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The New 'Qualified Business Income Deduction' Varies Based On Your Business Type - Or Does It?

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Taxes

Two short weeks ago, we dissected perhaps the most widely-anticipated but least-understood aspect of the Tax Cuts and Jobs Act: the new deduction available to business owners. As a reminder, under the new law, after January 1, 2018, the owner of a:

- sole proprietorship reported directly on Schedule C
- rental activity reported directly on Schedule E
- S corporation, or
- partnership...

...is entitled to take a deduction equal to 20% of the "qualified business income" earned from the business.

Qualified business income is best thought of as the ordinary, non-investment income of the business. Stated in another way, this is the revenue the business was designed to generate, less the applicable expenses. So we ignore things like interest or dividend income or capital gains from the sale of property.

The deduction, however, is limited to the LESSER OF:

- 20% of qualified business income, or
- 50% of the total W-2 wages paid by the business.

There is also an alternative limitation based on the owner's allocable share of 2.5% of the unadjusted basis of certain business assets, but let's cast that aside for today.

This "50% of W-2 wage limitation," however, does not apply, if the total TAXABLE INCOME of the business owner is less than $315,000 for the year (if married, $157,500 if single). There is a short range of income in excess of these thresholds where the W-2 limitation is phased in, but by the time taxable income reaches $415,000 (if married, $207,500 if single), the "50% of W-2 wage limitation" applies in full.

*Example: A, a married taxpayer, operates a business as a sole proprietor. The business has one employee, who is paid $50,000 during 2018. The business has no significant assets. During 2018, the business generates $200,000 of income to A, and A's total taxable income, after deductions, is $215,000. A is entitled to a deduction of $40,000 ($200,000 * 20%). The "W-2 wage limitation" -- which would normally be $25,000 ($50,000 * 50%) does not apply because A's taxable income is less than $315,000.*

Assume instead that all facts remain the same, except the business generates $400,000 of income to A, and after deductions, his taxable income if $450,000. In this case, A's deduction is limited to $25,000, the LESSER OF:

- 20% of $400,000, or $80,000, or
- 50% of W-2 wages of $50,000, or $25,000.

With the basics established, let's move on. In this post, we spent 10,000 words breaking down the new law, but something has been bothering me of late. In that article, we spent the majority of time discussing how the new deduction allows owners of sole proprietorships, S corporations and partnerships to retain their competitive tax advantage over C corporations, while providing them with a *new* competitive advantage over employees.

But in those 10,000 words, I may well have buried - or even worse, flat-out ignored, the lede: kick-started by some insightful emails from readers, I started to think about Section 199A differently: how does the new deduction position owners of sole proprietorships, S corporations and partnerships *against each other*.

The results may surprise you. If we are to interpret Section 199A based on its most obvious reading, the new law will provide anomalous results, rewarding some business types over the other at one level of income, and then reversing those results at a different income level.

Let's take a look...

Case Study 1: High Income Business With No Outside Employees

Consider the following fact pattern:

- A is the sole owner of a business. In the scenario where the business is held in a partnership, A owns 99% of the partnership with his wife owning the remaining 1%.
- A builds and sells a product.
- A has no employees; rather, he gets by with the help of a few independent contractors.
- The business has no substantial fixed assets.

Assume that in 2018, the business generates $500,000 of ordinary income. Assume further that this is also A's taxable income on his 2018 return. Let's look at how A's deduction varies depending on how he chooses to operate his business:

Sole Proprietorship

With income of $500,000 reported on Schedule C, A would begin the process of computing his deduction by simply multiplying his qualified business income (QBI) of $500,000 by 20%, yielding a tentative deduction of $100,000.

The deduction, however, is limited to 50% of the W-2 wages paid by the business. As a sole proprietorship, A cannot pay himself wages, and because there are no other employees, the business has no W-2 wages; as a result, the "50% of W-2 Wages" limitation is $0. In addition, because A's taxable income is above the top threshold of $415,000, the limitation applies in full.

Thus, A gets no deduction in 2018.

S Corporation

Assume instead, that A operates as a wholly-owned S corporation during 2018. As an owner of an S corporation, there is tremendous motivation for A to forego wages in exchange for distributions, because Rev. Ruling 59-221 provides that S corporation income is not subject to self-employment tax. As a result, every dollar of wages A DOESN'T pay himself saves him 15.3% in payroll tax (up to the Social Security wage base; 2.9% after that).

The IRS is wise to this game, however, so A knows he must pay himself "reasonable compensation" or else end up staring down the barrel of a painful audit. As a result, he pays himself $125,000 in wages during 2018. This reduces his flow-through income from $500,000 to $375,000.

In computing qualified business income, Section 199A(c)(4) provides that QBI does not include "reasonable compensation paid to the taxpayer." This has been widely interpreted -- and I have shared the same view -- to mean that the $125,000 of wages A receives and reports on his Form 1040 are not included in his calculation of QBI and are thus not eligible for the 20% deduction.

As a result, the popular view is that A's QBI is $375,000, and his tentative deduction is $75,000.

The deduction is limited, however, to 50% of the W-2 wages paid by the S corporation. In this case, to comply with the reasonable compensation requirement, A was paid a salary of $125,000. As the sole owner, A's share of the wage deduction is the full $125,000, and his 50% limit is set at $62,500.

Thus, A is entitled to claim a deduction of $62,500, equal to the LESSER OF:

- his QBI deduction of $75,000 ($375,000 * 20%), or
- his W-2 limitation of $62,500 ($125,000 *50%).

Partnership

Assume instead, that A operates as a partnership, in which he owns 99% and his wife owns the remaining 1%. Because all partnership income is generally subject to self-employment tax (except for limited partners under Section 1402(a)(13)), there is not the same motivation for A to forego wages in exchange for distributions, as he will pay the full payroll tax on all of his income, regardless of how it gets to his hands. Furthermore, as a partner in a partnership, A generally CAN'T pay himself wages in accordance with Revenue Ruling 69-184, and instead, is compensated for his services by means of a "guaranteed payment" under Section 707(a) or Section 707(c).

Assume A pays himself a guaranteed payment of $125,000 in 2018, the same salary he drew in the S corporation scenario. This reduces his flow-through income from $500,000 to $375,000.

In computing qualified business income, Section 199A(c)(4) similarly provides that QBI does not include "any guaranteed payment...paid to a partner for services." As with the S corporation wages, this has been widely interpreted to mean that the $125,000 of guaranteed payments A receives and reports on his Form 1040 are not included in his calculation of QBI and are thus not eligible for the 20% deduction.

If this view is correct, A's QBI is $375,000, and his tentative deduction is $75,000.

The deduction is limited, however, to 50% of the W-2 wages paid by the S corporation. In this case, the partnership paid no W-2 wages, as guaranteed payments are NOT wages for these purposes. As a result, A's "50% of W-2 Wages" limitation is $0, and A is entitled to no deduction.

See the problem? Same business. Same owner. Same revenue. But different results under new Section 199A. It would look like this:

	Sole Prop.	**S Corp.**	**Partnership**
Business Income	$500,000	$500,000	$500,000
W-2 Wages	n/a	($125,000)	n/a
Guaranteed Payments	n/a	n/a	($125,000)
Net Income	**$500,000**	**$375,000**	**$375,000**
QBI	$500,000	$375,000	$375,000
Tentative Deduction	$100,000	$75,000	$75,000
50% of W-2 Wages Limitation	$0	$62,500	$0
Final Deduction	**$0**	**$62,500**	**$0**

Does that make sense? Why should the owner of an S corporation, simply by virtue of the pre-existing requirement that reasonable compensation be paid to a shareholder who provides

services, be entitled to a $62,500 deduction that is not available to the EXACT. SAME. BUSINESS. operated as a sole proprietorship or a partnership?

Let's look at another example, and see how the pendulum can swing:

Case Study 2: Low Income Business With No Outside Employees

Assume instead that in 2018, the same business laid out in Case Study 1 generates $200,000 of ordinary income. Assume further that this is also A's taxable income on his 2018 return. Let's look at how A's deduction varies depending on how he chooses to operate his business:

Sole Proprietorship

With income of $200,000 reported on Schedule C, A's tentative deduction is $40,000.

Because A's taxable income is below the threshold of $315,000, the W-2 limitation does not apply. As a result, A gets a full deduction of $40,000 in 2018.

S Corporation

Even with income of only $200,000, A is required to take reasonable compensation if he hopes to get his hands on that $200,000 in cash without problems with the IRS. Assume he pays himself $80,000; this reduces his flow-through income from $200,000 to $120,000. If we embrace the popular view that this also reduces his QBI eligible for the 20% deduction to $120,000, A's tentative deduction becomes $24,000 (20% * $120,000). Because A's taxable income is less than the $315,000 threshold, the W-2 limitations do not apply.

Thus, A is entitled to claim a deduction of $24,000.

Partnership

Assume A pays himself a guaranteed payment of $80,000 in 2018, the same salary he drew in the S corporation scenario. This reduces his flow-through income from $200,000 to $120,000. This would reduce, under the conventional interpretation of Section 199A, A's QBI to $120,000, and his tentative deduction is $24,000.

As with the previous two situations, the W-2 limitation does not apply, and thus A is left with a deduction of $24,000.

It would look like so:

	Sole Prop.	S Corp.	Partnership
Business Income	$200,000	$200,000	$200,000
W-2 Wages	n/a	($80,000)	n/a
Guaranteed Payments	n/a	n/a	($80,000)
Net Income	**$200,000**	**$120,000**	**$120,000**
QBI	$200,000	$120,000	$120,000
Tentative Deduction	$40,000	$24,000	$24,000
50% of W-2 Wages Limitation	n/a	n/a	n/a
Final Deduction	**$40,000**	**$24,000**	**$24,000**

Now, the shoe is on the other foot. Because the W-2 limitations don't apply -- but the requirement that an S corporation owner receive reasonable compensation remains -- the S corporation owner is disadvantaged relative to the sole proprietorship. As is the partnership in my example, but remember, the partner is not technically *required* to take a guaranteed payment.

It's hard to imagine that this is what Congress intended when they enacted Section 199A -- for identical businesses to have different deductions based on their choice of entity -- but the most straightforward reading of the legislative tax yields these exact results.

What is the fix?

What if we're going about this all wrong? What if the most straightforward reading of the statute isn't the *correct* one? What if it doesn't accurately reflect the true intentions of the people who added it to the law?

That requires a rather large leap of faith. After all, the Tax Cuts and Jobs Act will likely be remembered less for its rate cuts and changes to deductions than for the *way it unfolded*. Five-hundred pages of legislative text released days before it was to be voted on. Numerous 11th hour negotiations that left that text virtually unrecognizable. And then new text presented just HOURS before a vote, complete with strike-throughs and handwritten notes impacting major legislation.

Thus, Occam's Razor would dictate that the results we're seeing above are not the consequences Congress desired, but rather the results of late nights and the resulting shoddy drafting.

But for the remainder of this post, I'm going to give Congress and its tax writers the benefit of the doubt, and suggest that they couldn't possibly have sought these results, where similarly situated businesses are granted widely disparate deductions. That they didn't set out to create these anomalies, and in fact, if read correctly, the text of Section 199A will *prevent them*.

But how can we get there? We'll have to give Section 199A another read, this time with the mindset that the people who were drafting the provision were under significant time constraints, and simply doing the best they could. And as a result, maybe the most straightforward interpretation of the statute is not the correct one; rather, maybe we need to read with a more critical eye and see if that by reading a few key provisions differently, we can remedy the inequitable consequences reflected above.

Let's start with Section 199A(c)(4). This provision reads, in its unedited form, as follows:

Qualified business income shall not include—

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

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

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

As I said above, the near-universal interpretation of this subparagraph has been the most obvious reading: when you compute the items of income on your Form 1040 that are eligible for thee 20% deduction, you don't add to your business income -- in the case of a S corporation or a partnership -- any wages or guaranteed payments you are paid from the at business. That is why, in the examples above where the shareholder or partner received wages and guaranteed payments, the business owner's QBI was LESS than it was for the sole proprietor.

But perhaps that's not correct. Maybe what this is saying is, and hear me out...

QBI is your income allocated to you from your business. But that income allocated to you, by definition, is AFTER the business has deducted the wages paid to you -- in the case of an S corporation -- or the guaranteed payments if you are a partner. And because QBI should not reflect those wages or guaranteed payments, perhaps this provision is saying your income from the S corporation or partnership should be the income BEFORE the business deducted the wages or guaranteed payments.

Is that too big of a stretch? Well, consider this...when the House bill was drafted and passed, it would have bestowed a 25% tax rate on "qualified business income." This is from the JCT summary of the House version of HR 1:

> Net business income or loss includes the amounts received by the individual taxpayer as wages, director's fees, guaranteed payments and amounts received from a partnership other than in the individual's capacity as a partner, that are properly attributable to a business activity. These amounts are taken into account as an item of income with respect to the business activity. For example, if an individual shareholder of an S corporation engaged in a business activity is paid wages or director's fees by the S corporation, the amount of wages or director's fees is added in determining net business or loss with respect to the business activity. This rule is intended to ensure that the amount eligible for the 25-percent tax rate is not erroneously reduced because of compensation for services or other specified amounts that are paid separately (or treated as separate) from the individual's distributive share of passthrough income.

As you can see, the House bill made clear that for pass-through owners, the benefit of the 25% rate was not intended to apply only to their share of the ordinary income of the business, but *also to any wages or guaranteed payments received.*

Given that, why is it far-fetched to believe that when the House and Senate broke break bread and reached a consensus on Section 199A, they didn't intend to embrace this aspect of the House bill? Why give a 25% rate in the House bill to the flow-through income PLUS any wages or guaranteed payments received, but then in the Senate bill limit the 20% deduction to only the flow-through income?

If we go down this path, and interpret Section 199A(c)(4) to mean that in computing QBI, a shareholder or partner must increase the amount of flow-through income by the wages or guaranteed payments received, it remedies the strange results we witnessed in our second case study, where the taxpayer earned $200,000 of income from the business for the year before wages or guaranteed payments, and total taxable income was below the threshold, where the "50% of W-2 wages limitation" does not apply. Check it out:

	Sole Prop.	**S Corp.**	**Partnership**
Business Income	$200,000	$200,000	$200,000
W-2 Wages	n/a	($80,000)	n/a
Guaranteed Payments	n/a	n/a	($80,000)
Net Income	**$200,000**	**$120,000**	**$120,000**
QBI	$200,000	$120,000	$120,000
Addback: wages/GP received	n/a	$80,000	$80,000
Final QBI	$200,000	$200,000	$200,000
Tentative Deduction	$40,000	$40,000	$40,000
50% of W-2 Wages Limitation	n/a	n/a	n/a
Final Deduction	**$40,000**	**$40,000**	**$40,000**

Well, lookee there. By adding back the wages and guaranteed payments received in computing QBI, we place shareholders and partners on equal footing with a sole proprietor. Seems like this would accomplish the last sentence in the House bill summary, which stated:

This rule is intended to ensure that the amount eligible for the 25% rate is not erroneously reduced because of compensation for services or other specified amounts that are paid separately (or treated as separate) from the individual's distributive share of pass-through income. (underline added)

This interpretation alone, however, would not fix the problem that arose in our first case study. To remedy that result, we need to look at Section 199A(b)(4), which defines wages for purposes of the W-2 wage limit. The subparagraph states that "W-2 wages:"

...shall not include any amount which is not properly allocable to a qualified business for purposes of subsection (c)(1).

Subsection (c) as we discussed above, governs the computation of QBI. So again, if we take a very straightforward interpretation of this (b)(4), it would appear to contemplate an entity that has multiple lines of business, the income from one or more of which would be "qualified business income," while the income from one or more of the others would NOT be "qualified business income" -- perhaps because the business line is a pure service business -- and only the W-2 wages paid in the qualified business should count towards the limitation.

But Section 199A(b)(4) is far from clear. What if instead, what it is saying is that because under our alternative reading of Section 199A(c)(4), wages paid to the shareholder of an S corporation are not permitted to reduce QBI, we also shouldn't include those amounts in the W-2 wage limit, because they are not "allocable to a qualified business." If this were the case, it would combine with the addback of wages and guaranteed payments in computing QBI to always put owners of a sole proprietorship, S corporation, or partnership on equal footing. Look what it does to our first case study, where business income was $500,000 and the W-2 limitation applied in full:

	Sole Prop.	**S Corp.**	**Partnership**
Business Income	$500,000	$500,000	$500,000
W-2 Wages	n/a	($125,000)	n/a
Guaranteed Payments	n/a	n/a	($125,000)
Net Income	**$500,000**	**$375,000**	**$375,000**
QBI	$500,000	$375,000	$375,000
Addback: wages/GP received	n/a	$125,000	$125,000
Final QBI	$500,000	$500,000	$500,000
Tentative Deduction	$100,000	$100,000	$100,000
50% of W-2 Wages Limit **does not include wages to s/h**	$0	$0	$0
Final Deduction	**$0**	**$0**	**$0**

Seems fair, doesn't it? If a sole proprietor with income over the taxable income limit can't claim the 20% of QBI deduction because, by definition, it cannot pay W-2 wages to its sole owner/employee, then why should an S corporation get a deduction simply because it CAN pay a salary to its shareholder/employee? After all, in both cases the combined income taxed at ordinary rates on the owner's tax return is $500,000. Why should $500,000 of income give rise to no deduction in the case of the sole proprietor, and $62,500 in the case of the S corporation shareholder?

It shouldn't. But only by assuming that:

1. Section 199A(c)(4) requires us to add back wages paid to a shareholder and guaranteed payments to a partner in computing the shareholder or partner's QBI, and
2. The W-2 wage limitation should NOT include any wages paid to the shareholder computing the deduction...

...can we achieve equity between the three business types.

Next, consider a slightly more complicated example, where:

- the business has outside employees, who are paid $200,000 in W-2 wages.
- the owner draws a salary of $100,000 from the S corporation or $100,000 of guaranteed payments from the partnership.

The top table is what happens under the straightforward interpretation of Sections 199A(b)(4) and (c)(4). The bottom table is the result if we take the alternate read we discussed above. Which makes more sense to you?

	Sole Prop.	**S Corp.**	**Partnership**
Business Income	$1,000,000	$1,000,000	$1,000,000
W-2 Wages to Employees	($200,000)	($200,000)	($200,000)
W-2 Wages to Shareholder	n/a	($100,000)	n/a
Guaranteed Payments	n/a	n/a	($100,000)
Net Income	**$800,000**	**$700,000**	**$700,000**
QBI	$800,000	$700,000	$700,000
Tentative Deduction	$160,000	$140,000	$140,000
50% of W-2 Wages Limit	$100,000	$150,000	$100,000
Final Deduction	**$100,000**	**$140,000**	**$100,000**
	Sole Prop.	**S Corp.**	**Partnership**
Business Income	$1,000,000	$1,000,000	$1,000,000
W-2 Wages to Employees	($200,000)	($200,000)	($200,000)
W-2 Wages to Shareholder	n/a	($100,000)	n/a
Guaranteed Payments	n/a	n/a	($100,000)
Net Income	**$800,000**	**$700,000**	**$700,000**
QBI	$800,000	$700,000	$700,000
Addback: wages/GP received	n/a	$100,000	$100,000
Final QBI	$800,000	$800,000	$800,000
Tentative Deduction	$160,000	$160,000	$160,000
50% of W-2 Wages Limit **(does not include wages paid to s/h)**	$100,000	$100,000	$100,000
Final Deduction	**$100,000**	**$100,000**	**$100,000**

Here's the beauty of Section 199A: I can go with option 1, and stick to my straightforward interpretation of the statute, even in the face of results that make little to no sense from a policy perspective. Or I can say, "this can't be what Congress intended, they must have meant it to be read *this* way," and embrace the alternative interpretation that gives rise to the equitable results evidenced above. And no matter which path I choose, at this point, *no one can tell me that I'm wrong.*

Because nobody understands what is going on with Section 199A. What the people who drafted it were trying to accomplish. Who was supposed to benefit, and who wasn't. How we are to interpret such seemingly basic terms as "W-2 wages."

Of course, absent and further guidance, the courts would likely interpret Section 199A the same we way all have -- in the straightforward manner laid out above that gives rise to the inequities between business types. The courts will not be concerned with "fairness;" rather, they will hold Congress and the IRS to the plain meaning in the statute. As a result, until we're told otherwise, tax preparers should interpret the law in the same manner, even if it punishes their client.

Maybe I'm right in this column, and the alternative reading of the statute -- the one that treats owners of a sole proprietorship, S corporation or partnership identically -- is the correct one. Much, much more likely, however, I'm wrong, and courtesy of harried revisions and sloppy drafting, we'll be stuck with these unpredictable and inequitable results for the foreseeable future.