Section 199A Update
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Agenda
1. Defining QBI, and what’s new for 2020 returns

2. How entities report QBI

3. How individuals calculate QBI, from basic to advanced

4. Aggregating activities for QBI

5. Is rental property a business for QBI?
Defining QBI
Defining QBI

At its simplest, the Section 199A deduction is available to taxpayers for business income reported on their personal Form 1040, equal to 20% of their business income.

For the QBI deduction, there is no passive activity (Section 469) tests to apply; if a taxpayer has income from a passive activity, it qualifies for the QBI deduction.

Sounds simple enough....
The idea behind QBI is to provide some amount of parity between C-corps and other types of businesses

• C-corps have a flat 21% tax
  • $100 of income = $21 tax, or $79 left after tax

• Highest marginal tax rate for individuals is 37%
  • Without QBI, $100 x 37% = $37 of tax or $63 left after tax
  • With QBI: $100 of income x 20% QBI deduction = $80; $80 x 37% = $30 of tax, or $70 left after tax

• For someone in the 24% bracket:
  • $100 x 20% QBI = $80 x 24% = $19 of tax, or $81 left after tax
2020 Thresholds

QBI begins to phase out (for specified service businesses) or phase into an alternate calculation (for other businesses) once taxable income reaches these thresholds:

• $163,300 for single filers (including MFS)

• $326,600 for married filing jointly

And the phase in for the alternate calculation (or complete phase out for SSTB) is at:

• $213,300 for single filers (and MFS)

• $426,600 for MFJ
QBI Calculation

- Above the thresholds, taxpayers need to take into consideration W-2 wages paid by the entity, and the unadjusted basis of assets in the business.
New Form

New for 2019 returns and going forward, QBI is calculated on:

- Form 8995 or 8995-A

- 8995 = taxpayers whose income is below the phaseout thresholds

- 8995-A = income above the thresholds OR a taxpayer is a patron in certain agricultural or horticultural cooperatives
Polling Question #1

What is the new form for claiming QBI?

A. Form 8995 or 8995-A

B. Form 5471

C. Schedule C

D. Schedule Q
In March, AICPA wrote a letter to the IRS, asking for clarification on various QBI issues:

- IRS says the deduction for 1/2 of SE tax reduces QBI; AICPA asks — what about when the SE tax is attributed to guaranteed payments (which are not a part of QBI)?

- IRS says S-corp shareholders who have a self-employed health insurance deduction must reduce QBI by the deduction, even though the deduction is already accounted for in QBI from the K-1 of the S-corp (and the SE health insurance deduction is really a deduction from W-2 wages, which is not QBI)

- Should retirement plan contributions of a partner where the contribution is a part of guaranteed payments, reduce QBI income?

- IRS says charitable contributions (i.e. passsthrough contributions on a K-1) reduce QBI, even though the regulations under Section 162 say charitable contributions are not a business expense
Understatement Penalty

• Section 6662 of the Internal Revenue Code is revised with a special section relating to tax returns claiming the QBI deduction — Section 6662(d)(1)(C):

  • Normally, a substantial understatement penalty applies if the tax understatement is over $5,000 and is more than 10% of the tax required to be shown

  • Section 6662(d)(1)(C) adds a clause relating to returns claiming QBI: 10% is changed to 5%
QBI on the Entity Side
How Entities Report QBI

- Entities themselves do not claim the QBI deduction

- Instead the entity must report QBI information on the K-1

  - S-corp: K-1 Box 17V (instructions say boxes V through Z are for QBI, but W through Z are “reserved for future use” and we don’t know what they will be for)

  - Partnership: K-1 Box 20Z

  - Estate: K-1 Box 14I (if the estate distributes income through to the beneficiaries; estates can also claim QBI itself)
How Entities Report QBI

The K-1 must show:

- The partner’s/shareholder’s/beneficiary’s share of business income from the entity
- Share of W-2 wages paid by the entity
- Share of “unadjusted basis immediately after acquisition”
- Any items from publicly traded partnerships or REITs
W-2 Wages

Three methods to account for W-2 wages (this applies for sole proprietorships too); see Rev Proc 2019-11:

1. The unmodified box method

2. The modified box 1 method

3. The tracking wages method
Unmodified Box Method

Use the lesser of:

• Box 1 of W-2, or

• Box 5 of W-2
Modified Box 1 Method

• Take box 1 of the W-2, and:

  • **Subtract** anything that is not wages for withholding purposes, such as supplemental unemployment compensation

  • **Add** Form W-2 Box 12 items with Codes D (401k deferrals), E (403b deferrals), F (salary reduction SEP deferrals), G (457b deferrals) or S (SIMPLE deferrals)
Tracking Wages Method

Take total wages subject to federal income tax withholding and add amounts shown in Box 12 of the W-2 for codes D, E, F, G or S as defined on the previous
Contractors, Owners, Etc

• Payments to contractors do not count here

• Watch your software

• S-corp W-2 wages to shareholders:
  • Are deducted by the S-corp and factor into the pass-through QBI income from the S-corp
  • DO count toward the W-2 wage allocation
Unadjusted Basis of Assets

- Simple version: the basis in depreciable assets = UBIA
- Longer version: see next slides
Unadjusted Basis in Assets

Basis is the depreciable basis without adjustments for:

• Depreciation claimed

• Tax credits claimed (such as a business credit which reduce the basis of an asset for depreciation purposes)

• Section 179 expense claimed
UBIA

• Does NOT include land as land is not depreciable

• Does not include intangible assets where amortization is claimed
Putting it Together
Simple Example

• The QBI deduction is the lesser of 20% of QBI or 20% of taxable income before QBI (so AGI minus itemized deductions)
Sole Proprietor

- Let’s say a married sole proprietor has net Schedule C income of $60,000; their spouse has W-2 income of $60,000

- SE tax is $8,478

- SE tax deduction is $4,239

- Let’s say they have a SE health insurance deduction of $10,000

- On their tax return, taxable income before QBI would be: $60,000 + 60,000 - $4,239 - $10,000 - $24,400 standard deduction = $81,361
Sole Proprietor

QBI Deduction:

• QBI of $60,000 adjusted by deductions attributed to the QBI: $4,239 SE tax deduction and $10,000 health insurance = $45,761

• QBI deduction is the lesser of 20% of taxable income ($81,361 x .2 = $16,272) or 20% of QBI ($45,761 x .2 = $9,152)

• This person’s QBI deduction is $9,152
Turning Up the Complexity

• Let’s say a married person has the following: $75,000 of W-2 wages from the S-corp they own, and $300,000 of K-1 pass-through income from the S-corp

• The W-2 wages from the S-corp would be $75,000

• Let’s say the UBIA is $150,000

• Let’s say taxable income is $375,000

• We will use 2019 for this example
$375,000 is the taxable income; this is within the phaseout range for a married person, which runs from $321,400 to $421,400. The percentage is: $375,000 - $321,400 = $53,600 in the phaseout range, divided by $100,000 = 53.6%.

Calculate the greater of: 50% of W-2 wages, or 25% of wages plus 2.5% of UBIA.

- 50% of wages = $37,500
- 25% of wages ($18,750) + 2.5% of UBIA ($3,750) = $22,500

So use $37,500.

Calculate the amount that regular QBI exceeds $37,500.

- Regular QBI = $300,000 x .2 = $60,000 minus $37,500 = $22,500.
The Calculation

- $22,500 is the difference between regular QBI and the W-2/UBIA amount

- $22,500 x .536 = $12,060

- $60,000 “regular” QBI - $12,060 = $47,940 QBI deduction
Specified Service Trade or Business (SSTB)
SSTB

• If income is below the phaseout ranges, a full deduction is allowed for an SSTB

• If income is within the phaseout/phase-in range, a partial deduction is allowed for an SSTB

• If income is above the end of the range no deduction is allowed at all for an SSTB
Specified Service Businesses

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Investing and investment management
- Trading
- Dealing in certain assets
- Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners
Polling Question #2

True or false: a tax preparation business is considered to be a specified service trade or business:

A. True

B. False
Warning: a related non-SSTB that provides services to an SSTB may be considered an SSTB itself!

50% or more common ownership
SSTB Example

• Let’s use our prior example but say the business is an SSTB

• The percentage is 53.6%

• Start with: regular QBI os $60,000 minus a 53.6% reduction = $27,840 adjusted amount

• Then take the greater of 50% of wages or 25% of wages plus 2.5% of assets — $37,500 is the amount in our example — and subtract 53.6% = $17,400

• $27,840 - $17,400 = $10,440 x 53.6 = $5,596

• $27,840 - $5,596 = $22,244 final QBI total
Aggregation
Aggregation

Taxpayers can aggregate business activities if the following are true:

1. Common ownership: same person or group of people owns 50% or more of each business for a majority of the year, including the last day of the year

2. All entities have the same tax year

3. So SSTBs can be aggregated

4. Integration: businesses must satisfy at least two of these factors:
   1. Provide products, property or services that are the same or are offered together
   2. They share facilities, management, employees or centralized business elements
   3. They operate in coordination with each other or rely on each other
Aggregation

• Aggregation for QBI can be different from aggregation for Section 469 passive activity rules

• Failure to aggregate is not considered an election not to aggregate (i.e. you can aggregate in a future year even if not done in 2018 or 2019)

  • But once you do aggregate, you are stuck with that unless there is a “significant change in facts and circumstances”

• Aggregation can only be made on an original tax return, not an amendment

  • Exception: because the final regs didn’t come out until 2019, you CAN amend 2018 to aggregate
Aggregation

- Aggregation is only (maybe) beneficial when a taxpayer’s income is over the threshold amounts and the W-2/UBIA calculation comes into play.

- Aggregating allows for a combined calculation for the aggregated businesses, rather than calculating each business separately.

  - This may — or may not — result in a higher QBI deduction.

- Because you are stuck with the aggregation once you aggregate, taxpayers and their tax preparers need to really think about this before leaping into aggregation.
Self-Rental
Self-Rental

• Self-rental to a trade or business makes the rental activity qualify for QBI treatment

• WARNING: if the self-rental is to an SSTB, then the self-rental income is also considered SSTB
Rental Property
Rental Property

• Is rental property a trade or a business?
  • This has been a vexing question for tax pros, the IRS and the courts for nearly 80 years!
  • The answer is not straightforward
How Rental Property is Taxed

• Rental Property Refresher (yes this ties into our QBI discussion!):

• Rental property is either a “trade or business” under Section 162, or “investment” property under Section 212

• Either way, it is shown on Schedule E, and is not subject to SE tax (EXCEPTIONS: reporting and SE tax may be different with short-term rentals where “significant personal services” are provided)

• The same deductions (with one exception, for home offices) are available either way

• Rental activity, by default, is a passive activity under Section 469 — losses can be deducted up to $25,000, subject to AGI phaseouts

• If a taxpayer meets the tests to be a “real estate professional,” the loss limitations and AGI phaseouts do not apply

• Real estate professional = someone who works in certain fields related to real estate, and who owns rental properties, and who meets certain hours of participation thresholds

• Yes, this is an over-simplification of the definition of a real estate pro!
Rental Activity as a Trade or Business

Perspectives on trade or business status:

• “Historical” court standard: an activity is a trade or business if the taxpayer is involved in the activity on a “regular and continuous basis.” No definition is provided and there is no hours test. “It is if it is.”

• Triple-net leases and other situations where the taxpayer is only collecting a rent check and doing nothing else are NOT seen as being a trade or business.

• QBI Deduction Safe Harbor: Revenue Procedure 2019-38
Taxpayer must document (and attach a statement to their tax return attesting to) 250+ hours spent on:

• Advertising to rent or lease the real estate

• Negotiating and executing leases

• Verifying information contained in prospective tenant applications

• Collection of rent

• Daily operation, maintenance, and repair of the property

• Management of the real estate

• Purchase of materials

• Supervision of employees and independent contractors
Rev Proc 2019-38

• Note that this is just a safe harbor, not a “test” of trade or business status for a rental

• So ANY rental can qualify as a trade or business and thus for a QBI deduction

• Rev Proc 2019-38 simply provides a safe harbor

• Beware: we need to think about this a lot more now than ever before; if we say a rental is a business and it shows a loss, we need to subtract that loss from other QBI
Rentals

Why don’t we have a clear answer on rentals?

• Before the QBI deduction it was often a moot point

• Same deductions are allowed, whether a rental is a business or considered investment property = net income or loss is the same either way

• Rental activity is considered passive, so the same loss limitations apply either way

• Section 1231 loss deductions would be one area where it matters (business = 1231 loss; investment = capital loss)

• But most rentals will be sold at a gain (especially if held for more than a few years) because of accumulated depreciation; the gain is taxed the same whether the rental is a business or investment property
Rentals

• In conclusion: to repeat, we need to think about the tax implications of rentals now more than ever
Polling Question #3

This is asking for your opinion: which of the following do you think about the business status of rentals?

A. Any rental activity that is carried on with regularity and continuity is a business.

B. Someone who meets the QBI safe harbor for rental real estate has a business.

C. A person who qualifies as a “real estate professional” has a business

D. I need to research this and think about it more
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