualified business income amount or
- 20 percent of your taxable income (after subtracting net capital gains).

Above the Threshold—Aggregation Not Elected

If you do not elect aggregation and you have taxable income above $207,500 (or $415,000 on a joint return), you apply the following additions to the above rules:

- If you have an out-of-favor specified service business, its qualified business income amount is $0 because you are above the taxable income threshold.
- For your in-favor businesses, you apply the wage and qualified property limitation on a business-by-business basis to determine your qualified business income amount.

The wage and property limitations work like this: for each business, you find the lesser of

1. 20 percent of the qualified business income for that business, or
2. the greater of (a) 50 percent of the W-2 wages with respect to that business or (b) the sum of 25 percent of W-2 wages with respect to that business plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property with respect to that business.

If You Are in the Phase-In/Phase-Out Zone
If you have taxable income between $157,500 and $207,500 (or $315,000 and $415,000 joint), then apply the phase-in protocol.

If You Have Losses
If one of your businesses has negative qualified business income (a loss) in a tax year, then you allocate that negative qualified business income pro rata to the other businesses with positive qualified business income. You allocate the loss only. You do not allocate wages and property amounts from the business with the loss to the other trades or businesses.

If your overall qualified business income for the tax year is negative, your Section 199A deduction is zero for the year. In this situation, you carry forward the negative amount to the next tax year.

Aggregation of Businesses—Qualification
The Section 199A regulations allow you to aggregate businesses so that you have only one Section 199A calculation using the combined qualified business income, wage, and qualified property amounts.

To aggregate businesses for Section 199A purposes, you must show that

- you or a group of people, directly or indirectly, owns 50 percent or more of each business for a majority of the taxable year;
- you report all items attributable to each business on returns with the same taxable year, not considering short taxable years;
- none of the businesses to be aggregated is an out-of-favor, specified service business; and
- your businesses satisfy at least two of the following three factors based on the facts and circumstances:
    1. The businesses provide products and services that are the same or are customarily offered together.
    2. The businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
    3. The businesses operate in coordination with or in reliance upon one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

- part-time or seasonal employees,
- employees covered by a collective bargaining agreement if health benefits were the subject of good-faith bargaining, and
- employees who are non-resident aliens with no earned income from sources within the United States.

Sincerely,

Robyn Urig EA

ACCOUNTING • PAYROLL • TAX PREPARATION • INVESTMENT ADVISOR 513.882.3530