Nonpassive Business Loss Limit (Sec. 461(l))

Excess Nonpassive Business Loss Not Deductible in Current Year

- Applies to all taxpayers other than C corporations.
- "Excess Business Loss" = The excess of the taxpayer's aggregate deductions "attributable to trades or businesses" over aggregate gross income attributable to such "trades or businesses" plus:
  - $250,000, or
  - $500,000 (if MFJ) (inflation indexed)

- The excess loss is an NOL carryforward (thus can only offset 80% of T.I.)
- Applied at partner or S shareholder level.
- Applies to Trusts and Estates.
- Applies after the sec. 469 PAL rules (sec. 461(l)(6)).
- Effective Date: TYBA 12/31/2017

Observation #1: Could be big surprise in the year that nonpassive losses are “freed-up” from a complete disposition of a passive activity.

Observation #2: Consider impact of excess losses when claiming bonus depreciation.

Example

Taxpayer is Single or H of H and the Business Loss is <$600,000>

	Income/ Loss	NOL Carryover
Div. Inc.	900K	
Bus Loss <600K>		
Allowed Loss	?	
AGI		

	Income/ Loss	NOL Carryover
Div. Inc.	900K	
Bus Loss <600K>		
Allowed Loss	<250K>	<350>
AGI	650K	

The excess loss limits the ability of taxpayers to use large losses against nonbusiness income: W-2 wages, pensions, interest, dividends, capital gains, etc.

20% x QBI Deduction (Sec. 199A)

Revenue Impact:

<415 Bil.>

Over 10 Years

Tax Cuts and Jobs Act

Title 1

Subtitle A – Individual Tax Reform

Part I – Tax Rate Reform

Part II – ____________________??

- Sec. 11011: *Deduction for Qualified Business Income [new IRC §199A]*
- Sec. 11012: *Limitations on Losses of Taxpayers Other than Corporations [new IRC §461(l)]*

Tax Cuts and Jobs Act

Title 1

Subtitle A – Individual Tax Reform

Part I – Tax Rate Reform

Part II – Deduction for Qualified Business Income of Pass-Thru Entities

- Sec. 11011: *Deduction for Qualified Business Income [new IRC §199A]*
- Sec. 11012: *Limitations on Losses of Taxpayers Other than Corporations [new IRC §461(l)]*

Overview Of Sec 199A

QBI Deduction - Sec. 199A

- Individuals, trusts, and estates can deduct 20% of qualified business income (QBI).
- Applies to each Trade or Business (T or B) of the taxpayer from PSPs, S Corps, Sch C, E, and F.
- Though QBI can be negative, the QBI deduction will never generate an NOL and must be removed from an NOL (new sec. 172(d)(8)).

- Positive QBI can be a passive or nonpassive T or B income.
- Because QBI losses must be "allowed" the QBI deduction is calculated:
  - o After the sec. 469 loss limits, and
  - o After the sec. 461(l) limit on excess nonpassive business losses.
- Sec. 469 definition of "activity" may differ from a QBI business.

- Applies to net rental income if the rental is a "trade or business"
  - Most rentals are a T or B based upon caselaw—detail below.

Threshold Question

- Is the T or B a Specified Service Business?
- If so, the deduction phases-out if T.I. is too high.

Specified Service Business (SSBs)

The QBI deduction is potentially allowed IN FULL if T.I. does not exceed:

  - $157,500 or
  - $315,000 if MFJ.

- Phases-out if T.I. exceeds the above Threshold Amounts. The phase-out range is
  - $50,000 or
  - $100,000 if MFJ

Specified Service Businesses (SSBs) from sec. 1202(e)(3)(A):

"any trade or business involving the performance of services in the fields of health, law, ~~engineering, architecture~~, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its [owners]." OR

"(B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

Clues in Sec. 448(d)(2)(A) and Regs.

Different section but same words.

Sec. 448(d)(2)(A)

"The term "qualified personal service corporation" means any corporation—

A) substantially all of the activities of which involve the performance of services in the fields of: health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting."

Reg 1.448-1T(e)(4)(ii).

- Field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals.

- Does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.

Reg 1.448-1T(e)(4)(iii).

- Performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such.

- Does not include services by persons who broadcast or disseminate the performances (i.e., radio station D.J.).

Reg 1.448-1T(e)(4)(iv).

- The field of consulting means the provision of advice and counsel.
- Ten examples in the regulations.

Reg 1.448-1T(e)(5)(vii) Example (1).

- The field of accounting includes “the preparation of audit and financial statements and the preparation of tax returns”’

Limited Guidance under Sec. 1202(e)(3)(A) No Regs.

PLR 201717010 (4/28/2017)

- “Company's sole function is to provide healthcare providers with a copy of its laboratory report.”
- Company receives compensation for reporting results of tests to healthcare providers, which is based on each test performed.”
- “[Y]ou represent that the skills employees bring with them when Company hires them are almost useless when performing the X tests and that the skills they acquire at Company are not useful to other employers.

IRS Conclusion:

- “Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients.”
- “In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.”

“Company is not in a trade or business

(i) involving the performance of services in the field of health or

(ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.”

PLR 201436001

- "Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry."
- Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of §1202(e)(3)."

Principles of Statutory Construction:

- "Statutory words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them." *Caminetti v. United States*, 242 U.S. 470, 485-486 (1917).
- A statutory term is construed "in its context and in light of the terms surrounding it." *Leocal v. Ashcroft*, 543 U.S. 1, 9 (2004); see also *Jarecki v. G. D. Searle & Co.*, 367 U.S. 303, 307 [7 AFTR 2d 1585] (1961) ("a word is known by the company it keeps").
- Legislatures are presumed to have intended that a statute's terms "be given a reasonable construction". *Hazlett v. Evans*, 943 F. Supp. 785.

Steps if a Non-SSB (Detail below)

1) Potential QBI Deduction: 20% x QBI

2) W2+UB Limit Phases-in based upon TI: (% W-2 Wages + Unadjusted Basis)

3) TI-NCG Limit: Taxable income minus Net Capital Gain.

For SSBs, the High T.I. Phase-out must be considered before proceeding to Step Two.

- Unlike current sec. 199 (repealed), sec. 199A does not allow a taxpayer to use W-2 wages from a separate T or B.
  - The QBI deduction must be computed for "each" qualified trade or business. (Section 199A(b)(1)(A))
  - No analog to repealed sec. 199 QPAI (qualified production activity income)

- The deduction is neither for AGI (i.e., does not reduce AGI), nor an itemized deduction. (Conference Rpt. Pg. 39)
- Is allowed for AMT purposes (analogous to repealed sec. 199). (Sec. 199A(f)(1)(B))
- The deduction does not apply for SE purposes. (Sec. 199A(f)(1)(B))

Impact on the NIIT

- The QBI deduction does not reduce the NII. (Sec. 199A(f)(1)(B))
- Because the QBI deduction is not a for AGI deduction, it does not reduce modified AGI.
- A profitable rental will generally be subject to the NIIT and eligible for the QBI deduction.

The NIIT is 3.8% of the LESSER OF:

1) NII for the tax year, OR
2) The excess of modified AGI over the threshold amount (250K MFJ or 200K Other)

Effective Date: tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026.

Single	H of H	MFJ	Indiv. Bracket	Rate on QBI
<$9,525	<$13,600	<$19,050	10%	8%
<$38,700	<$51,800	<$77,400	12%	9.6%
<$82,500	<$82,500	<$165,000	22%	17.6%
<$157,500	<$157,500	<$315,000	24%	19.2%
<$200,000	<$200,000	<$400,000	32%	25.6%
<$500,000	<$500,000	<$600,000	35%	28%
>$500,000	>$500,000	>$600,000	37%	29.6%

Detail

Qualified Business Income (QBI)

(can be positive or negative)

“[The net amount of *qualified items* of income, gain, deduction, and loss with respect to any *qualified trade or business of the taxpayer*.”

Qualified Items

Income, gain, deduction, and loss to the extent such items are:

- U.S. Effectively Connected Income
- Allowed in determining T.I. (Sec. 199A(c)(3)(A).

Investment Items Not Qualified Items

- STCG, STCL, LTCG, LTCL

(Does this include sec. 1231 Gain?)

- Dividends, dividend equivalents, and payments in lieu of dividends.
- Interest income unless allocable to a T or B.
- Annuity income
  (See Sec. 199A(c)(3)(B)

Qualified Trade or Business (T or B)

Any T or B except:

(A) a specified service T or B, or

(B) a T or B of performing services as an employee.

“Treatment of reasonable compensation and guaranteed payments.” (Sec 199A(c)(4)

“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.

Non-SSBs

(no high T.I. phase-out)

Threshold Question

- Determine if the T or B is an SSB.
- For now, ignore REITS, Publicly Trade PSPs and Agricultural Co-ops. (detail later).

Steps if a Non-SSB

1) Potential QBI Deduction: 20% x QBI

2) W2+UB Limit Phases-in based upon TI: (% W-2 Wages + Unadjusted Basis)

3) TI-NCG Limit: Taxable income minus Net Capital Gain.

STEP ONE

Potential QBI Deduction

- 20% of QBI "for each trade or business" (Sec. 199A(b)(2))

  Note: NOT each "activity".

- Although QBI can be negative, only a T or B with positive QBI generates a deduction.

STEP TWO

W-2+UB Limit—phases-in begins when T.I. reaches: $157,500 or $315,000 MFJ

(fully phased-in when T.I. reaches 207,500 or $415,000 (MFJ))

“Taxable Income” T.I.

Warning: whenever sec. 199A mentions “taxable income” (TI), it means TI without regard to the sec. 199A deduction (sec. 199A(e)(1)).

W-2+UB Limit

The deduction for each business is limited to the GREATER OF:

- 50% of "W-2 wages" paid by the business, OR

- 25% of "W-2 pages" paid by the business PLUS
  2.5% of the "unadjusted basis" immediately after acquisition of all "qualified property.“ (Sec. 199A(b)(2))

W-2 Wages

- Total wages (defined in §3401) subject to withholding.
- Elective deferrals, and
- Deferred compensation

- Assume for now that the W-2+UB Limit is fully phased-in so TI (pre-sec. 199) is above either:

  $207,500 or

  $415,000 for MFJ

- W-2 Wages must be "properly allocable" to the QBI (Sec. 199A(b)(4)(B)
- No related party prohibition. Ex: 100% S shareholder counts as W-2 wages paid.
- Partners and S Shareholders shares will be on the K-1 (detail below).

2.5% of Unadjusted Basis...

- "Qualified property" is
  - any tangible property, subject to depreciation (Sec. 199A(b)(6(A)).
  - Held at year end and available for use.
  - Used "at any point" during the year in the business.
  - If the "*depreciable period"* has not ended.

- Depreciable period begins when the property is first placed in service and
- Ends on the LATER OF

1) 10 years, or

2) Last year of the recovery period (not ADS)

Definition of Unadjusted Basis?

Per Pub. 946, pg. 40:

Original basis, but without reducing it by MACRS depreciation; however, you do reduce your original basis by:

- Amortization taken on the property
- Any section 179 deduction claimed.
- Any special depreciation allowance taken.

Example A

- Sch C. Business purchases a machine for $500,000 (5 year MACRS life) in 2013 and claims MACRS depreciation (no 179 or bonus).

- $500,000 unadjusted basis through 2022 (10 years) – 5 years beyond its MACRS life (unless disposed of earlier)

Example B

- In 2013, taxpayer purchases a commercial building for $5 mil. that is depreciable over 39 years (on leased land).

- $5 mil. unadjusted basis through 2051 unless disposed of earlier.

- 2.5% x $5mil. = $125,000

Example C – Bad News

- Sch C. Busines purchases a machine for $500,000 on Oct. 1, 2016 and claims sec. 179 expense for entire $500,000.
- $0 unadjusted basis.
- Apparently the same if 100% bonus depreciation.

Partners and S Shareholders

- QBI deduction is determined at the partner or S shareholder level.
  - Allocable share of W-2 wages or a partner must match the allocation of W-2 wage expense.
  - Allocable share of unadjusted basis of a partner must match the allocation of depreciation.

Note: Every K-1 must show W-2 wages and unadjusted basis for each T or B.

Trusts and Estates

W-2 wages and unadjusted basis will be apportioned between the beneficiaries and the fiduciary (and among the beneficiaries) under the treasury regulations– (per sec. 199A(f)(1)(B) incorporating sec. 199(d)(1)(B)(i))

See Reg. 1.199-5(e)

Phase-in of W-2+UB Limit

- The W2+UB limit phases in when T.I. is above the "Threshold amount".
- Threshold amount:
  - $157,500, or
  - $315,000 (MFJ)
- Phase-in based upon ratio of T.I. over phase-in range divided by the range:
  - $50,000, or
  - $100,000 for MFJ

Example (1) (MFJ)
Not a Service Business

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	300K	0	0
Interest Inc.	34K		
AGI	334K		
Std. Ded.	- 24K		
T.I. (pre-199A)	310K		

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	300K	0	0
Interest Inc.	34K		
AGI	334K		
Std. Ded.	-24K		
T.I. (pre-199A)	310K		
QBI Ded.	- 60K	20% x 300K	
T.I.	=250K		

Pre-sec. 199A T.I. does not exceed $315K so W-2+UB Limit is inapplicable

Example (2)

Same as Ex. (1) except
$340K of QBI
(v. 300K)

Example (2) (MFJ)

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C T or B	340K	0	0
Interest Inc.	34K		
AGI	374K		
Std. Ded.	-24K		
T.I. (pre-199A)	350K		
QBI Ded.			
T.I.			

Now, the W-2+UB limit is phased in because TI exceeds 315K.

Excess Amount (sec.199(b)(3)(B)(iii))

QBI deduction without the W2+UB limit in excess of the deduction if the limit applied in full:

$68 (20% x 340K) - $0 ($0 W-2 wages and unadjusted basis) = $68.

Phase-in of W-2+UB Limit

Multiply the excess amount by ratio of: (T.I. – Threshold Amount) ÷ phase-in range)

68,000K x 35% (350K – 315K) ÷ 100K = $23.8K

QBI Deduction = $44.2K ($68K (full amount - $23.8 (phased-in limit)

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	340K	0	0
Interest Inc.	34K		
AGI	374K		
Std. Ded.	-24K		
T.I. (pre-199A)	350K		
QBI Ded.	- 44.2K	68K – 23.8K* = 44.2	
T.I.	=305.8K		

*Phase-in of W-2+UB limit: $23.8 ($68K x 35% (35 (350K – 315K) ÷ 100K)

Example (3)

Same as Ex. (2) except the business pays $40K of W-2 wages

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	340K	40K	0
Interest Inc.	34K		
AGI	374K		
Std. Ded.	-24K		
T.I. (pre-199A)	350K		
QBI Ded.			
T.I.			

The W-2+UB limit is phased-in because T.I. exceeds $315,000

Excess Amount

QBI deduction without the W2+UB limit in excess of the deduction if the limit applied in full:

$68 (20% x 340K) - $20 (W-2 wages of $40,000) = $48.

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	340K	40K	0
Interest Inc.	34K		
AGI	374K		
Std. Ded.	-24K		
T.I. (pre-199A)	350.0K		
QBI Ded.	- 51.2K	68K – 16.8K* = 51.2K	
T.I.	=298.8K		

*Phase-in of W2+UB Limit: $16.8 ($48K x 35% (35 (350K – 315K) ÷ 100)

Example (4)

Same as Ex. (3) except
Sch C business of $420,000

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	420K	40K	0
Interest Inc.	34K		
AGI	454K		
Std. Ded.	-24K		
T.I. (pre-199A)	430K		

W2+UB limit is fully phased-in;
T.I. exceeds $415,000

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	420K	40K	0
Interest Inc.	34K		
AGI	454K		
Std. Ded.	-24K		
T.I. (pre-199A)	430K		
QBI Ded.	20K	50% x $40K	
T.I.	410K		

STEP THREE

The TI-NCG Limit

(The sum total of the taxpayers QBI deductions (positive and negative) cannot exceed 20% x T.I. minus Net Capital Gain) (Sec. 199A(a)(1))

Sec. 1(h) Definition of "Net Capital Gain" (NCG)

Capital gain

+

Qualified dividend income. (Sec. 1(h)(11))

- Add up the positive and negative QBI deductions from each business.
- The sum is the "combined qualified business income amount" (CQBIA)

- For now, ignore qualified REIT dividends, publicly traded partnership income, and qualified cooperative dividends.

  These are not QBI.

TI-NCG Limit

The total QBI deduction cannot exceed THE LESSER OF:

1) CQBIA (sum of combined deductions),

   OR

2) 20% x (T.I. minus "net capital gain" (NCG))

(b) Combined qualified business income amount.

For purposes of this section-

(1) In general.

The term "combined qualified business income amount" means, with respect to any taxable year, an amount equal to-

(A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus

(B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

(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.

(c) Qualified business income.

For purposes of this section-

(1) In general.

The term "qualified business income" means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income.

(2) Carryover of losses. Net Negative QBI Carries to Following Year

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year.

Example 1: QBI Can be Negative

		QBI	20% QBI	50% W-2	Step 3 Amt.	
Year 1						
	Business A	300,000	60,000	50,000	50,000	
	Business B	(300,000)	(60,000)	-	(60,000)	
	Net QBI	-			**(10,000)**	**Combined QBI Amount**
Year 2						
	Business A	300,000	60,000	50,000	50,000	
	Business B	300,000	60,000	-	-	
	Carryover from Yr 1		-		-	
	Net QBI	600,000			**50,000**	**Combined QBI Amount**

Example 2

		QBI	20% QBI	50% W-2	Step 3 Amt.	
Year 1						
	Business A	300,000	60,000	50,000	50,000	
	Business B	(400,000)	(80,000)	-	(80,000)	
	Net QBI	(100,000)			**(30,000)**	**Combined QBI Amount**
Year 2						
	Business A	300,000	60,000	50,000	50,000	
	Business B	300,000	60,000	-	-	
	Carryover from Yr 1	(100,000)	(20,000)		(20,000)	
	Net QBI	500,000			**30,000**	**Combined QBI Amount**

Example 3

		QBI	20% QBI	50% W-2	Step 3 Amt.	
Year 1						
	Business A	300,000	60,000	50,000	50,000	
	Business B	300,000	60,000	-	-	
	Net QBI	600,000			**50,000**	**Combined QBI Amount**
Year 2						
	Business A	300,000	60,000	50,000	50,000	
	Business B	(400,000)	(80,000)	-	(80,000)	
	Carryover from Yr 1	-	-		-	
	Net QBI	(100,000)			**(30,000)**	**Combined QBI Amount**

Example 4

		QBI	20% QBI	50% W-2	Step 3 Amt	
Year 1						
	Business A	300,000	60,000	50,000	**50,000**	
	Business B	(400,000)	(80,000)	-	**(80,000)**	
	Net QBI	(100,000)			**(30,000)**	**Combined QBI Amount**
Year 2						
	Business A	300,000	60,000	50,000	**50,000**	
	Business B	-	-	-	-	
	Carryover from Yr 1	(100,000)	(20,000)		**(20,000)**	
	Net QBI	200,000			**30,000**	**Combined QBI Amount**

Example (5)

For non-SBBs, no upper limit on the QBI deduction if the W2+UB and TI-NCG limits are met.

In Millions (ignore itemized deduction or std. ded.) Not an SSB

T or B	Income	W-2 Wages	Unadjusted Basis
Bus. #1	$300 Mil.	$120 mil.	$0
T.I. (pre-199A)	300 Mil.		
QBI Ded.	- 60 Mil.	$300 mil. x 20%	
T.I.	=440 Mil.		

SSBs

Must first consider High T.I. Phase-out

Qualified Trade or Business:

Any T or B except:

(A) a specified service business, or

(B) a T or B of performing services as an employee.

(3) Exception for specified service businesses based on taxpayer's income.

(A) In general. If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), then-

(i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

(Sec. 199A(d)(3)(A)(i))

Specified Service Businesses:

"any trade or business involving the performance of services in the fields of health, law, ~~engineering, architecture~~, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its [owners]." OR

"(B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

(3) Exception for specified service businesses based on taxpayer's income.

(A) In general. If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), then-

(i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

(ii) only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

(Sec. 199A(d)(3)(A))

(B) Applicable percentage. For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of-

(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(ii) $50,000 ($100,000 in the case of a joint return).

The "applicable percentage" reflects how much of SSB exception remains after a portion is phased-out based on the TI in excess of the threshold amount.

(Sec. 199A(d)(3)(B))

Steps

- Same Step One, but the High T.I. Phase-out must be considered before proceeding to Step Two.

- Step Three is the same. The QBI deductions, positive and negative, are combined and compared to (T.I. – NCG).

SSB High T.I. Phase-out

- No phase-out if T.I. does not exceed:
  - $157,500 or
  - $315,000 if MFJ.
- Phases-out if T.I. exceeds the above Threshold Amounts. The phase-out range is
  - $50,000 or
  - $100,000 if MFJ

Example (1) (MFJ) -- An SSB

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	300K	0	0
Interest Inc.	24K		
AGI	324K		
Std. Ded.	-24K		
T.I. (pre-199A)	300K		

	Income/ QBI/Loss	W-2 Wages	Unadj. Basis
Sch. C TorB	300K	0	0
Interest Inc.	24K		
AGI	324K		
Std. Ded.	-24K		
T.I. (pre-199A)	300K		
QBI Ded.	- 60K	20% x 300K	
T.I.	=240K		
A.M.T.I. (pre-exemption)	=264K	240K (T.I.) + 24K (s.d.)_	

The "applicable percentage" is 100%. None of the SSB exception is phased-out because TI is below the threshold amount of $315K.

Example (2)

Same as Ex. (1) except $340K of QBI (v. 300K) and W-2 wages of $150K are paid (still $0 unadjusted basis)

- The taxpayer's T.I. is 25% of the way through the phase-out range; therefore, the "applicable percentage" is 75% (100% - 25%)

	Income/ QBI/Loss	W-2 Wages x 75%	QBI x 75%
Sch. C TorB	340K	112.5K	$255K
Interest Inc.	24K		
AGI	364K		
Std. Ded.	-24K		
T.I. (pre-199A)	340K		
QBI Ded.	$51K	20% x $255	
T.I.	$289K		

- The SSB exception is 25% phased-out.
- I believe that W2+UB Limit would be phased-in (also 25%) AFTER first applying the SSB exception phase-out (guidance needed).

Phase-in of W-2+UB Limit

Excess amount: QBI deduction without the W2+UB limit (after the High TI phase-out) in excess of the deduction if the limit applied in full:

$51 (20% x 255K) - $51 ($112.5 W-2 wages) = $0.

Phased-in W2+UB limit: $0 because W-2 wages are sufficient.

$0 x 25% = $0

QBI Deduction = $51 ($51 (full amount - $0 (phased-in limit)

	Income/ QBI/Loss	W-2 Wages x 75%	QBI x 75%
Sch. C TorB	340K	112.5K	$255K
Interest Inc.	24K		
AGI	364K		
Std. Ded.	-24K		
T.I. (pre-199A)	340K		
QBI Ded.	$51K	20% x $255	
T.I.	$289K		

Result after considering the High T.I. phase-out and next applying the phase-in of the W2+UB limit.

Example (3)

Same as Ex. (2) except $0 W-2 wages (instead of $150K) Guidance needed here but sec. 199A(d)(3)(A)(ii) applies to "this section [199A] " NOT merely this subsection.

	Income/ QBI/Loss	W-2 Wages x 75%	QBI x 75%
Sch. C TorB	340K	0	$255K
Interest Inc.	24K		
AGI	364K		
Std. Ded.	-24K		
T.I. (pre-199A)	340K		

- Applying the High TI phase-out before the phase-in of the W2+U.B. limit, the QBI deduction is potentially $51K (20% x $255K).

Excess Amount of $51K

QBI deduction without the W2+UB limit (after High TI phase-out) in excess of the deduction if the limit applied in full (after High TI phase out):

$51K ((20% x 255K) - $0 ($0 W-2 wages and UB) = $51K)

Phasing-in of W2+UB Limit:

Multiply the excess amount by 25% and the product is the W2+UB phased-in limit:

51K (excess amt.) x 25% = $12.75K (phased-in limit)

QBI Deduction = $38.25 ($51K (full amount - $12.75K (phased-in limit)

	Income/ QBI/Loss	W-2 Wages x 75%	QBI x 75%
Sch. C TorB	340K	0	$255K
Interest Inc.	24K		
AGI	364K		
Std. Ded.	-24K		
T.I. (pre-199A)	340K		
QBI Ded.	38.25K	$51 - $12.75	
T.I.	301.75		

- Applying the High TI phase-out first, the QBI deduction is potentially $51K (20% x $255K).
- Next, the phase-in of the W2+UB limit reduces the deduction by 25% to $12.75K.

When is rental real estate a Section 162 trade or business?

Caselaw

Campbell v. Comm'r, 5 TC 272 (1945)

- Taxpayer inherited residential property in 1934 and tried to rent or sell it.
- Never used it as his residence, and

- attempted to rent it (unsuccessfully), until it was sold in 1941 at a loss.

- Campbell sought ordinary loss treatment under the predecessor to section 1221(a)(2), which required the property to be a trade or business asset.

The Tax Court Found a Trade or Business

- Cited *Jephson v. Comm'r*, 37 BTA 1117 (1938), with similar facts.
- BTA said the taxpayer was "carrying on a business, albeit without actual profit during the years in question."

In *Hazard v. Comm.'r*,
7 T.C. 372 (1946),
acq. 1946-2 CB 3

A single family residential rental in Kansas City was viewed as a trade or business of the taxpayer and thus produced an ordinary loss on sale under the predecessor to sections 1221(a)(2) and 1231.

Second Circuit applied a tougher test in *Grier v. U.S.*, 218 F.2d 603 (2nd Cir. 1955) (Rejected Hazzard)

- Grier required a "broader activity" than a single residential rental, long-term (14 years), to one tenant, with minimal repair activity.

- Ruled that the rental was an investment activity.

Grier referred to:

- *Pinchot* (eleven commercial buildings in New York),
- *Gilford* (eight buildings in New York),
- *Fackler* (a six-story commercial building),
- and *Rogers* (sixty-one properties).

The Tax Court only follows *Grier* in the Second Circuit (Golsen Rule)

Balsamo v. Comm'r, TC Memo 1987-477 (1987)

"[The Tax Court's] position [implicitly contrary] is not controlling for purposes of our decision today. We must decide this issue pursuant to the law as articulated by the Second Circuit [per Golsen]. The case of Grier ...provides the basis for our conclusion." (Citations omitted).

Reiner v. U.S., 222 F.2d 770 (7th Cir. 1955)

The issue was whether the taxpayer, living in the U.S. could carry back and forward her NOL resulting from the 1944 bombing raid on her rental property (former primary residence) in Austria during WW2 (confiscated by the Nazi gov't for 5 years).

Reiner, Quoting the Tax Court in *LaGriede*:

"It is clear from the facts that the real estate was devoted to rental purposes, and we [the Tax Court] have repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used.

We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used. It is clear, also, that the business was 'regularly' carried on, there having been no deviation, at any time, from the obviously planned use."

Factually indistinguishable from *Grier*.

Stratton v. Comm'r, TC Memo 1962-218 (1962),

- Full-time attorney who sold at a net loss, a single-family residence that had been rented to the same tenant for three years.
- Taxpayer sought capital loss treatment.

Tax Court agreed with IRS:

"This [Tax] Court has repeatedly held that the renting of improved real estate constitutes the carrying on of a trade or business, regardless of whether or not the taxpayer engaged in any other trade or business, ... [citing Hazard, Jephson and another case]"

Does the Tax Court ever treat a rental as an investment?

Yes!

Triple Net Lease Property

- A triple-net lease in which the tenant is responsible for taxes, insurance, and repairs, is normally a mere investment.

Herbert v. Comm'r, 30 T.C. 26 (1958)

But the IRS has never revoked its acquiescence to *Hazard*.

GCM 38779 (7/27/81)

Chief Counsel rejected the National Office audit division request for a reversal of the acquiescence to Hazard.

Other Sec. 199A Issues

Tomorrow, will discuss:

- REIT Dividends
- Publicly Traded Partnerships
- Agricultural or Horticultural Cooperatives
  - Cooperative Dividends

Owner SEP/401(k)/Qualified Plan Contribution

- Is the qualified plan contribution (Form 1040 front page) deductible in calculating the QBI?

- Best guess is no (doesn't reduce it) based upon analogous repealed sec. 199.

- Not discussed in committee reports or statute.

Penalty Mod. For "Any Taxpayer Who Claims" the QBI Deduction

"There is a substantial understatement ... if the amount of the understatement for the taxable year exceeds the greater of-

(i) ~~10~~ 5 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000." (Sec. 6662)